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THE UNIVERSITY OF TEXAS SCHOOL OF LAW

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1. E. Ernest Goldstein, *Thank You Fidel! Or How the International Law Society and the* Texas International Law Journal *Were Born*, 30 TEX. INT'L L.J. 223 (1995).

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The Right to Leave the Eurozone

JENS C. DAMMANN*

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The Eurozone is facing an existential crisis. Greece has been teetering on the verge of national insolvency. Repeated interventions by the European Union and the International Monetary Fund have so far allowed Greece to avoid this fate, but no one can predict for how long. Portugal, Ireland, and Spain have also had to rely on rescue packages by the European Union, and it remains unclear to what extent their economies will weather the crisis.

One of the options discussed in this context is for individual countries to leave the Eurozone. Initially, this option was brought into play solely for countries like Greece that were at the center of the economic crisis. Some believe that such countries could profit from leaving the Eurozone because a subsequent devaluation of their national currencies would make it easier for their economies to become competitive again.

More recently, however, it has been suggested that some of the more stable EU Member States—most notably Germany—might also want to leave the Eurozone. The chief attraction of such a move would be to avoid being caught by mountainous liabilities generated by ever-new rescue packages.

Against this background, a crucial question is whether the Member States have a unilateral right to exit the Eurozone while staying in the European Union. In the existing literature, this question has so far been answered with a resounding, "no." By contrast, this Article takes the opposite position. More specifically, my argument has two steps: First, I show that, as a doctrinal matter, the case against a right to withdraw from the Eurozone is far from compelling. Second, I demonstrate that, under certain conditions, a right to leave the Eurozone is desirable as a matter of legal policy.

INTRODUCTION

The Eurozone is perhaps the most ambitious part of European unification. It officially came into existence on January 1, 1999, when eleven Member States replaced their national currencies with the euro.[1] Exactly two years later, Greece joined the Eurozone,[2] and subsequently, five other Member States followed suit.[3] As of 2013, seventeen of the twenty-seven Member States are united in the Eurozone.[4]

1. Council Regulation 974/98 of 3 May 1998 on the Introduction of the Euro, Annex, 1998 O.J. (L 139) 11 (EC) (listing the countries participating in the Eurozone).

2. Council Regulation 2596/2000 of 27 November 2000 Amending Regulation No. 974/98 on the Introduction of the Euro, art. 1 (EC), 2000 O.J. (L 300) 2 (providing for Greece to be included among those countries that have the euro as their currency).

3. Council Decision 2006/495 of 11 July 2006 in Accordance with Article 122(2) of the Treaty on the Adoption by Slovenia of the Single Currency on 1 January 2007 (EC), 2006 O.J. (L 195) 25; Council Decision 2007/503 of 10 July 2007 in Accordance with Article 122(2) of the Treaty on the Adoption by

The Eurozone was a controversial project from its onset. The various preconditions for a successful common currency that had been posited by economists in the literature on optimal currency areas[5] were not met. Most notably, the Eurozone lacked—and continues to lack—a central authority in charge of fiscal policy.[6] Moreover, political integration has remained limited, and labor mobility within the Eurozone is quite low.[7] Accordingly, many economists predicted the Eurozone would fail.[8] In particular, critics feared that the common currency, the euro, would become a soft currency prone to inflation domestically and likely to suffer devaluation vis-à-vis other currencies.[9]

Seeming to spite its critics, the Eurozone initially avoided some of the dire predictions that had been made. Both internally—in terms of price stability—and externally—in terms of exchange rates relative to other currencies—the euro proved to be stable.[10] Thus, at the end of its first decade, the Eurozone was widely thought to have proven its critics wrong. As late as 2008, Erik Nielsen, Chief European Economist at Goldman Sachs, noted that "the Euro and the Euro-zone economy have all the hallmarks of a success, including . . . contributing to an unprecedented degree of financial stability."[11]

However, the last few years have shown that this enthusiasm was quite premature. The Eurozone is now facing a fundamental challenge in the form of the sovereign-debt crisis. By 2009, investors had grown highly concerned about the

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Cyprus of the Single Currency on 1 January 2008 (EC), 2007 O.J. (L 186) 29; Council Decision 2007/504 of 10 July 2007 in Accordance with Article 122(2) of the Treaty on the Adoption by Malta of the Single Currency on 1 January 2008 (EC), 2007 O.J. (L 186) 32; Council Decision 2007/504 of 8 July 2008 in Accordance with Article 122(2) of the Treaty on the Adoption by Slovakia of the Single Currency on 1 January 2009 (EC), 2008 O.J. (L 195) 24; Council Decision 2010/416 of 13 July 2010 in Accordance with Article 140(2) of the Treaty on the Adoption by Estonia of the Euro on 1 January 2011 (EC), 2010 O.J. (L 196) 24.

4. Wolfram Berger, *The ECB in an Enlarged Monetary Union: How to Reform the Rotation Scheme*, J. ECON. & SOC. POL'Y, Jan. 1, 2012, at 1, 3 n.4. The current seventeen Eurozone Member States include Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. EUROPEAN COMMISSION, ECONOMIC AND FINANCIAL AFFAIRS, *What is the Euro Area?* (Sept. 10, 2012), http://ec.europa.eu/economy_finance/euro/adoption/euro_area/index_en.htm.

5. The leading work remains Robert A. Mundell, *A Theory of Optimum Currency Areas*, 51 AM. ECON. REV. 657 (1961).

6. *E.g.*, MICHAEL HEINE & HANSJÖRG HERR, DIE EUROPÄISCHE ZENTRALBANK 206 (2004).

7. JOHAN VAN OVERTVELDT, THE END OF THE EURO 61–62 (2011) [hereinafter VAN OVERTVELDT].

8. *E.g.*, Martin Feldstein, *The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability*, 11 J. ECON. PERSP. 23, 41–42 (1997). American economists in particular were quite skeptical. *Cf.* VAN OVERTVELDT, *supra* note 7, at 62 (summarizing some of the concerns that were voiced at the time).

9. *See, e.g.*, Jörg Bibow, *The Markets Versus the Eurosystem*, *in* THE EURO, THE EUROSYSTEM, AND THE EUROPEAN ECONOMIC AND MONETARY UNION 159, 161 (Detlev Ehrig, Uwe Staroske & Otto Steiger eds., 2011) (criticizing the Eurozone on the ground that "as of November 2000 the new currency's external value in relation to its major trading partners had fallen by some 20 percent and inflation had increased from a very low level to well above the ECB's declared tolerance level").

10. Wilhelm Hankel et al., *The Euro-Project at Risk* 4 (Ctr. for European Integration Studies (ZEI)), Working Paper No. B 04-2010, 2010), *available at* http://econstor.eu/bitstream/10419/46218/1/638549396.pdf.

11. VAN OVERTVELDT, *supra* note 7, at 78 (citing GOLDMAN SACHS, THE EURO AT TEN: PERFORMANCE AND CHALLENGES FOR THE NEXT DECADE 200 (2008)).

ability of some Member States to meet their financial obligations.[12] Disparagingly named "PIIGS," these Member States included Portugal, Italy, Ireland, Greece, and Spain.[13] Soon thereafter, Greece came close to national insolvency—a fate that was avoided only just in time when European leaders and institutions, together with the International Monetary Fund (IMF), adopted a 110 billion euro rescue package in May 2010.[14] Additional rescue packages for Ireland (2010),[15] Portugal (2011),[16] and Greece (2011)[17] followed. Moreover, while Italy and Spain have so far avoided direct bailouts, in 2012 the European Union agreed to come to the aid of Spanish banks to the tune of 100 billion euros.[18]

These rescue packages did not come without strings attached. For Greece in particular, the availability of rescue funds was conditioned on its willingness to slash its budget and adopt various other reforms aimed at greater austerity.[19] These interventions have been quite controversial—many are blaming them for worsening an already devastating economic crisis in Greece.[20] As of February 2013, Greek unemployment stands at almost 27%.[21] The Greek economy shrank by almost 7% in 2011[22] and by a similar percentage in 2012.[23] Not surprisingly, some believe that the austerity measures demanded by the European Union and the IMF may have been ill timed.[24]

Whether or not one agrees with these criticisms, it is far from certain whether the measures taken so far are sufficient to resolve the European Union's sovereign-debt crisis. Against this background, one option that is increasingly being discussed

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12. Landon Thomas, Jr., *With Greece Teetering, the Worst May Not Be Over for Europe*, N.Y. TIMES, Dec. 31, 2009, at B1 [hereinafter Thomas, *Greece Teetering*].

13. Marcus Walker, *Debt Fears Rattle Europe*, WALL ST. J., Dec. 16, 2009, at A1.

14. James Kanter & Judy Dempsey, *Europe Approves Rescue for Debt-Ridden Greece*, N.Y. TIMES, May 8, 2010, at B1.

15. Stephen Castle & Liz Alderman, *Europe Approves Irish Rescue and New Rules on Bailouts*, N.Y. TIMES, Nov. 29, 2010, at B1.

16. Patricia Kowsmann, *Portugal Reaches a Deal on Bailout*, WALL ST. J., May 4, 2011, at A12.

17. Min Zeng, *Treasurys Bounce Back*, WALL ST. J., July 23, 2011, at B14.

18. Robin Wigglesworth & Mary Watkins, *Investors Fear Spain Heading for Full Bailout*, FIN. TIMES, June 12, 2012, at 33.

19. *EU Austerity Drive Country by Country*, BBC (May 21, 2012), http://www.bbc.co.uk/news/10162176 (The Greek government agreed to "far-reaching spending cuts, equal to 1.5% of its [GDP]" and measures to "cut the Greek government's debt from 160% of GDP to a little over 120% of GDP by 2020").

20. Editorial, *Greek Tragedy*, N.Y. TIMES, Feb. 9, 2012, at A22 (arguing that "slashing wages, jobs and public spending across the board" in accordance with the demands made by the European Union "will only deepen [the Greek] recession"); Editorial, *Kicking the Can: Without Debt Relief, Greece Can't Grow and the Crisis Won't End*, N.Y. TIMES, June 7, 2011, at A30 (asserting that "a new round of tightening just now could deepen the recession and further shrink the tax base, making it even harder for the government to cut its deficit").

21. *See* Suzanne Daley, *Rise in Oil Tax Forces Greeks To Face Cold as Ancients Did*, N.Y. TIMES, Feb. 4, 2013, at A1 (reporting an unemployment rate of 26.8%).

22. Landon Thomas, Jr., *As Greek Plan Nears, Unease About Bond Holdouts*, N.Y. TIMES, Feb. 15, 2012, at B1.

23. Eleni Chrepa, *Greek Economy to Return to Growth End of 2013, Research Group Says*, BLOOMBERG (Jan. 10, 2013), http://www.bloomberg.com/news/2013-01-10/greek-economy-to-return-to-growth-end-2013-research-group-says.html (reporting estimates that the Greek economy shrank by 6.6% in 2012).

24. *See* Wigglesworth & Watkins, *supra* note 18 ("At one point waiting was a rational, even logical, thing to do, but it's now clear that the situation is not turning around.").

is for individual Member States to leave the Eurozone. For the most part, this option is mentioned with respect to the PIIGS.[25] In particular, at the height of the crisis in 2012, it was widely thought that Greece would seek to end its membership in the Eurozone in the foreseeable future.[26] However, the exit discussion is no longer confined to Member States with ailing economies. Rather, some voices are now suggesting that the more solvent Member States, such as Germany, might eventually leave the Eurozone.[27]

Interestingly, despite the attention that these speculations have received by pundits,[28] politicians,[29] and economists,[30] the idea of a unilateral withdrawal from the Eurozone has failed to provoke much discussion among legal scholars. Rather, there exists a broad agreement among the latter regarding the options for leaving the European Union. In a nutshell, while Member States are free to quit the European Union entirely (and the Eurozone with it), they have no unilateral right to withdraw from the Eurozone while staying in the European Union.[31]

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25. Jeremy Warner, *Once Greece Goes, The Whole Euro Project Will Unravel,* THE DAILY TELEGRAPH (Nov. 8, 2011), http://blogs.telegraph.co.uk/finance/jeremywarner/100013174/once-greece-goes-the-whole-euro-project-will-unravel/; Roger Bootle, *Leaving the Euro: A Practical Guide* 4 (unpublished manuscript), http://www.policyexchange.org.uk/images/WolfsonPrize/wep%20shortlist%20essay%20-%20roger%20bootle.pdf; Bret Stephens, *Lesson From Europe (Take 2)*, WALL. ST. J., Aug. 16, 2011, at A11.

26. *E.g.*, John Authers, *Memories of Lehman Hang Over Greek Polls*, FIN. TIMES, June 16, 2012, at 16 (noting that the Greek membership in the Eurozone is "in question"); Gerald P. O'Driscoll Jr., *How the Euro Will End*, WALL ST. J., June 13, 2012, at A15 (considering Greek exit "almost a foregone conclusion"); Nelson D. Schwartz, *Whatever Greek Votes Decide, the Euro Looks Likely to Suffer*, N.Y. TIMES, June 16, 2012, at BU4 (noting that for many observers, the prospect of a Greek exit "has moved from 'if' to 'when'").

27. *See* Stephens, *supra* note 26, at A11 (speculating that Germany might leave the Eurozone and return to the Deutsche Mark); *see also* Barry Eichengreen, *The Breakup of the Euro Area, in* EUROPE AND THE EURO 11, 12–13 (Alberto Alesina & Francesco Giavazzi eds., 2010) (noting that the "defector could conceivably be a Germany, concerned with politicization of the ECB policy and inflationary bias").

28. *See, e.g.*, Landon Thomas, Jr., *Pondering a Dire Day: Leaving the Euro*, N.Y. TIMES, Dec. 13, 2011, at B1 (speculating that Greece may leave the Eurozone); Wolfgang Münchau, *After the Downgrades Comes the Downward Spiral*, FIN. TIMES, Jan. 16, 2012, at 9 (same).

29. *See, e.g.*, Quentin Peel, *Merkel Upbeat on Fiscal Treaty*, FIN. TIMES, Jan. 10, 2012, at 4 (reporting that according to Mrs. Merkel, no country should leave the Eurozone); Hugh Carnegy, Chris Giles & Peter Spiegel, *Merkel and Sarkozy Break Currency Bloc Taboo*, FIN. TIMES, Nov. 4, 2011, at 2 (reporting that European leaders were for the first time contemplating a Greek exit from the Eurozone); Christian Reiermann, *Athens Mulls Plans for New Currency: Greece Considers Exit from Euro Zone*, SPIEGEL ONLINE (May 6, 2011), http://www.spiegel.de/international/europe/athens-mulls-plans-for-new-currency-greece-considers-exit-from-euro-zone-a-761201.html (reporting that Greek politicians were considering Greece's exit from the Eurozone); Hal Scott, *When the Euro Falls Apart: A Sequel* 5 (Harvard Public Law, Working Paper No. 12-16, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1998356.

30. *E.g.*, Nicholas Economides et al., *What's at Stake in the Greek Vote*, WALL ST. J., June 15, 2012, at A11 (arguing against a Greek exit from the Eurozone); Nouriel Roubini, *Greece Must Go*, SLATE (June 18, 2012), http://www.slate.com/articles/news_and_politics/politics/2012/05/greece_will_leave_the_eurozone_sooner_or_later_sooner_is_better_.html (arguing in favor of a Greek exit from the Eurozone); Stergios Skaperdas, *How to Leave the Euro*, N.Y. TIMES, Nov. 10, 2011, at A35 (reflecting on the modalities of an exit from the Eurozone).

31. MARÍA LORCA-SUSINO, THE EURO IN THE 21ST CENTURY: ECONOMIC CRISIS AND FINANCIAL UPROAR 203–05 (2010); Philipp Bagus, *The Eurosystem: Costs and Tragedies, in* INSTITUTIONS IN CRISIS: EUROPEAN PERSPECTIVES ON THE RECESSION 117, 128 (David Howden ed., 2010); Christoph Herrmann, *Griechische Tragödie—der währungsverfassungsrechtliche Rahmen für die Rettung, den Austritt oder den Ausschluss von überschuldeten Staaten aus der Eurozone* [*Greek Tragedy—The Constitutional Framework*

If this view is correct, then the prospect of a unilateral withdrawal from the Eurozone is essentially off the table; leaving the European Union would entail losing access to EU markets, a move that would have devastating economic consequences. Of course, in the absence of a feasible option to withdraw unilaterally, a Member State seeking to leave the Eurozone could still try to do so via an amendment to the Treaty on the Functioning of the European Union (TFEU).[32] However, any such amendment requires the consent of all other Member States,[33] and even if the other Member States were to consent, they might not all do so without a quid pro quo. Rather, individual Member States might grant their consent only in return for various concessions—be it from the Member State that seeks to leave or from other Member States supporting the withdrawal.

But is it really true that the Treaty prohibits Member States from withdrawing from the Eurozone? In this Article, I argue that this view is misguided not only as a matter of black letter law, but also *de lege ferenda*. Admittedly, it can be shown that there is no general and unconditional right for Member States to leave the Eurozone. However, with respect to those Member States that no longer fulfill the conditions that made them eligible to join the Eurozone in the first place, the doctrinal case against a withdrawal right is weak.

I am not arguing that the Treaty unambiguously grants such a right. Rather, my point is that, as a matter of legal doctrine, the Treaty *can* be read to include a right to withdraw from the Eurozone for the countries at issue. Moreover, I argue that such an interpretation is desirable as a matter of legal policy. Drawing on insights from the law and economics literature on the optimal design of default rules, I show that recognizing this right to withdraw is much more likely to lead to desirable outcomes than the alternative. Accordingly, in light of the European Union's general goal of promoting the well-being of its peoples,[34] the TFEU should be interpreted to include a withdrawal right from the Eurozone for those Member States that no longer meet the conditions for introducing the euro.

The structure of this Article is as follows: Part I explains various other legal options for leaving the Eurozone; Part II addresses the withdrawal right itself—more specifically, it explains why such a right has been called into question and shows that the relevant arguments are unpersuasive; Part III makes the case why, as a matter of legal policy, a right of exit is desirable; Part IV summarizes and concludes.

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for the Rescue, the Withdrawal, or the Expulsion from the Eurozone of States with Excessive Debts], 13 EuZW [EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT] 413, 417 (2010); Hannes Hofmeister, *Goodbye Euro: Legal Aspects of Withdrawal from the Eurozone*, 18 COLUM. J. EUR. L. 111, 134 (2011); Phoebus Athanassiou, *Withdrawal and Expulsion from the EU and EMU: Some Reflections* 21 (European Central Bank, Legal Working Paper Series No. 10, 2009), http://www.ecb.int/pub/pdf/scplps/ecblwp10.pdf; Martin Seidel, *Der Euro—Schutzschild oder Falle?* [The Euro—Protective Shield or Trap?] 26 (ZEI Working Paper, B01 2010), http://www.zei.uni-bonn.de/publikationen/archiv/zei-working-paper; Scott, *supra* note 29, at 6.

32. *See infra* Part III.

33. *Id.*

34. Consolidated Version of the Treaty on European Union art. 3(1), Mar. 30, 2010, 2010 O.J. (C 83) 13 [hereinafter TEU].

I. OTHER OPTIONS FOR LEAVING THE EUROZONE

The right discussed in this Article is the right to withdraw unilaterally from the Eurozone while staying part of the European Union. It is important to note, though, that there are several other potential options for leaving the Eurozone: (1) a full-fledged exit from the European Union; (2) an exit via an amendment to the Treaties; and (3) an exit via the *clausula rebus sic stantibus*. I begin by analyzing these other options, not least in order to show that they do not offer an adequate substitute for a right to withdraw unilaterally from the Eurozone.

A. Leaving the European Union

Unlike previous versions of the foundational Treaties, Article 50 of the Treaty on European Union (TEU) explicitly grants Member States the right to withdraw from the European Union.[35] The procedure can be summed up as follows: First, the Member State that wishes to leave the European Union has to notify the European Council.[36] Then, the European Union and the relevant Member State negotiate an agreement governing the terms of the withdrawal.[37] This agreement does not have to be approved by all of the Member States. Rather, it is the Council acting by a qualified majority[38] that concludes the agreement on behalf of the European Union.[39] Moreover, the right to withdraw from the European Union does not depend on a successful conclusion of the negotiations.[40]

Crucially, any withdrawal from the European Union also includes withdrawal from the Eurozone. This is because the provisions that govern the Eurozone are not part of a separate treaty. Rather, they are found in the TFEU.[41] Once a Member State has left the European Union, it no longer has the rights and duties that the Treaty imposes with respect to the Eurozone.

As a practical matter, it is easy to understand why Member States such as Greece are unwilling to leave the Eurozone when the only way to do so is by leaving the European Union entirely: it is the European Union that grants Greece access to European markets. Under EU law, goods can be moved freely from one Member State to another—no tariffs or unjustified quantitative restrictions can be imposed.[42] Similarly, the Treaty grants free movement of workers, services, and capital, as well

35. *Compare id.* art. 50(1), *with* Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340) 1.

36. TEU, *supra* note 34, art. 50(2).

37. *Id.*

38. The term "qualified majority" is defined by TFEU Article 238(3)(b). *See* Consolidated Version of the Treaty on the Functioning of the European Union art. 238(3), Mar. 30, 2010, 2010 O.J. (C 83) 47 [hereinafter TFEU].

39. TEU, *supra* note 34, art. 50(2).

40. *Id.* art. 50(3) (providing that, in the absence of an agreement, the withdrawal becomes effective after the withdrawing state has declared its intention to withdraw).

41. TFEU, *supra* note 38, arts. 136–44.

42. *Id.* art. 26.

as the freedom of establishment.[43] Thus, an exit would likely be disastrous to the economy of a Member State.

B. Withdrawal by Treaty Amendment

The second option for leaving the Eurozone is to amend the TFEU. Regardless of the well-known discussion about whether the European Union has a constitution[44]—a question that should be answered in the affirmative[45]—it is important and universally agreed upon that the Member States remain the "masters of the treaties" and can therefore amend them at any time.[46]

Indeed, such changes occur with a certain frequency. Because of the nature of the European Union as a work in progress,[47] EU law is inherently more dynamic than most other legal systems. Since the establishment of the European Economic Community in 1957, its constitutional treaty has undergone at least five fundamental transformations.[48] The latest transformation occurred as a result of the Treaty of Lisbon,[49] which only came into force in December 2009.[50]

However, none of this means that amending the Treaties is easy. It is difficult and becoming ever more so because an amendment to the Treaty has to be signed and ratified by every Member State.[51] While the European Economic Community—as it was then called—only had six members when it was started in 1957,[52] the European Union is now comprised of twenty-seven Member States—a fact that has not made treaty amendments any easier. As a practical matter, therefore, it seems at the very least highly unclear whether—and at what cost—a consensus can be

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43. *Id.* arts. 26, 49.

44. For a thoughtful discussion of this issue see Mattias Kumm, *Beyond Golf Clubs and the Judicialization of Politics: Why Europe Has a Constitution Properly So Called,* 54 AM. J. COMP. L. 505 (2006).

45. *Id.* at 507.

46. In fact, the TEU itself contains a provision dealing with the procedure for amending the Treaties. TEU, *supra* note 34, art. 48.

47. The Preamble of the TEU specifically invokes the dynamic nature of the European Union by stressing the Member States' resolution "to continue the process of creating an ever closer union among the peoples of Europe." TEU, *supra* note 34, pmbl., at 15–16.

48. These included the Single European Act, the Maastricht Treaty, the Treaty of Amsterdam, the Treaty of Nice, and the Lisbon Treaty. *See* PAUL CRAIG & GRÁINNE DE BÚRCA, EU LAW: TEXT, CASES AND MATERIALS 7–37 (4th ed. 2008) (summarizing the relevant treaties).

49. Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community, Dec. 13, 2007, 2007 O.J. (C 306) 1 [hereinafter Lisbon Treaty].

50. *See, e.g., id.*; Council of the EU, *Treaty of Lisbon*, http://www.consilium.europa.eu/Documents/treaty-of-lisbon (last visited Feb. 16, 2013).

51. Arguably, a limited exception to this principle lies in the so-called passerelle clauses contained in various treaty provisions. TFEU, *supra* note 38, arts. 81(3), 153(2), 192(2), 312(2), 333(2); TEU, *supra* note 34, arts. 31(3), 48(7). In certain situations, these clauses allow the Council or the European Council to reduce the lower hurdles for EU decision-making. However, in order for a passerelle clause to find application, the change requires a unanimous decision of the Council or the European Council. TFEU, *supra* note 38, arts. 81(30), 153(2), 192(2), 213(2), 333(2); TEU, *supra* note 34, arts. 31(3), 48(7). In effect, this means that all Member State governments have to agree, since the Council and the European Council are composed of representatives of the Member States. *See* TEU, *supra* note 34, art. 15, 16(2) (governing the composition of the European Council and the composition of the Council, respectively).

52. CRAIG & DE BÚRCA, *supra* note 48, at 5–6.

reached. Accordingly, for a Member State seeking to leave the Eurozone, withdrawal via treaty amendment is a highly uncertain and potentially costly option.

C. Clausula Rebus Sic Stantibus

Under the Vienna Convention on the Law of Treaties from 1969,[53] the parties to an international treaty can sometimes invoke a fundamental change of circumstances as a ground for terminating or withdrawing from the treaty or simply as a ground for suspending the operation of the treaty.[54] Can this provision—also known as the *clausula rebus sic stantibus*—be brought to bear on the issue at hand?

The fact that not all of the Member States have ratified the Vienna Convention[55] is irrelevant in this context. Like many other principles enshrined in the Vienna Convention,[56] the doctrine of *rebus sic stantibus* constitutes a rule of customary international law.[57] As such, it is binding on all the Member States as well as on the European Union itself. No less an authority than the Court of Justice of the European Union itself has acknowledged this fact.[58]

Moreover, the fact that an exit from the Eurozone concerns only part of the TFEU—namely the provisions on the Eurozone—does not necessarily prevent the application of the *clausula rebus sic stantibus* either. At least according to some voices, this doctrine allows not only for the termination or suspension of a treaty, but may also—and more relevant to the problem at hand—serve as the basis for a right to demand the revision of a treaty.[59]

Nonetheless, any attempt to use the *clausula rebus sic stantibus* as a basis for allowing Member States to withdraw from the Eurozone would be highly unlikely to succeed. First, there are good arguments against applying the doctrine of *rebus sic stantibus* to the TFEU at all. Second, there is little reason to believe that the euro crisis satisfies the various requirements of the *clausula rebus sic stantibus*.

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53. Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331 [hereinafter Vienna Convention].

54. *Id.* art. 62.

55. A list of those nations that have signed the Vienna Convention can be found at the United Nations Treaty Collection, *available at* http://treaties.un.org/Pages/ViewDetailsIII.aspx?&src=TREATY&mtdsg_no=XXIII~1&chapter=23&Temp=mtdsg3&lang=en (last visited Aug. 26, 2012).

56. *E.g.*, Chubb & Son, Inc. v. Asiana Airlines, 214 F.3d 301, 309 (2d Cir. 2000), *cert. denied*, 533 U.S. 928 (2001) (categorizing "the Vienna Convention as an authoritative guide to the customary international law of treaties"). As many scholars are careful to stress, however, not all provisions of the Vienna Convention are part of customary international law. *E.g.*, ATHANASSIOS VAMVOUKOS, TERMINATION OF TREATIES IN INTERNATIONAL LAW 138 (1985).

57. VAMVOUKOS, *supra* note 56, at 150–51; MARK E. VILLIGER, COMMENTARY ON THE 1969 VIENNA CONVENTION ON THE LAW OF TREATIES 780, para. 30 (2009); Harlan Grant Cohen, *Finding International Law: Rethinking the Doctrine of Sources*, 93 IOWA L. REV. 65, 90 n.91 (2007); Emily K. Penney, Comment, *Is That Legal?: The United States' Unilateral Withdrawal from the Anti-Ballistic Missile Treaty*, 51 CATH. U.L. REV. 1287, 1300 (2002); Kal Raustiala, *The Geography of Justice*, 73 FORDHAM L. REV. 2501, 2539 (2005).

58. In the words of the Court, "the rules of customary international law concerning the termination and the suspension of treaty relations by reason of a fundamental change of circumstances are binding upon the Community institutions and form part of the Community legal order." Case C-162/96, A. Racke GmbH & Co. v. Hauptzollamt Mainz, 1998 E.C.R. I-3655, para. 46.

59. *E.g.*, VAMVOUKOS, *supra* note 56, at 199–200.

1. Applicability to the Treaty on the Functioning of the European Union

While the European Court of Justice has declared the *clausula rebus sic stantibus* to be part of EU law, the relevant case pertained to an international treaty concluded between the European Union and a third country.[60] Whether the *clausula rebus sic stantibus* can be applied to the foundational treaties of the European Union themselves is an entirely different question.

One of the pillars of EU law—namely the principle that EU law enjoys primacy over the law of the Member States—rests on the assumption that EU law is different from international law.[61] In another area—interpretation of EU law—the Court of Justice has also refused to apply principles of international law and instead developed principles that are very different from those laid down in the Vienna Convention.[62] Hence, one would have to justify why the *clausula rebus sic stantibus* should at all apply to the foundational Treaties where other central principles of international law do not.

Moreover, even assuming that the nature of EU law does not stand in the way of applying the *clausula rebus sic stantibus*, the question remains whether the provisions of the European Union's foundational Treaties preclude invoking the doctrine.[63] It is generally agreed upon that the *clausula rebus sic stantibus* does not constitute mandatory law.[64] Accordingly, the parties are free to specify the consequences of a change of circumstances in their treaty, either explicitly or implicitly. Obviously, if one shares the view advanced in this Article—that the TFEU allows countries to leave the Eurozone once they no longer meet the admission requirements—then the TFEU already contains a solution for changing circumstances of the sort that arose in the sovereign-debt crisis. Yet even if a more restrictive approach was taken, one would have to come to the same conclusion: Article 50 of the TEU explicitly allows Member States to leave the European Union, thus creating a clear path for those countries that no longer wish to comply with their duties under the Treaties. Any recourse to the *clausula rebus sic stantibus* is thereby precluded.[65]

2. The Sovereign-Debt Crisis as a Fundamental Change

Even if the various obstacles described above could somehow be overcome, it would still be very difficult to use the doctrine of *rebus sic stantibus* as a basis for a

60. The case concerned a cooperation agreement between the European Economic Community and Yugoslavia. Case C-162/96, A. Racke GmbH & Co., 1998 E.C.R. I-3655, para. 1, 53.

61. Thus in its landmark decision *Costa v. ENEL*, the Court stressed that "[b]y contrast with ordinary international treaties, the EEC Treaty has created its own legal system." Case 6/64, 1964 E.C.R. 585, 593.

62. For an analysis of the principles governing the interpretation of EU law see, e.g., Nial Fennelly, *Legal Interpretation at the European Court of Justice*, 20 FORDHAM INT'L L.J. 656 (1997).

63. *Cf.* Herrmann, *supra* note 31, at 417. Herrmann argues that those provisions of the TFEU treaties that govern treaty violations constitute *lex speciales* that preclude the application of the *clausula rebus stic stantibus*. *Id.* However, that argument fails to persuade where the change in circumstances relates not primarily to a treaty violation but to a change in a country's economic situation.

64. *E.g.*, VILLIGER, *supra* note 57, at 780, para. 30.

65. Christian Calliess, *EUV Art. 50*, *in* EUV/AEUV 468, para. 13 (Christian Calliess & Matthias Ruffert, eds., 4th ed. 2011); Juliane Kokott & Matthias Pechstein, *Art. 53 EUV*, *in* EUV/AEUV 324, 325, para. 2 (Rudolf Streinz ed., 2d ed. 2012).

withdrawal right: it is hard to categorize the sovereign-debt crisis—or the circumstances underlying that crisis—as a fundamental change of circumstances as required by the *clausula rebus sic stantibus*.

The elements of the *clausula rebus sic stantibus* are fairly restrictive: the circumstances which existed at the time the Treaty was concluded must have undergone a fundamental change,[66] the relevant circumstances must have "constituted an essential basis" of the parties' consent,[67] and the change that occurred must have led to a radical transformation of the extent of the obligations that remain to be executed under the Treaty.[68] Moreover, there exists a general consensus that these provisions are not to be applied liberally. Rather, the *clausula rebus sic stantibus* applies only in extreme cases.[69]

Does the sovereign-debt crisis meet these requirements? In answering this question, it is helpful to ask which countries might seek to leave the Eurozone.

To begin, consider the case that Germany or some other solvent Member State wishes to leave the Eurozone to avoid being burdened with the cost of ever-new rescue packages. In such a case, the difficulties with finding a fundamental change in circumstances are particularly conspicuous. One might be tempted to argue that for these countries the fundamental change of circumstances lies in the necessity to bail out the more fragile economies of the Eurozone, such as Greece. However, the problem with this argument is that the rescue packages were created through separate agreements. The TFEU did not compel any country to participate in the various bailouts. On the contrary, Article 125 of the TFEU explicitly provides that "[a] Member State shall not be liable for or assume the commitments of . . . another Member State."[70] At the very least, this provision means that Member States are under no duty to bail out other Member States.[71] Given that participation in the various bailout packages was voluntary, it is hard to argue that—as the *clausula rebus*

66. Vienna Convention, *supra* note 53, art. 62.

67. *Id.*

68. *Id.*

69. Gabčikovo-Nagymaros Project (Hung. v. Slovk.), Judgment, 1997 I.C.J. 7, para. 104 (Sept. 25); *see also* David D. Caron, *The Legitimacy of the Collective Authority of the Security Council*, 87 AM. J. INT'L L. 552, 585 n.133 (1993) (noting that "it would seem rare indeed that the requirements of Article 62 could be met"); Harlan Grant Cohen, *"Undead" Wartime Cases: Stare Decisis and the Lessons of History*, 84 TUL. L. REV. 957, 1003 n.263 (2010) (stating that "rebus sic stantibus, is notoriously rarely applied"); Paolo Di Rosa, *The Recent Wave of Arbitrations Against Argentina Under Bilateral Investment Treaties: Background and Principal Legal Issues*, 36 U. MIAMI INTER-AM. L. REV. 41, 66 (2004) (pointing out that "it is very rare for international tribunals to grant relief to a treaty Party on the basis of rebus sic stantibus"); Geoffrey R. Watson, *The Death of Treaty*, 55 OHIO ST. L.J. 781, 822 (1994) (noting that "rebus sic stantibus has rarely if ever been invoked in a formal setting").

70. TFEU, *supra* note 38, art. 125.

71. To what extent the no-bailout clause also imposes a prohibition against voluntary bailouts undertaken by other Member States is controversial. Recent scholarship has been supportive of the idea that voluntary bailouts should at least be allowed to some extent. *See, e.g.*, Peter Behrens, *Ist ein Ausschluss aus der Euro-Zone ausgeschlossen?* [*Is an Expulsion From the Eurozone Excluded?*], 13 EUROPAISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [EUZW] 121, 121 (2010) (asserting that the no-bailout clause does not prevent the Member State from voluntarily coming to the aid of other member states); Franz C. Mayer & Christian Heidfeld, *Verfassungs- und europarechtliche Aspekte der Einführung von Eurobonds* [*The Introduction of Eurobonds: Constitutional and EU Law Considerations*], 65 NEUE JURISTISCHE WOCHENSCHRIFT [NJW] 422, 424-25 (2012) (arguing that the no-bailout-clause does not prohibit every kind of financial support for other Member States).

sic stantibus demands—the financial crisis led to a radical transformation of any obligations that remain to be executed under the Treaty.[72] After all, the duties remaining to be executed under the TFEU did not change or grow more burdensome.

Regarding the countries at the center of the sovereign-debt crisis, such as Greece, Portugal, Ireland, and Spain, the *clausula rebus sic stantibus* may seem easier to invoke. For these countries, the TFEU-imposed lack of a national currency and the resulting inability to regain competitiveness via devaluation has arguably grown substantially more burdensome as a result of the crisis. However, other problems lurk. To begin, as noted above, those circumstances that later changed must have "constituted an essential basis" of the parties' consent.[73] Changes that the parties anticipated do not qualify,[74] and many commentators believe that the same is true for changes that the parties *should have* anticipated.[75] This restriction matters because the budget problems facing Greece and other countries for the most part are not new, even if the euro crisis has made them worse.[76] Nor can one reasonably argue that the countries joining the Eurozone assumed that, from that point on, no financial or other crisis would ever befall their economies. In other words, in light of the glaring budget problems that some Member States faced even before the creation of the Eurozone, it seems difficult to argue that a sovereign-debt crisis was not considered at least a possible future scenario.

A further obstacle is that a fundamental change resulting from a breach of an obligation under the Treaty by the party invoking the change is insufficient to satisfy the requirements of the *clausula rebus sic stantibus*.[77] This limitation is an expression of a broader principle of good faith: a party may not invoke a change of circumstances if the party itself caused the change or failed to prevent it despite being able to do so.[78] These principles become relevant in the present context because those Member States that are hit hardest by the euro crisis are hardly blameless. Greece gained access to the Eurozone based on statistics that later proved to be manipulated.[79] Moreover, Greece and other Member States continually

72. Mayer & Heidfeld, *supra* note 71, 424–25.

73. Vienna Convention, *supra* note 53, art. 62.

74. VILLIGER, *supra* note 57, at 773, para. 15.

75. *Id. But see* VAMVOUKOS, *supra* note 56, at 189 (arguing that the fact that change was objectively foreseeable does not preclude application of the doctrine).

76. There are exceptions. Spain, for example, had a very modest budget deficit of 1.2% of its GDP in 1999, and as late as 2007, Spain even had a budget surplus. EUROPEAN COMMISSION (EC), EUROSTAT, *General Government Deficit/Surplus*, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tec00127&plugin=1 (last visited Jan. 7, 2013). Similarly, Ireland had a budget surplus until 2008. *Id.*

77. Vienna Convention, *supra* note 53, art. 62(2)(b).

78. VILLIGER, *supra* note 57, at 777, para. 23.

79. *E.g.*, Robert Z. Aliber, *Foreword* to JOHAN VAN OVERTVELDT, THE END OF THE EURO: THE UNEASY FUTURE OF THE EUROPEAN UNION, at i, xi (2011) (noting that the Greek government "satisfied the Maastricht criteria only because it had massaged the data on its deficit and on its indebtedness"); Anthee Carassava, *Greece Admits Faking Data to Join Europe*, N.Y. TIMES, Sept. 23, 2004, at A10 ("Greece confessed Wednesday to having repeatedly misrepresented significant economic data before it joined the European currency union, prompting suggestions that it might not have qualified had the true figures been known."); Ulrich Häde, *Staatsbankrott und Krisenhilfe* [*Bankruptcy and Crisis Support*], 20 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [EuZW] no. 9, 273, 273 (2009).

violated their duty under the TFEU to avoid excessive budget deficits.[80] These actions have very much contributed to the financial crisis that the relevant states are now facing.

In sum, the *clausula rebus sic stantibus* does not offer an easy way out of the Eurozone. Rather, there are numerous doctrinal obstacles to invoking this doctrine that in their entirety seem very difficult to overcome. Given that the other two options discussed above—namely a complete withdrawal from the European Union or an amendment to the TFEU—also appear unpalatable or uncertain, the decisive question becomes the one at the heart of this Article: does the Treaty grant the Member States a right to unilaterally withdraw from the Eurozone? It is this question to which I turn below.

II. WITHDRAWAL DE LEGE LATA

Although the TEU does not explicitly address the issue, there is broad agreement in the literature that, as a matter of black letter law, a Member State does not have a right to unilateral withdrawal from the Eurozone.[81]

From a methodological perspective, this consensus is slightly surprising. There is general agreement that in interpreting EU law teleological considerations are of paramount importance.[82] In undertaking such a teleological interpretation, one has to take into account the fact that the TEU explicitly defines the goals of the European Union.[83] According to Article 3 of the TEU, the "Union's aim is to promote peace, its values and the well-being of its peoples."[84] The TEU further provides that the Union shall, among other things, work to achieve economic growth, price stability, full employment, and social progress.[85] It is these general goals that the TFEU seeks to further by establishing a currency union.[86] Given these aims, an

80. *E.g.*, Council Decision 2011/79 of 8 November 2011 amending Decision 2011/734/EU Addressed to Greece with a View to Reinforcing and Deepening Fiscal Surveillance and Giving Notice to Greece to Take Measures for the Deficit Reduction Judged Necessary to Remedy the Situation of Excessive Deficit, 2011 O.J. (L 320) 28 (EU); Council Decision 2011/57 of 20 December 2010 Amending Decision 2010/320/EU Addressed to Greece with a View to Reinforcing and Deepening Fiscal Surveillance and Giving Notice to Greece to Take Measures for the Deficit Reduction Judged Necessary to Remedy the Situation of Excessive Deficit, 2011 O.J. (L 26) 15 (EU).

81. See the sources cited *supra* note 31.

82. *See* Fennelly, *supra* note 62, at 664 (noting that the teleological approach is "[t]he characteristic element in the Court's interpretive method"). Indeed, where the purpose of a provision is at odds with the provision's plain meaning, the former will prevail. *See, e.g.*, Case C-173/06, Agrover Srl v. Agenzia Dogane Circoscrizione Doganale di Genova, 2007 E.C.R. I-8783, paras. 21–22 (rejecting the literal interpretation of a provision of the Customs Code in "light of the purpose and general scheme of that provision").

83. *See, e.g.*, Case 53/81, Levin v. Staatssecretaris van Justitie, 1982 E.C.R. 1036, para. 15 (invoking the objectives of the Treaty in interpreting what is now the TFEU); Matthias Ruffert, *EUV Art. 3*, *in* EUV/AEUV 45, para. 9 (Christian Calliess & Matthias Ruffert, eds., 4th ed. 2011) (noting that the objectives of the EU are taken into account in interpreting the Treaties). *Cf.* Fennelly, *supra* note 62, at 678 (noting that the Court employs the teleological method of interpretation "to give priority to the proclaimed objectives of the EC Treaty").

84. TEU, *supra* note 34, art. 3(1).

85. *Id.* art. 3(3).

86. *Cf.* TFEU, *supra* note 38, art. 119 (1) ("For the purposes set out in Article 3 of the TEU, the activities of the Member States and the Union shall include . . . the adoption of an economic policy . . . ."), art. 119 (2) (stating that "these activities shall include a single currency").

obvious question to ask is whether the economic and other benefits of a withdrawal right will outweigh its costs—a question that, as I will show below,[87] has to be answered in the affirmative.

What explains the unanimous rejection of a unilateral withdrawal right? In this section, I will address the various arguments against a withdrawal right that have been mentioned in the literature as well as several potential arguments that have not. As I will show, none of these arguments are particularly convincing, at least with respect to those Member States that no longer meet the criteria for initial admittance to the Eurozone. Admittedly, this does not imply that the Treaty clearly grants a withdrawal right to such Member States. However, my point simply is to show that the Treaty is ambiguous on this issue. As a result, it leaves room for the interpretation that Member States no longer fulfilling the admission requirements to the Eurozone are entitled to unilateral withdrawal from the Eurozone.

A. The Duty to Join the Eurozone

The strongest argument against the existence of a withdrawal right relies on the fact that the TFEU imposes a duty on the Member States to join the Eurozone.[88]

The fact that such a duty exists can hardly be debated. First and most importantly, it is implied by the provisions governing the introduction of the euro. Member States that are not yet part of the Eurozone because they do not yet meet the various requirements for introducing the euro are called "Member States with a derogation."[89] These Member States will periodically undergo scrutiny to assess whether they meet the relevant requirements.[90] If they do, a procedure is set in motion in order to abrogate their derogation and replace their national currency with the euro. Crucially, the initiation of this procedure does not require the consent of the Member State that is to introduce the euro.[91] In other words, if the conditions for introducing the euro are met, the euro will be introduced regardless of whether or not the relevant Member State so desires.

Just as importantly, the existence of a duty to join the Eurozone can be derived via an *argumentum e contrario* from those provisions that allow certain Member States—namely Denmark and the United Kingdom—to refrain from joining the Eurozone. Thus, in the case of Denmark, Protocol No. 16 provides that Denmark shall have an exemption and that the procedure for introducing the euro "shall only be initiated at the request of Denmark."[92] Similarly, in the case of the United Kingdom, the preamble to Protocol No. 15 recognizes that "the United Kingdom shall not be obliged or committed to adopt the euro without a separate decision to do so by its government and parliament," and the Protocol itself provides that "[u]nless the United Kingdom notifies the Council that it intends to adopt the euro, it shall be

87. *Infra* Part IV.

88. Hofmeister, *supra* note 31, at 127.

89. TFEU, *supra* note 38, art. 139(1).

90. *Id.* art. 140.

91. *Id.* art. 140(2).

92. Protocol (No 16) on Certain Provisions Relating to Denmark to the TEU and TFEU, *supra* notes 34, 38, para. 2.

under no obligation to do so."[93] Of course, if it is necessary for the protocols to affirm that the United Kingdom and Denmark are under no obligation to introduce the euro, then the obvious implication is that the other Member States for whom no equivalent exception is made are very much under a duty to join the Eurozone. Thus, for Member States other than Denmark and the United Kingdom, the existence of a duty to join the Eurozone cannot be called into question.

This duty, in turn, has obvious implications for the withdrawal right question: to the extent that the TFEU imposes a duty to join the Eurozone, it makes little sense to grant a withdrawal right. After all, if a Member State withdrew from the Eurozone, that same Member State would immediately have to rejoin. In other words, any duty to join the Eurozone implies the absence of a withdrawal right.

This argument is compelling as far as it goes. However, one has to keep in mind that the duty to join the Eurozone is not an unconditional one. Rather, the duty to introduce the euro is contingent upon meeting the various requirements set forth in the TFEU.[94] These requirements—known as the "convergence criteria"—include, inter alia, a high degree of price stability, the sustainability of the government financial position, stable currency exchange rates,[95] and stable long-term interest-rate levels.[96] The second of these criteria—namely the sustainability of the government's financial position—imposes restrictions on both a country's budget deficit and government debt. They must not exceed 3% and 60% of the country's GDP, respectively.[97] The right, and hence the duty, to join the Eurozone presupposes that a Member State meets these various convergence criteria.

This contingent nature of the duty to join the Eurozone is of crucial importance in the context at hand. Those Member States that meet the requirements for joining the Eurozone are then under a duty to join, and, accordingly, they cannot be granted a withdrawal right. By contrast, those Member States that no longer fulfill the various preconditions for joining the Eurozone are no longer under any duty to introduce the euro. The same would be true for those Member States that never met the requirements for joining the Eurozone in the first place. Therefore, with respect to Member States falling into the latter categories, the duty to join the Eurozone cannot be adduced as an argument against the existence of a withdrawal right.

93. Protocol (No 15) on Certain Provisions Relating to the United Kingdom of Great Britain and Northern Ireland to the TEU and TFEU, *supra* notes 34, 38, para. 1.

94. The convergence criteria are anchored in Article 140 TFEU. *See* TFEU, *supra* note 38, art. 140. They are also laid out in more detail in a Protocol to the Treaties. Protocol (No 13) on the Convergence Criteria to the TEU and TFEU, *supra* notes 34, 38 [hereinafter Convergence Protocol].

95. More specifically, countries seeking to join the Eurozone must observe, for at least two years and without resorting to devaluation, "the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System." TFEU, *supra* note 38, art. 140(1). I will explain the exchange rate mechanism below. *Infra* Part II.B.

96. TFEU, *supra* note 38, art. 140 (1).

97. *Id.* art. 126 (2); Protocol (No. 12) on the Excessive Deficit Procedure to the TEU and TFEU, *supra* notes 34, 38, art. 1.

B. The Irrevocable Determination of Exchange Rates

Those voices in the literature that reject a withdrawal right also invoke the provisions that govern the introduction of the euro in individual Member States.[98] As noted above, those Member States, that are not yet part of the Eurozone because they do not yet meet the various requirements for introducing the euro are called "Member States with a derogation."[99] These Member States will periodically be scrutinized to assess whether they meet the relevant requirements.[100] If they do, a procedure is set in motion in order to abrogate their derogation and to replace their national currency with the euro. As part of that procedure, Article 140 TFEU provides:

> If it is decided . . . to abrogate a derogation, the Council shall, acting with the unanimity of the Member States whose currency is the euro and the Member State concerned . . . *irrevocably* fix the rate at which the euro shall be substituted for the currency of the Member State concerned . . . .[101]

The word "irrevocably" implies that the decision to introduce the euro is permanent such that a country cannot withdraw from the Eurozone.[102] To further bolster this argument, one could point to the text of Protocol No. 4 on the statute of the European system of central banks and of the European Central Bank (ECB). That Protocol, which—like all protocols attached to the Treaties—is of equal rank as the Treaties themselves,[103] also uses the words "irrevocable" and "irrevocably" in connection with the fixing of exchange rates.[104]

However, the irrevocability language has to be understood in context. On its face, it is open to two interpretations. On the one hand, one can read the term "irrevocable" to mean that the exchange rate shall be forever fixed, implying that the decision to join the Eurozone is itself eternal. On the other hand, one can read the relevant provisions as meaning that while a country is part of the Eurozone, the exchange rates underlying the introduction of the euro shall not be corrected ex post.

The second, narrower reading is much more plausible for two reasons. First, Article 50 of the TEU explicitly grants the Member States the right to leave the European Union and thus the Eurozone.[105] Accordingly, any claim that the irrevocable fixing of the exchange rates also makes membership in the Eurozone irrevocable is plainly wrong.

Second, and even more importantly, it is helpful to consider the history of the European currency union. Since 1979, i.e., long before the introduction of the euro, most current Member States participated in a system of stable exchange rates, the so-

98. Athanassiou, *supra* note 31, at 13–14.

99. TFEU, *supra* note 38, art. 139(1).

100. *Id.* art. 140.

101. *Id.* art. 140(3) (emphasis added).

102. Athanassiou, *supra* note 31, at 13–14; Hofmeister, *supra* note 31, at 121.

103. TEU, *supra* note 34, art. 51.

104. Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank to the TEU and TFEU, *supra* notes 34, 38, art. 46(3) ("irrevocably fixing the exchange rates"); *id.* art. 49 ("banknotes denominated in currencies with irrevocably fixed exchange rates").

105. TEU, *supra* note 34, art. 50.

called European Monetary System.[106] The European Monetary System was based on the so-called Exchange Rate Mechanism (ERM).[107] Exchange rates were, in principle, fixed and were only allowed to move within a certain corridor (usually +/- 2.25%).[108]

Crucially, though, these exchange rates were periodically adjusted ("realigned").[109] Moreover, two Member States—the United Kingdom and Italy—withdrew from the ERM, and one of them—the United Kingdom—did so permanently.[110]

Against this background, there were two obvious questions that had to be answered when the provisions on the Eurozone were introduced. First, should it be possible to realign the exchange rates underlying the euro once they had been introduced—as was routinely done in the case of the ERM? Second, should Member States be allowed to withdraw from the Eurozone—as they did in the case of the ERM? The language, according to which the exchange rates are fixed irrevocably, only targets the first of these questions. If anything, that implies that the Treaty does not intend a general prohibition against withdrawing from the Eurozone.

C. The Irreversible Introduction of the Euro

Another text-based argument raised against the existence of a withdrawal right is derived from a Protocol to the Treaty of Maastricht.[111] According to the text of that Protocol—which is no longer part of the current Treaties—the Member States "[d]eclare the irreversible character of the Community's movement to the third stage of Economic and Monetary Union by signing the new Treaty provisions on Economic and Monetary Union."[112] This sentence—and more specifically the term "irreversible"—is said to imply that there can be no right to withdraw from the Eurozone.[113]

However, that argument proves erroneous for two reasons. To begin, such an interpretation, despite any validity it may have had at the time, would bring the relevant text into contradiction with current EU law. With the introduction of the exit right in Article 50 of the TEU, the Member States have clarified that a Member

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106. For a concise description of the European Monetary System see, e.g., Roger J. Goebel, *European Economic and Monetary Union: Will the EMU Ever Fly?*, 4 COLUM. J. EUR. L. 249, 258–62 (1998).

107. *E.g.*, *id.* at 259 (describing the Exchange Rate Mechanism as a major component of the European Monetary System and a method for stabilizing exchange rates). In 1999, the old Exchange Rate Mechanism was replaced with a new Exchange Rate Mechanism. *See* Resolution of the European Council on the Establishment of a New Exchange Rate Mechanism, 1997 O.J. (C 236) 5 (replacing "the European Monetary System" with an "exchange-rate mechanism"). Under the new Exchange Rate Mechanism, a fluctuation of 15% up or down is allowed. *Id.* para. 2.1.

108. Goebel, *supra* note 106, at 259.

109. *Id.* at 261.

110. *Id.* at 260–61.

111. Protocol on the Transition to the Third Stage of the Economic and Monetary Union to the Treaty on European Union (Maastricht Treaty), Feb. 7, 1992, 1992 O.J. (C 191) 1 (as in effect 1992) [hereinafter Transition Protocol].

112. *Id.*

113. Hofmeister, *supra* note 31, at 121.

State can leave the European Union—and hence the Eurozone. Accordingly, the idea that one cannot leave the Eurozone is simply incompatible with the TEU.

More importantly, the above interpretation also misunderstands the purpose of the relevant Protocol. The fact that the movement to the third stage of the Economic and Monetary Union—and hence the creation of the euro—is irreversible does not imply that membership in the Eurozone cannot fluctuate. The Protocol at issue is clearly concerned with the creation of the euro, not with the question of which states are part of the Eurozone. This becomes obvious if one takes into account the following sentence:

> Therefore all Member States shall, whether they fulfil [sic] the necessary conditions for the adoption of a single currency or not, respect the will for the Community to enter swiftly into the third stage, and therefore no Member State shall prevent the entering into the third stage.[114]

The concern addressed by this sentence is that those Member States that are not ready to enter the third stage might slow down the Community—now known as the European Union—as a whole. But of course, to address this problem, it is not necessary to keep membership in the Eurozone constant. Quite to the contrary, the relevant Protocol acknowledges the problem that different Member States may opt for different speeds and that the laggards should not delay the rest of the European Union. Thus, allowing withdrawal of those Member States that fail to satisfy the requirements of the Eurozone is very much in keeping with the Protocol's spirit.

D. Europe à la Carte?

One might also attempt to argue that allowing the Member States to withdraw from the Eurozone would essentially open up the door to a *Europe à la carte*, where every Member State can pick and choose those provisions of the TFEU and the TEU that it likes while opting out of the others.[115] That, in turn, might prompt the collapse of the European Union as a whole.

However, it is not clear why a (contingent) right to withdraw from the Eurozone should lead to a *Europe à la carte* in the first place. The TFEU's provisions on the Eurozone are very much different from the other provisions of the Treaty. The latter are designed to apply to all Member States alike. However, that is not the case for the rules governing the Eurozone. Quite the contrary, the Treaty specifically distinguishes between those countries that are part of the Eurozone and those that are not.[116] Moreover, while there is no legal right to pick and choose whether to enter the Eurozone,[117] the states enjoy considerable de facto control over whether or not they join the Eurozone. For example, by failing to reduce its budget deficits, a Member State can delay meeting the criteria for joining the Eurozone and thereby delay the introduction of the euro as its currency. It follows that the Treaty already

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114. Transition Protocol, *supra* note 111.

115. *Cf.* Hofmeister, *supra* note 31, at 131–32 (arguing that the risk of cherry-picking has to be taken seriously).

116. *Cf.* TFEU, *supra* note 38 (entitling the headline to chapter 4 as "Provisions Specific to Member States Whose Currency is the Euro").

117. *See supra* Part II.A.

explicitly incorporates a different-speeds model with respect to the Eurozone. This contrasts with the other provisions of the Treaty that, in principle, apply to all Member States alike. Accordingly, giving a contingent right to the Eurozone simply does not imply a general rule that allows Member States to partially opt out of the TFEU or the TEU.

E. Argumentum e Contrario *Based on Article 50 of the Treaty on European Union*

Article 50 of the TEU allows Member States to leave the European Union. At first glance, this provision would seem to invite an *argumentum e contrario*: if the treaty provides for an exit right from the European Union but does not mention any right to exit the Eurozone, then one could reason that no such right is intended.

However, upon closer examination, this line of reasoning is unpersuasive. The explicit recognition of the exit right in Article 50 of the TEU was only introduced by the Treaty of Lisbon,[118] which entered into force in December 2009[119]—long after the provisions on the Eurozone had been included in the Treaty. This matters because the obvious purpose of Article 50 is to protect the sovereignty of the Member States.[120] That purpose would be rendered *ad absurdum* if Article 50 were now adduced as evidence against the existence of a right to withdraw from the Eurozone. The very provision designed to bolster the sovereignty of the Member States would end up helping to curtail that sovereignty in a crucial area.

F. Ever Closer Union

One might be tempted to derive a further argument against a withdrawal right from the idea that the European Union is designed to be a one-way street towards ever-greater integration.[121] As one scholar has put it, "the legal process of European integration is a one-way ratchet in which commitments, once made, cannot be undone."[122] Along this line of thought, granting a right to withdraw from the Eurozone clashes squarely with the idea that the Member States should move towards more integration.

In assessing this argument, it should first be noted that the European Union is indeed committed to the goal of ever more integration. After all, the preamble of the TEU explicitly emphasizes that the Member States pledge "to continue the

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118. Lisbon Treaty, *supra* note 49.

119. EUROPEAN COMMISSION, *Lisbon Treaty: A Fresh Start for the EU* (Dec. 1, 2009), http://ec.europa.eu/news/eu_explained/091201_en.htm.

120. This is true regardless of whether or not one believes that the Member States were entitled to withdraw from the European Union even before the introduction of what is now Article 50. Regarding the latter debate compare Timothy Zick, Note, *Are the States Sovereign?*, 83 WASH. U. L. Q. 229, 266 n.210 (2005) (noting that at least theoretically "the member states [of the EU] can withdraw from the EU") with Peter Ørebech, *The EU Competency Confusion: Limits, "Extension Mechanisms," Split Power, Subsidiarity, and "Institutional Clashes,"* 13 J. TRANSNAT'L L. & POL'Y 99, 106 (2003) (noting that "no state may unilaterally withdraw from the EU").

121. Scott, *supra* note 29, at 7.

122. *Id.*

process of creating an ever closer union among the peoples of Europe . . . ."[123] Correspondingly, Article 1 of the TEU stresses that the Treaty on European Union "marks a new stage in the process of creating an ever closer union among the peoples of Europe . . . ."[124]

An entirely different question, however, is whether this commitment towards an ever closer union implies a one-way street in the sense that any step backwards violates the spirit of EU law. The answer to this question has to be "no." Historically, the road to European unification has been a dialectical process, where expansions of EU power have been countered by new safeguards to protect the sovereign interests of the Member States.

For example, at the level of primary EU law, the introduction of the subsidiarity principle[125] by the 1992 Treaty of Maastricht[126] sought to guard the Member States against the atrophy of their powers.[127] More recently, the creation of a right to withdraw from the European Union has provided an additional layer of security for the Member States.[128]

Moreover, steps towards greater deference to the sovereignty of the Member States are not just found in the Treaties themselves. Rather, similar developments can be observed in the case law of the Court of Justice. The Court's jurisprudence in the area of the free movement of goods may serve to illustrate this point. The free movement of goods prohibits, inter alia, quantitative restrictions on imports as well as measures having equivalent effect.[129] In the landmark *Dassonville* decision,[130] the Court of Justice greatly expanded the range of Member State norms subject to judicial scrutiny under the free movement of goods by holding that "[a]ll trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions."[131] However, this definition proved overbroad in that it subjected even those Member State rules to scrutiny that had only a very indirect and uncertain impact on the free movement of goods. Accordingly, the Court of Justice backtracked in the equally famous *Keck* decision.[132] There, the Court held that "contrary to what has previously been decided," national rules concerning mere selling arrangements did not fall within the scope of the free movement of goods as long as they met certain requirements such as being de jure and de facto non-discriminatory.[133]

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123. TEU, *supra* note 34, pmbl.

124. *Id.* art. 1.

125. The principle of subsidiarity can now be found in Article 5 of the Treaty on European Union. TEU, *supra* note 34, art. 5(3).

126. Treaty on European Union, Feb. 7, 1992, 1992 O.J. (C 191) 1 (as in effect 1992).

127. For a thoughtful analysis of the subsidiary principle see generally Christoph Henkel, *The Allocation of Powers in the European Union: A Closer Look at the Principle of Subsidiarity*, 20 BERKELEY J. INT'L L. 359 (2002).

128. Regarding the right to leave the European Union see *supra* Part II.A.

129. TFEU, *supra* note 38, art. 34.

130. Case 8/74, Procureur du Roi v. Bénoit & Gustave Dassonville, 1974 E.C.R. 837.

131. *Id.* para. 5.

132. Joined Cases C-267 and C-268/91, Keck and Mithouard, 1993 E.C.R. I-6097, I-6131, para. 16.

133. *Id.*

The lesson is simple: EU law is firmly committed to an ever-closer union. However, the way towards that goal is not always a straight line. Rather, there necessarily are—and always have been—steps back and forth. Accordingly, it is by no means against the spirit of the Treaties to allow individual Member States to withdraw from the Eurozone—especially in light of the fact that, in some cases, such withdrawals may allow the Eurozone to function in a more effective manner.

G. Summary

In sum, the doctrinal case against the right to withdraw from the Eurozone is by no means compelling. That is true, at least, in those cases where Member States no longer satisfy the criteria that allowed them to join the Eurozone in the first place. Of course, this finding does not per se imply that a withdrawal right should be recognized. However, as shown in Part III, the policy case in favor of a withdrawal right is strong.

III. THE LEGAL POLICY CASE FOR A RIGHT TO WITHDRAW

Is a right to unilateral withdrawal from the Eurozone desirable as a matter of legal policy? In this Part, I argue that the answer is "Yes," at least with respect to those states that—like Greece—no longer fulfill the requirements that they had to meet in order to join the Eurozone in the first place.

A. The Default Character of the Treaty on the Functioning of the European Union

For analytical purposes, it is helpful to begin by noting that what is at stake is merely the content of a default norm. Regardless of whether or not the TFEU is read to include a right to withdraw from the Eurozone, the Member States are free to amend the Treaty at any time.[134]

Accordingly, if a Member State such as Greece is denied an exit right as a matter of black letter law, this does not necessarily mean that the relevant Member State has to remain in the Eurozone. Rather, it can still reach a bargain with the other Member States, allowing it to exit the Eurozone via a treaty amendment. On the other hand, if one interprets the Treaty to grant a withdrawal right, this does not have to be the last word either. If the other Member States prefer Greece to remain in the Eurozone, they can always bargain with Greece to persuade the latter to abstain from exercising its withdrawal right.

Of course, the problem of having to choose a suitable default rule in the presence of high transaction costs is a familiar one. Ideally, the chosen default minimizes the sum of the transaction costs incurred in opting out of the default as well as the costs resulting from failures to opt out. There exists a substantial body of theoretical scholarship that offers various strategies for dealing with precisely this kind of challenge: namely the literature on the optimal design of legal defaults.[135]

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134. TEU, *supra* note 34, art. 48.

135. This literature includes, in particular, the various articles by Ian Ayres and his coauthor Robert

1. Hypothetical Bargains: Planning for Failures to Opt Out

The classical approach for choosing default rules is to let the legal default reflect the arrangement that most parties would have chosen in the absence of transaction costs: the "hypothetical bargain."[136]

Proceeding in this way has two main advantages. First, the hypothetical bargain approach often minimizes transaction costs since, in most cases, the default already reflects the preferred solution, thereby absolving the parties of the necessity of bargaining around the default.[137] Second, where transaction costs or informational asymmetries effectively prevent parties from opting out, the hypothetical bargain approach can reduce the costs of opt-out failures. This is because even if the parties are prevented from opting out, the hypothetical bargain approach ensures that most of them end up with their preferred outcome.

Of course, the challenge inherent in the hypothetical bargain approach lies in identifying the hypothetical bargain. In other words, what would the parties agree upon in the absence of transaction costs? The obvious answer—that the parties would choose the solution that maximizes benefits for both parties—does not solve this riddle but merely reframes the question. In the context at hand, this limitation of the hypothetical bargain approach proves crucial: whether the Member States, knowing what they know now, would negotiate for a withdrawal right in the absence of transaction costs is very difficult to say.

Presumably, in the absence of transaction costs and other obstacles to the bargaining process, the Member States would agree upon a withdrawal right if such a right maximizes the aggregate benefits for all of the Member States. However, whether that is the case is difficult to answer. Indeed, economists cannot even agree on whether, at this point, a Greek withdrawal from the Eurozone would benefit Greece,[138] let alone whether it would benefit the European Union as a whole.[139]

Gertner. For a review of their work on the optimal design of legal default rules, see Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992); Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591, 1600 (1999) [hereinafter Ayres & Gertner, *Majoritarian vs. Minoritarian Defaults*]; Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032 (2012).

136. *E.g.*, Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983); Jeffrey M. Lipshaw, *Of Fine Lines, Blunt Instruments, and Half-truths: Business Acquisition Agreements and the Right to Lie*, 32 DEL. J. CORP. L. 431, 445 n.62 (2007).

137. *See, e.g.*, Charles K. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 DEL. J. CORP. L. 1081, 1090 n.33 (2011) (noting that the hypothetical bargain approach can lower transaction costs as long as implementing the default rule is cheaper than negotiation).

138. *Compare* Nicholas Economides et al., *What's at Stake in the Greek Vote*, WALL ST. J., June 15, 2012, at A11 (arguing that an exit from the Eurozone would amount to fiscal suicide and would force Greece "into a crisis many times more severe than its present one") *with* Nouriel Roubini, *Greece Must Go*, SLATE (June 18, 2012), http://www.slate.com/articles/news_and_politics/politics/2012/05/greece_will_leave_the_eurozone_sooner_or_later_sooner_is_better_.html (arguing that "Greece is stuck in a vicious cycle of insolvency, lost competitiveness, external deficits, and ever-deepening depression" and that "[t]he only way to stop [this vicious cycle] is to begin an orderly default and exit"). *Cf.* Eichengreen, *supra* note 27, at 12 (noting that "it is [not] obvious that the economic problems of the participating member states can be significantly ameliorated by abandoning the euro, although neither can this possibility be dismissed").

139. *Compare* Economides et al., *supra* note 138, at A11 (arguing that the European Union should be relieved if Greece does not leave the Eurozone), *with* Roubini, *supra* note 138 (arguing that an orderly

Nor is this lack of consensus particularly surprising. The costs and benefits of staying in the Eurozone versus leaving it depend, in no small part, on the future conduct of Greece, the other Member States, and European institutions such as the ECB. Given that their behavior is uncertain, so is the answer to the question of whether Greece should exit the Eurozone. For example, one of the benefits of leaving the Eurozone would be for Greece to regain an independent monetary policy that is specifically tailored to the needs of the Greek economy, whereas the ECB's monetary policy necessarily has to react to the aggregate needs of the Eurozone area. However, the benefit of having an independent monetary policy depends in large part on how wisely the institutions of the relevant country use that power,[140] and it is difficult to predict how Greece would fare in this respect.

Moreover, the exit right question cannot just be confined to Greece. Rather, in the future, other Member States may find themselves in such dire economic straits that withdrawal from the Eurozone may be an attractive option. But it is impossible to predict at this point exactly which Member States may want to withdraw or what the circumstances of the European Union will be like when the time comes. Accordingly, one cannot easily predict whether or not an exit right is generally desirable.

2. Some Defaults Are Easier to Opt Out of Than Others

While the hypothetical bargain approach to choosing default rules proves unworkable in the case at hand, that approach is not the only reasonable way of choosing default rules, and it may not be the most efficient. One crucial point that the hypothetical bargain approach ignores is the fact that some defaults may be easier to opt out of than others due to informational asymmetry, coordination problems, or transaction costs.[141]

Choosing the default that, if inefficient, is easier to opt out of reduces the risk of opt-out failures.[142] This consideration is particularly important in those situations where, as in the situation at hand, it is very difficult to predict the outcome of a hypothetical bargain or the cost of opt-out failures.[143] Assuming that these other

Greek exit from the Eurozone would "minimize[] collateral damage to Greece and the rest of the eurozone").

140. *E.g.*, Alberto F. Alesina et al., *Optimal Currency Areas* 8 (Harvard Inst. of Econ. Research, Paper No. 1958, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=319761.

141. Ayres & Gertner, *Majoritarian vs. Minoritarian Defaults*, *supra* note 135, at 1600; Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 241 (2005).

142. *See* David Charney, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1848 (1991) (indicating that fee choice ex ante will enhance joint welfare and efficiency).

143. There are "five variables [that] can be used to assess the private and public cost of particular defaults." These are as follows: "the percentage of the population of contracting parties that, in a world without private information, would prefer to use default i," "the percentage of type i contracting parties who, in equilibrium, would expressly contract for rule i if the other rule were the default," "the private costs of expressly 'contracting' for rule i," "the inefficiency generated if a type i contracting party 'fails' to expressly contract for rule i when the other rule is the default," and "the expected 'externalized' public cost of filling the gap for a type i contracting party who fails to expressly contract around default rule i." Ayres & Gertner, *Majoritarian vs. Minoritarian Defaults*, *supra* note 135, at 1594–95.

variables are unknown, the most promising approach for minimizing the sum of transaction costs and costs resulting from failures to opt out is to make the rule that is easiest to opt out of the legal default.

This insight has important implications for the problem at issue: it is unclear whether the hypothetical bargain would have resulted in a withdrawal right, and it is equally difficult to predict the costs that are likely to follow from a failure to opt out. However, regarding the ease with which the Member States can contract around the default, the situation is much clearer. As shown in the following, it is far easier for the Member States to opt out of an existing withdrawal right than to contract for a withdrawal right where none exists by default.

a. No Withdrawal Right

Let us assume, first, that the TFEU is interpreted to preclude the members of the Eurozone from withdrawing. In that case, how difficult would it be for the Member States to opt out of the legal default?

Such an opt-out would require amending the TFEU, and as previously noted, such amendments are very difficult. They must be ratified by all twenty-seven Member States.[144] Moreover, the ratification process is governed by the domestic constitutional requirements of each Member State.[145] In practice, the freedom of the Member States to define their own ratification procedures has meant that some Member States have subjected proposed amendments to popular referenda.[146] Such referenda can be quite unpredictable because unsurprisingly—voters do not always line up neatly behind their governments. For example, the European Constitution, the result of long and painstaking negotiations, met an inglorious end after being rejected in popular referenda in France and the Netherlands.[147]

Setting aside the matter of popular referenda, the unanimity requirement makes the process highly vulnerable to hold-ups. Any Member State government can block the process in an effort to extort special concessions. Indeed, the history of the current sovereign-debt crisis provides ample proof of how serious this problem is. Thus, during the crisis, almost all of the Member States agreed to allow the European Union to exercise more oversight and control over the budget of those countries that violate the Eurozone's rules about debt limits.[148] The agreement also called for automatic punishment for those who violated the relevant rules.[149] Given that the United Kingdom is not part of the Eurozone, it did not stand to be directly affected by these changes. However, because the United Kingdom is a Member State of the European Union, its consent was still needed in order to write the relevant changes into the TFEU, as the other Member States intended.

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144. TEU, *supra* note 34, art. 48(4).

145. *Id.*

146. *E.g.*, Gráinne de Búrca, *If at First You Don't Succeed: Vote, Vote Again: Analyzing the Second Referendum Phenomenon in EU Treaty Change*, 33 FORDHAM INT'L L.J. 1472, 1477 (2010) (noting five cases in which proposed treaty amendments were rejected in popular referenda).

147. Stephen Castle & Graham Bowley, *Treaty on Running European Union Is Signed*, N.Y. TIMES, Dec. 14, 2007, at A14.

148. Steven Erlanger & Liz Alderman, *Chronic Pain for the Euro*, N.Y. TIMES, Dec. 12, 2011, at A1.

149. Stephen Fidler, *Investors Brace for Bank Verdict on EU Plan*, WALL ST. J., Dec. 12, 2011, at A1 [hereinafter Fidler, *Investors*].

In light of this veto power, the U.K. government could not resist the opportunity to try to extract concessions from the other Member States: at the relevant summit, British Prime Minister David Cameron demanded various legal changes in exchange for the United Kingdom's agreement to a Treaty amendment.[150] In particular, Cameron demanded protections against financial regulation at the EU level, restrictions regarding the European Union's working-time directive, and an end to plans for a financial-transactions tax.[151] Perhaps because it was considered too brazen, this tactic ultimately proved unsuccessful, and the British government failed to gain any concessions.[152] However, that was not the end of the story. Rather, the United Kingdom made good on its threat and—together with the Czech Republic[153]—withheld its consent to amend the Treaty. As a result, the agreement on fiscal discipline in the Eurozone[154]—backed by twenty-five of the twenty-seven Member States[155]—had to take the form of an international treaty outside the realm of EU law. This solution is highly problematic since it is at the very least uncertain to what extent non-EU treaties can rely on EU institutions to achieve their aims. In any case, the episode demonstrates the difficulty of getting all twenty-seven Member States on board.

In sum, the consequences of not recognizing a withdrawal right are obvious: opting out of such a default is enormously difficult.

b. Granting a Withdrawal Right

If the TFEU is read to include a withdrawal right, opting out of the default becomes substantially easier. An opt-out, in this case, would be a deal with the Member State willing to withdraw under which it agrees not to exercise its withdrawal right. Such a deal could take the form of an international treaty between the exit-prone Member State and one or more of the other Member States and thereby be made binding, or it could be a more informal arrangement based on an understanding that support will keep flowing only as long as Greece (or any other state bent on exercising its withdrawal right) stays in the Eurozone. Either way, the main advantage is that no amendment to the TFEU is needed. Accordingly, the unanimity requirement does not apply.

Of course, any negotiations aimed at persuading a Member State to stay within the Eurozone may nonetheless prove complicated. In particular, free riding problems may occur as some Member States may refuse to shoulder their fair share of the burden. For example, if Greece were willing to withdraw from the Eurozone, and if the other Member States were trying to persuade Greece to stay by way of

150. George Parker & Elizabeth Rigby, *Cameron Pledges Not to Jeopardise Negotiations*, FIN. TIMES, Dec. 2, 2011, at 8.

151. *Id.*

152. Fidler, *Investors*, *supra* note 149, at A1.

153. Peter Spiegel, *EU Agrees Tough Fiscal Treaty but Berlin Warned over Sovereign Rights*, FIN. TIMES, Jan. 31, 2012, at 1 [hereinafter Spiegel, *Tough Fiscal Treaty*].

154. Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), Mar. 2, 2012, T/SCG, *available at* http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf.

155. Spiegel, *Tough Fiscal Treaty*, *supra* note 153, at 1.

further financial concessions, some Member States may stay back, hoping to free ride on the others' efforts.

However, the peculiar composition of the European Union mitigates this problem. Relatively few Member States account for a relatively large percentage of the European economy: the six largest economies account for more than three quarters of the European Union's GDP.[156] In other words, as long as the main players can coordinate their actions, one can reduce free riding significantly, albeit not completely.

In sum, the legal default is much easier to opt out of if it includes a withdrawal right than if it does not. Accordingly, if the goal is to reduce opt-out failures, the preferable approach is to grant a withdrawal right. Admittedly, this does not end the analysis. There are other factors to be considered. However, as shown below, these other concerns do not justify a different approach.

B. Beyond the Costs of Opt-Outs and Opt-Out Failures

Aside from the goal of minimizing opt-out failures and transaction costs, there are several other potential costs to be considered. They particularly include costs imposed on countries and investors outside the Eurozone, agency costs resulting from the conflict between Member State governments and the governed, damage to the commitment function of the Eurozone, and higher borrowing costs for the Eurozone's weaker economies.

While all of these costs must be taken seriously, they cannot serve as a basis for rejecting a withdrawal right. Some of the relevant costs are simply unavoidable. With respect to others, one cannot predict how they will be affected by the existence of a withdrawal right.

1. Externalities

The theoretical literature on the optimal design of default rules is based on the Coase theorem, i.e., on the assumption that, in the absence of transaction costs, the initial allocation of property rights does not prevent an efficient outcome, as long as the parties are free to bargain.[157] Of course, the Coase theorem only holds in the absence of externalities. To the extent that a rule creates costs or benefits for third parties, a bargain that the parties strike may not be efficient even in the absence of transaction costs or information asymmetries.

That any solution to the euro crisis will produce significant externalities is obvious. After all, the euro crisis does not only affect the Member States of the Eurozone. Rather, it impacts economies around the world. It follows that any solution that the Member State governments reach regarding the existence of a withdrawal right may not be efficient.

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156. Author's own calculations based on data provided by Eurostat for the year 2011. *See* EUROPEAN COMMISSION, *National Accounts*, EUROSTAT, http://epp.eurostat.ec.europa.eu/portal/page/portal/national_accounts/data/main_tables (last visited Jan. 9, 2013).

157. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1–6, 15–17 (1960).

However, this objection ultimately proves irrelevant. To begin, its normative relevance seems dubious. Arguably, the TFEU has to be interpreted with a view to maximizing benefits for Europe. This follows from Article 3(1) of the TFEU, according to which the European Union's general goal is to promote the well-being of its peoples, not the well-being of other countries.[158]

In addition, concerns about externalities are moot in the sense that such externalities are unavoidable. Whichever default rule one chooses, to the extent that the solution that most benefits the European Union is substantially different from the one that benefits the world at large, the structure of the TFEU as a treaty all but ensures that the former will eventually prevail.

2. Agency Costs

For the same reason, there is no point in attaching too much importance to the problem of agency costs. To be sure, agency costs on the part of the bargaining parties may prevent an efficient outcome. And there is every reason to believe that the Member State governments are, in many ways, imperfect at representing the interests of the governed.

For example, governments may be more beholden to the interests of that part of the electorate that brought them into power rather than to the interests of all voters alike. And of course, like all agents, public officials are subject to the usual principal-agent conflict. For example, an elected official, eager to achieve her own reelection, may opt for a solution that is inefficient but camouflages the full cost of the crisis until after the next election. In this vein, Germany's chancellor, Angela Merkel, was criticized for allegedly delaying a rescue package for Greece in order to maximize her party's performance in upcoming elections in the German state of North Rhine-Westphalia.[159]

My point is not that such agency costs do not matter. They surely do. Rather, it is crucial to note that these agency costs are unavoidable. They are, in fact, an inherent limitation to the efficiency of international treaties.[160] Thus, no matter which default one chooses—and one has to choose some default norm—the outcome of any bargain that the Member States strike may be suboptimal due to the agency conflicts at issue.

3. Damage to Currency Union as Commitment Device

One potential concern is that a withdrawal right may undermine the usefulness of the currency union as a commitment device. In the economic literature, it is well-established that a common currency can serve as a commitment device that helps

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158. TEU, *supra* note 34, art. 3(1).

159. *E.g.*, Quentin Peel, *Critics Line Up to Rap Merkel over Crisis*, FIN. TIMES, Apr. 30, 2010, at 4 (reporting that Merkel was accused of postponing a solution to the Greek debt crisis until after the election).

160. *See* JOOST PAUWELYN, OPTIMAL PROTECTION OF INTERNATIONAL LAW: NAVIGATING BETWEEN EUROPEAN ABSOLUTISM AND AMERICAN VOLUNTARISM 93–97 (2008) (discussing the problem that states may not internalize all of the costs imposed that are relevant to the treaties that they conclude).

governments overcome the so-called inflation bias problem:[161] policy makers seeking to lower unemployment below its natural level may resort to inflation to stimulate the economy. However, well-informed market participants will anticipate this course of conduct and base their actions on the inflation that they expect. As a result, inflation remains sub-optimally high without unemployment being reduced.

A currency union can help overcome this problem. By adopting a currency union dominated by low-inflation countries, Member States with weak currencies can undertake a commitment to a hard-value policy.[162] By and large, this has been the effect of the Eurozone.[163] Countries like Italy and Greece suffered from relatively high inflation rates before the euro, but benefited from low inflation once the euro had been introduced. For example, according to World Bank data, annual inflation in 1995 was 9.8% in Greece and 4.9% in Italy.[164] Ten years later in 2005, the relevant numbers were 2.8% and 1.8%, respectively.[165]

Granting a withdrawal right might conceivably weaken the value of the euro as a commitment device. After all, such a right would imply that a country can return to a national currency and revert to its old high-inflation policies. However, there is reason not to overstate this concern. After all, the lack of a withdrawal right does not necessarily preclude an exit. Accordingly, despite the fact that a right to unilateral withdrawal from the Eurozone is unanimously rejected in the existing literature, at the height of the crisis in 2012, many observers considered an exit by Greece to be highly likely.[166] In other words, there may be good reasons why membership in a currency union can serve as a valuable commitment device. However, this fact is more likely to be due to the enormous costs of exiting from such a union, which generally make an exit unlikely. By contrast, given the possibility of a consensual exit, the mere lack of a right to unilateral withdrawal is unlikely to be seen as a reliable guarantee against an exit from the currency zone.

4. Borrowing Costs

Historically, the introduction of the euro has also had the advantage of reducing the borrowing costs for the economically weaker Member States of the Eurozone.[167] After the euro had been introduced, the Mediterranean countries profited from financing costs that were almost as low as Germany's.[168] Presumably, the explanation

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161. *E.g.*, Alesina et al., *supra* note 140, at 6. For a landmark article on the inflation bias problem, see Robert J. Barro & David B. Gordon, *Rules, Discretion and Reputation in a Model of Monetary Policy*, 12 J. MON. ECON. 101 (1983).

162. *E.g.*, Alesina et al., *supra* note 140, at 6 (describing the usual circumstances and positive effects of a country abandoning its currency and going along with the currency of an anchor country).

163. *Cf.* Eichengreen, *supra* note 27, at 15 (noting that the "[t]he advent of the euro has brought credibility benefits to members whose commitment to price stability was previously least firm").

164. *Inflation GDP Deflator (Annual %)*, WORLD BANK, http://data.worldbank.org/indicator/NY.GDP.DEFL.KD.ZG (last visited Jan. 9, 2013).

165. *Id.*

166. *E.g.*, Gerald P. O'Driscoll, Jr., *How the Euro Will End*, WALL ST. J., June 13, 2012, at A15 (characterizing Greek exit as "almost a foregone conclusion"); Nelson D. Schwartz, *The Day When Europe Holds Its Breath*, N.Y. TIMES, June 17, 2012, at BU4 (noting that for many observers, the prospect of a Greek exit "has moved from 'if' to 'when'").

167. Hankel et al., *supra* note 10, at 13.

168. *Id.* at 6.

lay in the market's expectation that the weaker Member States of the Eurozone would not be allowed to become insolvent and instead could count on bailouts, if necessary.

A withdrawal right, one may argue, could undermine this benefit given that it sends a signal to the market that membership in the Eurozone may not last forever. However, such a line of reasoning would be unpersuasive. The market's past assessment that all government bonds in the Eurozone are more or less equally safe is already history. In the course of the sovereign-debt crisis, rating agencies have downgraded governments in various European countries—sometimes to junk bond status[169]—and the borrowing costs for PIIGS states have shot up.[170]

Of course, there are ways to reduce borrowing costs for the weaker Eurozone countries. In particular, a firm commitment by the other Member States to future bailouts may have this effect. However, such measures are independent of the question of whether a withdrawal right is granted. Moreover, they would come at an obvious cost: while reducing a default risk by the weak economies (and thus lowering these countries' borrowing costs), they would increase the risks associated with government bonds issued by the stronger economies and thus raise the borrowing costs of the latter. Thus, it is unlikely that such guarantees would lower the borrowing costs for the Eurozone as a whole.

5. Extortion

Should one be concerned that granting a withdrawal right would lead to frequent attempts at extortion as numerous Member States threaten to leave the Eurozone unless paid to stay? This concern is far-fetched. Considering that withdrawal rights are appropriate solely for those Member States that no longer meet the convergence criteria, the threat to leave the Eurozone can only be used to extract concessions from other Member States if it is credible. In most cases, that is unlikely to be the case. After all, the economic and political costs of leaving the Eurozone are likely to be quite substantial.[171] Thus, even Member States who find themselves in difficult economic circumstances are unlikely to give serious consideration to the exit option unless their situation is truly desperate.

6. Letting a Good Crisis Go to Waste

One final, though fairly cynical, argument against a withdrawal right remains. One may argue that the sovereign-debt crisis is actually a welcome development in that it forces the Member States of the Eurozone to embark on what they would not

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169. *E.g.*, David Oakley & Peter Wise, *Portuguese Bonds Hit as Traders Fear Default*, FIN. TIMES, Jan. 26, 2012, at 35 (reporting that government bonds of Portugal and Greece were downgraded to junk-bond status).

170. Even Spain is now rapidly facing unusually high borrowing costs. *See* Stephen Castle, *Europeans Look at Plan to Cut Borrowing Costs*, N.Y. TIMES, June 21, 2012, at B6 (reporting that "Spain's 10-year bonds surpassed the 7 percent level, the highest rate for those bonds since the advent of the euro currency union").

171. *Cf.* Eichengreen, *supra* note 27, at 13 (noting that the political costs of abandoning the euro "are likely to be particularly serious"). Regarding the economic costs, Eichengreen argues that these would likely depend on the circumstances. *Id.* at 12–13.

otherwise have accomplished—namely the creation of a true fiscal union with a central authority in charge of fiscal policy. Based on this line of reasoning, the existence of a withdrawal right might be viewed as a liability, precisely because it reduces the economic and political pressure on the Eurozone and thereby makes the move towards a fiscal union less urgent.

This argument is not as outlandish as it may seem. There are certainly commentators who view the euro crisis as an opportunity for further integration.[172] Moreover, as a practical matter, it is true that the crisis has pushed the European Union somewhat closer to a fiscal union. The recent fiscal discipline pact is widely and correctly perceived as a step in that direction.[173] Furthermore, the institutions of the European Union are now reportedly working on plans to achieve a true fiscal union.[174] To the extent that a withdrawal would help end the euro crisis, it might dampen the incentives for further fiscal integration.

However, even setting aside the question of whether further political and fiscal integration is desirable as a matter of policy, the above line of reasoning seems far too speculative to be accorded much weight. In the long run, it is not clear how the sovereign-debt crisis will affect the prospects for further fiscal integration. It is indeed possible that the current crisis will pave the way towards further integration by making it clear that a common currency cannot function without a fiscal union. However, the opposite outcome is also conceivable. The continuous bailouts that the euro crisis has engendered have certainly made the voters of the economically stronger states wary of further transfer payments, and may thus have made a fiscal union much more difficult for voters to accept. And so, to the extent that a withdrawal right can help end the financial crisis and reduce the likelihood of further transfers—if only by facilitating an orderly exit for one or more of the PIIGS states—such an exit right may also serve the goal of further fiscal integration.

There is also another reason to believe that a withdrawal right could prove helpful to further fiscal integration. Thus, voters in the various Eurozone countries are more likely to accept fiscal integration if they know that there is a possible way out of the fiscal union. In sum, the argument that a withdrawal right might be an obstacle to further fiscal integration seems unpersuasive.

CONCLUSION

The legal policy case for granting the Member States a right to unilateral withdrawal from the European Union is strong. Moreover, regarding those Member States that no longer meet the requirements for being admitted to the Eurozone in the first place, there are no compelling doctrinal reasons to reject such a withdrawal right.

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172. *E.g.*, Manfred Schepers, *A Three-Pillar Plan to Underpin a New Fiscal Union*, FIN. TIMES, Nov. 24, 2011, at 7 (arguing that the sovereign-debt crisis is "a chance for radical and profound action" and suggesting that "Europe's leaders should seize this opportunity to put in place a permanent structure for eurozone governance").

173. *See, e.g.*, Brian Blackstone, *The Euro Crisis: Central Bank Keeps a Lid on Bond Buys: ECB's Approach Adds to Pressure on Euro-Zone Governments*, WALL ST. J., Nov. 29, 2011, at A12 (describing the call for the ECB to intervene to allow for more unity in the face of failing individual countries).

174. *EU plant eine echte Fiskalunion* [*EU Plans a True Fiscal Union*], SPIEGEL ONLINE (June 9, 2012), http://www.spiegel.de/wirtschaft/soziales/spiegel-eu-plan-fuer-eine-echte-fiskalunion-a-837949.html.

It follows that the TFEU should be interpreted accordingly: Member States that no longer meet the so-called convergence criteria should be allowed to withdraw from the Eurozone.

Obviously, reading the Treaty in this way will not, by itself, end the plight of the ailing Member States or secure the future of the Eurozone. However, in what is bound to be a long and unpleasant journey, such an interpretation would be at least a step in the right direction.

The Financial Stability Board: The New Politics of International Financial Regulation

STAVROS GADINIS*

Abstract

In response to the 2007–08 financial crisis, the G20 forged the Financial Stability Board, a new international body dedicated to promoting regulatory standards that best ensure the stability and soundness of the financial system. The FSB is an umbrella organization; its membership includes representatives from international standard-setters like the Basel Committee and the International Accounting Standards Board, alongside domestic regulators, such as central banks and representatives from national finance ministries and treasury departments. This Article argues that the participation of political appointees in the FSB sets it apart from other international bodies in financial regulation. Through the FSB, elected politicians can shape international financial regulation in ways not available to them in the past. This Article has identified three ways in which the G20 governments intervene in international financial regulation: through promoting specific amendments in international rulemakers' existing standards, setting entirely new policymaking initiatives, and intensifying efforts to monitor compliance with international rules at the domestic level. The Article offers extensive evidence from the interaction between the G20, the FSB, other international bodies, and domestic authorities.

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INTRODUCTION

In the ever-changing world of financial regulation, where new markets, new instruments, and new players continuously challenge established practices, few principles are as widely accepted as the need for independent regulators.[1] The financial system is thought to be best served by highly sophisticated technocrats, protected from the distorting influence of politics.[2] Yet, the 2007–08 financial crisis saw political leaders fighting to save fledgling financial institutions while burdening sovereign budgets with additional debt. When the crisis abated, legislative reforms around the world tightened banking supervision by creating many new regulatory powers. However, legislators granted these new powers not to independent agencies, as past regulatory paradigms would suggest, but to political leaders directly accountable to voters.[3] Effectively, politicians are now responsible for some of the most momentous decisions in a financial institution's life, such as whether it is in default or whether to extend credit to it. As a result, these reforms mark a clear departure from the paradigm of regulatory independence and have strengthened politicians' influence over financial regulation.

This Article claims that the growing influence of politicians over financial regulation characterizes not only domestic regulatory reforms, but international developments as well. In the midst of the 2007–08 financial crisis, as governments and central bankers were struggling to contain the turmoil, the Group of Twenty Finance Ministers and Central Bank Governors (G20) established a new entity, the Financial Stability Board (FSB). The FSB's core mission is to promote the regulatory standards that best ensure the stability and soundness of the financial system.[4] To achieve this mission, the G20 asked various international rulemakers, such as the Basel Committee and International Organization of Securities Commissions (IOSCO), to participate in a single board, the FSB.[5] Apart from

1. *See* Fabrizio Gilardi, *The Formal Independence of Regulators: A Comparison of 17 Countries and 7 Sectors*, 11 SWISS POL. SCI. REV. 139, 140 (2005) ("[T]he OECD recently described [independent regulatory agencies] as 'one of the most widespread institutions of modern regulatory governance' . . . .").

2. *See* Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 612 (2010) (discussing the view that keeping agencies independent from politics could promote expertise and improve problems).

3. *See* Stavros Gadinis, *From Independence to Politics in Banking Regulation*, 100 CALIF. L. REV. (forthcoming Apr. 2013) (claiming there has been a "shift away from regulatory independence and towards greater political involvement in post-crisis banking regulation around the world").

4. *Mandate*, FIN. STABILITY BD., http://www.financialstabilityboard.org/about/mandate.htm (last visited Aug. 24, 2012).

5. Chris Brummer, *Origins of the Financial Crisis and International/National Responses: An Overview*, 104 AM. SOC'Y INT'L L. PROC. 435, 436 (2010) [hereinafter *Origins of the Financial Crisis*]; *see*

international rulemakers, the FSB also includes domestic decision makers mostly from G20 countries: independent regulators, such as central bankers and securities commissioners, as well as representatives of elected politicians, such as finance ministers.[6] Thus, the FSB's reach spans multiple areas of financial activities and covers some of the most important regulatory players globally.

How does the establishment of the FSB affect international financial regulation? Some academic commentators underlined the FSB's potential to better coordinate the initiatives of its participants, who had previously operated largely independent of one another.[7] According to this account, the G20 and the FSB act as "executive coordinators" who can rally the troops to better confront complex problems, often involving multiple countries and multiple types of financial activity.[8] Others doubted whether the FSB's efforts bring real change to financial laws on the ground, since the FSB lacks any formal, binding authority on its participants.[9]

This Article argues that both proponents and critics of the FSB seem to underestimate one of its key attributes: its deeply political character. What sets the FSB apart from other international finance rulemakers is the direct participation of political leaders either elected by voters or immediately accountable to elected officials. Finance ministers and treasury secretaries constitute about one quarter of the FSB's Plenary, a significant bloc in an organization operating on the basis of consensus.[10] This strong relationship between the G20 and the FSB—between elected governments and independent financial regulators—determines the FSB's priorities, the intensity of its implementation efforts, and its ultimate effectiveness. Through the FSB, elected politicians can shape international financial rulemaking in

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also G20, *Declaration on Strengthening the Financial System*, at 1 (Apr. 2, 2009) [hereinafter *Declaration*] (detailing the establishment of the FSB by the G20).

6. *Origins of the Financial Crisis*, *supra* note 5, at 436–37.

7. *See* Sungjoon Cho & Claire R. Kelly, *Promises and Perils of New Global Governance: A Case of the G20*, 12 CHI. J. INT'L L. 491, 527 (2012) (discussing the FSB's role as a coordinator amongst various financial networks); Enrique R. Carrasco, *The Global Financial Crisis and the Financial Stability Forum: The Awakening and Transformation of an International Body*, 19 TRANSNAT'L L. & CONTEMP. PROBS. 203, 217 (2010) (discussing how the FSB was founded to "more effectively assist and collaborate with national authorities, standard setting bodies (SSBs) and international financial institutions in addressing vulnerabilities and implementing strong regulatory, supervisory, and other policies in the interest of financial stability"); *Origins of the Financial Crisis*, *supra* note 5, at 437 ("[The FSB] has helped set the basis for deeper coordination in the future between supervisory agencies, central banks, finance ministries, and political elites."); Robert B. Ahdieh, *Imperfect Alternatives: Networks, Salience, and Institutional Design in Financial Crises*, 79 U. CIN. L. REV. 527, 548 (2010) (evaluating how the transition to the FSB "increased [the] ability to serve the coordination functions necessary for financial stability").

8. *See* Cho & Kelly, *supra* note 7, at 493 (discussing the G20's unprecedented role as an "executive coordinator over pre-existing transgovernmental regulatory networks (TRNs)").

9. *See* Douglas W. Arner & Michael W. Taylor, *The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?* 12–13 (Asian Inst. Of Int'l Fin. Law, Univ. of H.K., Working Paper No. 6, 2009) (discussing future FSB reforms aimed at creating an "enforcement mechanism" that goes beyond the current voluntary system); Bessma Momani, *The IMF and the FSB: Intractable Political Reality and Organizational Mismatch*, *in* THE FINANCIAL STABILITY BOARD: AN EFFECTIVE FOURTH PILLAR OF GLOBAL ECONOMIC GOVERNANCE? 36, 38 (Stephany Griffith-Jones et al. eds., 2010), *available at* http://www.cigionline.org/sites/default/files/FSB%20special%20report_2.pdf (discussing how the FSB does not have "the power to challenge a country's sovereignty" and must "remain dependent on moral suasion").

10. *See Members of the Financial Stability Board*, FIN. STABILITY BD., *available at* http://www.financialstabilityboard.org/about/plenary.pdf (last updated Jan. 21, 2013) (listing current members of the FSB and their representatives, including finance ministers and treasury secretaries).

ways not available to them in the past. This Article argues that there are three main ways in which the G20 governments intervene in international financial regulation: through promoting specific amendments in international rulemakers' existing standards, through setting entirely new policymaking initiatives, and through intensifying efforts to monitor compliance with international rules at the domestic level.

A key element of the G20/FSB program consists in proposing specific amendments to prevalent international standards. For example, the G20 promoted the amendment of the capital adequacy rules so as to include a leverage ratio, previously required only in the United States and Canada.[11] Similarly, the FSB introduced specific proposals for accounting rules, to be incorporated in the long-standing convergence effort between the two main global standard-setters, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).[12]

The FSB has also begun implementing G20 calls for entirely new regulations, typically by assigning one or more of its participant international rulemakers to the task. Primary examples of FSB-led reforms include two of the most important initiatives emanating directly from the 2007–08 financial crisis: the global regulatory framework for systemically important financial institutions and the new standards on over-the-counter derivatives markets.[13] In both cases, the FSB created working groups, including various independent international rulemakers, provided them with guidance, and monitored their progress.[14]

Besides proposing new directions for standard setting, the FSB has also redoubled efforts to ensure the domestic implementation of these standards by adopting measures that increase peer pressure among jurisdictions to comply.[15] Responding to a G20 request, the FSB introduced a peer review program, which subjects an FSB member's financial regulatory system to review by a team that includes regulatory officials from other FSB member countries.[16] The resulting report becomes publicly available in an effort to have FSB member jurisdictions "lead by example."[17] Involving one country's regulatory officials in assessing another country's system is a delicate proposition, which arguably requires political backing.

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11. Katia D'Hulster, *The Leverage Ratio: A New Binding Limit on Banks*, CRISIS RESPONSE NOTE NO. 11, 1–2 (Dec. 2009), *available at* http://rru.worldbank.org/documents/CrisisResponse/Note11.pdf.

12. Fin. Stability Bd., *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, at 21–22 (June 19, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120619a.pdf.

13. Fin. Stability Bd., *Policy Measures to Address Systemically Important Financial Institutions*, at 1 (Nov. 4, 2011), *available at* www.financialstabilityboard.org/publications/r_111104bb.pdf; Fin. Stability Bd., *Implementing OTC Derivatives Market Reforms*, at 1 (Oct. 25, 2010) [hereinafter *OTC Derivatives Market Reforms*], *available at* http://www.financialstabilityboard.org/publications/r_101025.pdf.

14. Fin. Stability Bd., *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, at 6 (June 18, 2010) [hereinafter *G20 Recommendations (2010)*], *available at* http://www.financialstabilityboard.org/publications/r_100627c.pdf; Fin. Stability Bd., *Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, at 2 (Apr. 10, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110415a.pdf.

15. Fin. Stability Bd., *FSB Framework for Strengthening Adherence to International Standards*, at 1 (Jan. 9, 2010) [hereinafter *Strengthening Adherence*], *available at* http://www.financialstabilityboard.org/publications/r_100109a.pdf.

16. *Id.* at 2.

17. *Id.*

The peer review program expands the FSB's reach beyond the agenda of a regulatory network towards a more holistic approach to international financial regulation.

These FSB activities show the increased interest that political leaders are showing toward financial regulation. Because of its inherently political nature, this development represents a reevaluation of the earlier paradigm; whereas in the past, independent regulators were left to their own devices, they must now operate under close surveillance by political superiors. While recognizing the value of past regulatory efforts and the technical expertise and capabilities of independent rulemakers, governments around the world want to steer these rulemakers' efforts towards certain goals, oversee their progress, and intervene where necessary. In the past, international meetings at the heads-of-state level had little to say about financial regulation; after the 2007–08 financial crisis, these meetings show interest in measures as technical as accounting standards.

The Article proceeds as follows. Part I outlines briefly the highly decentralized mode of rulemaking in international finance, fragmented along sectorial, national, and professional lines. Part II argues that the composition of the FSB, which brings diverse international and domestic decision-makers together under the watch of G20 finance ministers, emphasizes the FSB's political underpinnings. Part III traces political influence on some of the most important initiatives of the FSB in the last few years, by highlighting connections with the G20. It shows that the G20's frequent and critical interventions constitute a stark departure from the paradigm of networks of independent regulators that was prevalent in international financial regulation in the last few decades.

I. INDEPENDENT INTERNATIONAL RULEMAKERS IN FINANCIAL REGULATION

International financial regulation famously lacks a central international organization, similar to the World Trade Organization, to launch regulatory initiatives, streamline governmental negotiations, and resolve any arising inter-governmental disputes.[18] In the absence of international commitments, each jurisdiction retains full domestic policymaking capacity; however, efforts to harmonize, or at least to coordinate, regulatory policies have found increasing success in the last two decades.[19] These efforts typically center on sets of standards covering specific areas of regulatory interest, such as capital adequacy, accounting, or disclosure obligations. While these standards do not generate any legally-binding obligation for compliance by domestic legislators, many governments willingly adopted them as part of their domestic laws.[20] As a result, these standards gained the moniker of "soft law" among legal academics.[21]

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18. *See* CHRIS BRUMMER, SOFT LAW AND THE GLOBAL FINANCIAL SYSTEM: RULE MAKING IN THE 21ST CENTURY 61 (2012) (discussing how the production of rules and standards in the international financial system arises through informal institutional arrangements with non-binding bylaws and charters).

19. *See* DAVID ANDREW SINGER, REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM 21 (2007) (noting the attractiveness of international regulatory harmonization to financial regulators because it allows them to strike a balance between stability and competitiveness domestically).

20. *See* Stavros Gadinis, *The Politics of Competition in International Financial Regulation*, 49 HARV.

How do these standards come to life? Often, soft law instruments are the product of so-called transnational regulatory networks (i.e., meetings between independent regulators from various states who agree to a common set of standards on a specific topic).[22] The priorities, choices, and implementation strategies of these networks reflect the preferences of the participating regulatory officials, with very little input from their elected governments. In other cases, global standards originate in non-state entities whose membership includes prominent professionals, such as the IASB,[23] or key industry participants, such as the International Swaps and Derivative Association (ISDA).[24] These private standard-setters are free to set their own course, regardless of the preferences of various governments. Finally, standards and policies produced by powerful domestic regulators can also be influential internationally, even though they do not result from any negotiation between governments. Overall, then, international financial regulation is the premise of decentralized rulemaking, which takes place away from the central political stage, with regulatory agencies and market participants in the key roles.

According to leading academic accounts, the insulation of international financial regulation from politics has a plethora of advantages in addressing global challenges. The soft law model invites participation from multiple countries, multiple levels of policymakers, and multiple market players, sidestepping concerns about the feasibility and legitimacy of a world government.[25] Moreover, soft law instruments benefit from the collective knowledge of industry experts. Transnational regulatory networks rely on independent agencies from around the world, which focus on technical regulatory priorities rather than political agendas.[26] Private firms

INT'L L.J. 447, 449–50 (2008) [hereinafter *The Politics of Competition*] ("In finance, as in other fields, governments adopt regulatory reforms to satisfy the demands of their constituencies.").

21. *See, e.g.*, Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257, 261 (2010–11) (describing how international financial regulation has a "soft law" quality since international financial rules are promulgated through non-binding agreements).

22. *See* Anne-Marie Slaughter, *International Law in a World of Liberal States*, 6 EUR. J. INT'L L. 503, 518 (1995) (addressing the generation of transnational voluntary norms that govern transnational networks); David Zaring, *Rulemaking and Adjudication in International Law*, 46 COLUM. J. TRANSNAT'L L. 563, 576 (2007–08) (discussing how international regulators initially create broad general principles and then attempt to harmonize substantive regulatory practices through harder rules or best practices).

23. *See* Andreas M. Fleckner, *FASB and IASB: Dependence Despite Independence*, 3 VA. L. & BUS. REV. 275, 277, 283 (2008) (detailing how policymakers rely on private entities such as the IASB, whose members include accountants, businesspeople, financial analysts, and academics, to set financial accounting and reporting standards); *The Politics of Competition*, *supra* note 20, at 478 (describing the IASB as not being formally attached to any particular jurisdiction).

24. *See* Anna Gelpern, *Commentary, Contracts as Organizations*, 51 ARIZ. L. REV. 57, 60, 63 (2009) (defining the ISDA as a private trade group with members worldwide, including service providers, large financial intuitions, commercial banks, etc.).

25. *See* ANNE-MARIE SLAUGHTER, A NEW WORLD ORDER 4–7 (2004) (discussing government networks as a means to accomplish the soft law model, which can achieve the functions of a world government by, for example, connecting foreign officials and creating multinational support systems, without sovereign states losing their domestic authority).

26. *See* Kal Raustiala, *The Architecture of International Cooperation: Transgovernmental Networks and the Future of International Law*, 43 VA. J. INT'L L. 1, 24 (2002) ("[P]olitical deference to agency actions in international affairs appears justified by a sense that the issues are narrowly technical . . . rather than broadly political . . . ."); David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT'L L. J. 281, 282 (1998) ("The regulatory cooperation studied here—involving banking, securities, and insurance regulators—is not the product of state arrangement, but of international agreement among domestic regulatory agencies that claim to be working for themselves, rather than for their governments.").

and professional associations bring to the policymaking table their deep understanding of market mechanisms and outcomes. As critics were quick to point out, these favorable portrayals of decentralized policymakers reflect the dominant ideology of the last two decades, which prioritized technical expertise but ignored experts' biased perspectives.[27] However, international financial regulation faces many dilemmas that present distributional consequences, which technical experts alone are ill-equipped to address.[28] Regardless of these criticisms and limitations, soft law instruments have become the prevailing regulatory paradigm in international financial regulation over the last twenty years.

The 2007–08 financial crisis—which saw giant financial institutions around the world collapsing in days, retail deposits being threatened, and sovereign debtors facing bankruptcy—revealed major weaknesses in the regulatory framework of the global financial sector. To fight financial turmoil of tremendous proportions, the governments of the most important financial markets in the world convened as the G20.[29] Together, they launched the first serious attempt to bring some order to the decentralized policymaking sphere of international finance by creating a new international body: the FSB.[30] The FSB is an umbrella organization that comprises the diverse players active in international financial policymaking—international institutions, regulatory networks, private associations, and domestic regulators.[31] In addition to these bodies, the FSB also has representatives from all G20 governments—including finance ministers and treasury secretaries.[32] The FSB's mandate is not to overhaul existing rulemakers but to coordinate their actions and remedy any gaps arising from their separate missions.[33]

Will the FSB alter the profile of international financial regulation? This question has sparked a heated debate among academic commentators. Some welcomed the G20's choice to "leverage" prior standards and saw the G20/FSB arrangement as creating an "executive coordinator over pre-existing transgovernmental regulatory networks."[34] In this light, the FSB formalizes and invigorates long-standing G20 efforts to coordinate regulatory networks. Although governments had tried in the past to achieve this coordination through the issue of

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27. *See* Philip Alston, *The Myopia of the Handmaidens: International Lawyers and Globalization*, 8 EUR. J. INT'L L. 435, 441 (1997) (discussing the disturbing nature of the theory that a global agenda should be set and implemented by "special interest groups"); David Kennedy, *The Politics of the Invisible College: International Governance and the Politics of Expertise*, 5 EUR. HUM. RTS L. REV. 463, 471 (2001) (describing how international policy professionals leave national politics behind and "think in terms of 'best practices,' practical necessity, [and] efficiency"); Sol Picciotto, *Networks in International Economic Integration: Fragmented States and the Dilemmas of Neo-Liberalism*, 17 NW. J. INT'L L. & BUS. 1014, 1036 (1996–97) (discussing the growth of international networks made up of both private and social actors, such as academics, professionals, scientific experts, etc., in which issues are increasingly resolved without direction from the state and national interest).

28. Pierre-Hugues Verdier, *Transnational Regulatory Networks and Their Limits*, 34 YALE J. INT'L L. 113, 115 (2009).

29. Cho & Kelly, *supra* note 7, at 516–17.

30. *Id.* at 521.

31. *Origins of the Financial Crisis*, *supra* note 5, at 436; *FSB Member Institutions*, FIN. STABILITY BD., http://www.financialstabilityboard.org/about/fsb_members.htm (last visited Oct. 27, 2012).

32. *Origins of the Financial Crisis*, *supra* note 5, at 436–37.

33. *Mandate*, *supra* note 4.

34. Cho & Kelly, *supra* note 7, at 493, 495.

non-binding "blueprints" or "frameworks,"[35] they had not been very successful.[36] Instead, this "network of networks" proved essential in addressing the 2007–08 financial crisis, which spanned many different aspects of the financial system at once.[37] Others emphasized that the FSB's wide membership ensures that emerging economies' voices will also be heard, and thus signals greater cross-border commitment to comply with FSB decisions.[38] Still others praised the increased salience of the FSB's actions, resulting from the increased transparency of its governance structure.[39]

Other commentators were more reluctant to see the FSB's impact in international financial regulation. After all, the FSB does not have any legally-binding powers and still relies heavily on the same tools that pre-crisis rulemakers used, such as soft law instruments and peer pressure.[40] As a result, the FSB lacks any meaningful means to hold its members accountable if they violate their promises to comply.[41] Even in terms of soft-law instruments, some critics viewed the FSB's agenda as incomplete, complaining that it prioritized certain weaknesses underlined by the 2007–08 financial crisis but avoided others,[42] and lacked a mechanism for revising its agenda to adjust to future challenges.[43]

II. FSB: INSTITUTIONAL STRUCTURE

As an organization that brings together international standard-setters with domestic government executives and independent regulators, the FSB borrows the

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35. *Id.* at 504–06.

36. *See* Carrasco, *supra* note 7, at 207 (stating that the Financial Stability Forum's work was initially underwhelming in addressing problems in the financial regulatory system).

37. *Origins of the Financial Crisis*, *supra* note 5, at 436–37.

38. Mario Giovanoli, *The Reform of the International Financial Architecture After the Global Crisis*, 42 N.Y.U. J. INT'L L. & POL. 81, 111 (2009); *see also* Pierre L. Siklos, *The FSB: Where Do We Go From Here?*, *in* THE FINANCIAL STABILITY BOARD: AN EFFECTIVE FOURTH PILLAR OF GLOBAL ECONOMIC GOVERNANCE?, *supra* note 9, at 57, 58 (stating that "several economies have emerged as powerful players . . . to challenge the 'old' economic powers," and that those economies hold their positions in part because they "agree[d] on several aspects of . . . a desirable economic policy strategy").

39. *See* Robert B. Ahdieh, *Imperfect Alternatives: Networks, Salience, and Institutional Design in Financial Crises*, 79 U. CIN. L. REV. 527, 548–50 (2010) (citing the institutional design changes of the FSB, such as the appointment of a secretary-general, the mandate for balanced representation on the steering committee, and the adoption of a formal charter, as factors increasing the organization's salience and legitimacy).

40. Arner & Taylor, *supra* note 9, at 14; Momani, *supra* note 9, at 38.

41. *See* Domenico Lombardi, *The Governance of the Financial Stability Board*, BROOKINGS INSTITUTION ISSUES PAPER 6 (Sept. 2011) (stating the FSB lacks "any formal power" and that it implements decisions through peer pressure rather than through the enforcement of legal obligations).

42. *See* Cally Jordan, *Does 'F' stand for Failure: The Legacy of the Financial Stability Forum* 28 (Melbourne Law Sch., Legal Studies Research Paper No. 429, 2009), http://ssrn.com/abstract=1478527 (arguing that while the FSB attempts to reform the financial system through tasks such as conducting "early warning exercises" and implementing "regulatory standards," it has failed to "adequately address issues associated with the capital markets, the instrument of propagation of systemic risk on a transnational scale").

43. *See* Douglas W. Arner, *Adaptation and Resilience in Global Financial Regulation*, 89 N.C. L. REV. 1579, 1626 (2011) (contending that the FSB's agenda "largely parallels the agreed causes of the global financial crisis and the necessary elements of regulation to address systemic risk," but that the FSB has not yet successfully established the "core elements of a new financial regulatory framework," and has thus not yet established future resilience).

membership setup of an earlier institution, the Financial Stability Forum (FSF). More specifically, the international bodies that participated in the FSF included the Basel Committee on Banking Supervision, the IASB, and the IOSCO, along with the International Monetary Fund (IMF) and the World Bank.[44] In terms of domestic policymakers, the FSF initially included finance ministers, central bank governors, and heads of key financial regulators from the G7 countries (Canada, France, Germany, Italy, Japan, the U.S., and the U.K.).[45] Australia, Hong Kong, the Netherlands, and Switzerland, along with the recently established European Central Bank (ECB), joined the FSF at a later date.[46]

The FSF's mission was ambitious, but its parameters were vague and evasive. Back in 1999, the G7 governments asked the FSF to assess the vulnerabilities of the financial system, identify and coordinate action to address these vulnerabilities, and promote coordination and information exchange among authorities responsible for financial stability.[47] However, this mandate lacked direction regarding any means available to the FSF or any concrete deliverables that would satisfy the mandate's general objectives.[48]

By 2008, governments around the world had decided to assign to the FSB many tasks that go beyond generally-expressed objectives. Thus, the FSB must "advise on and monitor best practice in meeting regulatory standards,"[49] assuming a direct role in assessing how various countries implement global rules in their domestic legal order. Moreover, the FSB must "undertake joint strategic reviews of the policy development work of the international standard setting bodies."[50] This represents a coordinated effort by political leaders around the world to influence the agenda of global rulemakers that they do not control directly. Other parts of the FSB's mandate provide it with even more concrete responsibilities, such as "set[ting] guidelines for and support[ing] the establishment of supervisory colleges"[51] and "support[ing] contingency planning for cross-border crisis management, particularly with respect to systemically important firms."[52] In this way, the FSB can influence the handling of a crisis by domestic regulators.

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44. Carrasco, *supra* note 7, at 206. There were other international organizations that were also members of the FSF, such as the Bank for International Settlements (BIS), the Organization for Economic Cooperation and Development (OECD), the International Association of Insurance Supervisors (IAIS), the Committee on Payment and Settlement Systems (CPSS), and the Committee on the Global Financial System (CGFS). *Id.* For a full discussion of the FSF membership and development, see *id.* at 204–08.

45. *Id.* at 206; Cho & Kelly, *supra* note 7, at 516.

46. Carrasco, *supra* note 7, at 206.

47. *Id.* at 205–06.

48. *See Origins of the Financial Crisis*, *supra* note 5, at 436–37 (chronicling the FSF's transition from an organization with no mandate to generate standards to an organization, renamed the FSB, with the mandate to "monitor global financial stability and promote medium-term reform"); Carrasco, *supra* note 7, at 207–08 (explaining that the standards the FSF implemented prior to the 2007–08 financial crisis often contained inconsistencies, were not transparent, and produced no effective results due to the FSF lacking any means to ensure adherence).

49. Fin. Stability Bd. Charter § I, art. 2(1)(d) [hereinafter Charter], *available at* http://www.financialstabilityboard.org/publications/r_090925d.pdf.

50. *Id.* § I, art. 2(1)(e).

51. *Id.* § I, art. 2(1)(f).

52. *Id.* § I, art. 2(1)(g).

How can the FSB achieve these objectives? Compared to its predecessor, the FSB has two main institutional advantages: an expanded membership and a tighter governance structure. The FSB's membership has expanded to include representatives from all G20 countries and Spain.[53] Emerging economies such as China, India, and Brazil are now part of a global coordinated effort on financial regulation.[54] Moreover, the FSB now counts among its members the European Commission, the jurisdictional reach of which extends well beyond that of the E.U. Member States that are also part of the G20.[55] As a result, the FSB now offers a negotiation forum for a wider set of interests.[56]

The governance structure of the FSB establishes a series of institutional mechanisms that distinguish between setting high-level objectives and pursuing policy reforms on the ground, thus allowing the FSB to be more effective. These institutional mechanisms give politicians a significant role in shaping the reform agenda and determining the priorities of international standard-setters. The FSB Charter accomplishes this goal through two main FSB organs: the Plenary and the Steering Committee.

The Plenary is the central organ of the FSB and the one in which political appointees—finance ministry officials—have the most distinct presence.[57] The Plenary is a meeting of all FSB members that convenes at least twice a year.[58] While most standard-setting bodies and international organizations have one or two seats at the Plenary, individual countries have up to three seats, which reflect the size of their national economy and financial sector.[59] Countries with three seats are represented by their banking regulator (in the U.S. case, the representative of the Federal Reserve), their finance minister (in the U.S. case, the representative of the U.S. Treasury), and their securities regulator (in the U.S. case, the representative of the Securities and Exchange Commission (SEC)).[60] Countries with two seats are represented by their banking regulator and their finance minister, while countries with one seat participate only with their banking regulator.[61] In total, eighteen out of seventy Plenary members are political appointees.[62] Arguably, these eighteen politicians are the most important component of the FSB Plenary, as the remaining members—the independent central bankers and securities regulators—regularly

53. Lombardi, *supra* note 41, at 5.

54. Charter, *supra* note 49, Annex A.

55. *Id.*; Lombardi, *supra* note 41, at 5; *About the European Commission*, EUROPEAN COMMISSION, http://ec.europa.eu/about/index_en.htm (last updated Oct. 11, 2012).

56. *See* Lombardi, *supra* note 41, at 5, 9 (discussing the wider membership process of the FSB in comparison with that of the FSF, thus fulfilling one of the FSB's original objectives).

57. Charter, *supra* note 49, § III, arts. 7(1), 8(1).

58. *Id.* § III, arts. 8(2), 9(1).

59. *Id.* § III, art. 10(1); *see generally Members of the Financial Stability Board*, *supra* note 10 (listing current FSB members, including countries, standard-setting bodies, international organizations, and their representatives).

60. Charter, *supra* note 49, § III, art. 8(1); *Members of the Financial Stability Board*, *supra* note 10, at 4.

61. *See Members of the Financial Stability Board*, *supra* note 10, at 1 (listing the member countries of the FSB along with their representatives, such as Australia, which has two representatives, one from its reserve bank and one from the treasury, and Argentina, which has one representative from the country's central bank).

62. *See id.* (counting as political appointees all members that work for a ministry or treasury, which totals fifteen, plus the heads of monetary authorities in authoritarian regimes—Hong Kong, Singapore, and Saudi Arabia).

meet in other forums, such as the Basel Committee or IOSCO,[63] without the participation of any political appointee. Thus, it is the presence of the politicians that distinguishes the FSB from the other international bodies in financial regulation.

The importance of politicians' presence through the Plenary becomes clear once one considers the wide span of the Plenary's powers. According to the FSB's charter, the Plenary is the FSB's main decision-making authority; it "adopts reports, principles, standards, recommendations and [other] guidance ... appoints the Chairperson," and generally holds the ultimate responsibility for any matter concerning the FSB.[64] Moreover, the Plenary reaches decisions by consensus.[65] As a result, any international standard-setter who wishes to gain the FSB's seal of approval must now convince the G20 governments about the value of its proposed regulatory framework. More importantly, the Plenary is not simply a passive international body, waiting around for the various international standard-setters to submit their newly minted rules for evaluation. Rather, the FSB is proactive; it often asks international standard-setters to develop rules in a specific direction, either in response to a G20 request or of its own initiative.[66] In subsequent meetings, the Plenary can easily assess the progress of such initiatives, as the most important international standard-setters are themselves Plenary members.

Overall then, the composition and powers of the Plenary allow politicians to gather first-hand information about how international standard-setters are rethinking their rules and how individual countries are implementing these rules. This information is useful because it allows politicians to understand the content of international rules and the risks that other countries pose to the global financial system. However, it also allows politicians to intervene in these standard-setters' work. The FSB can express G20 governments' desire to attain a certain objective, underline the importance of previously-overlooked regulatory goals, and push for a more timely regulatory solution to a pressing problem. As FSB members, the international standard-setters are on notice—governments are watching over their shoulders.

This continuous information gathering might also help build a sense of accountability and commitment to a common cause as standard-setters and individual states present their progress or their setbacks to the Plenary. Formally, FSB member states are under no legal obligation to comply with FSB decisions, for example, by adopting FSB-proposed standards.[67] However, FSB members recognize

63. *See Fact Sheet—Basel Committee on Banking Supervision*, BANK FOR INT'L SETTLEMENTS, http://www.bis.org/about/factbcbs.htm (last visited Sept. 11, 2012) (detailing the membership of the Basel Committee, which includes "[s]enior officials responsible for banking supervision or financial stability issues"); *Ordinary Members of IOSCO*, OICV-IOSCO (2012), http://www.iosco.org/lists/display_members.cfm?memID=1&orderBy=none (listing the members of the IOSCO).

64. Charter, *supra* note 49, § III, art. 7(3)(c), (e), (g).

65. *Id.* § III, art. 7(2).

66. Andrew Baker, *Mandate, Accountability and Decision Making Issues to be Faced by the FSB, in* THE FINANCIAL STABILITY BOARD: AN EFFECTIVE FOURTH PILLAR OF GLOBAL ECONOMIC GOVERNANCE?, *supra* note 9, at 19, 20.

67. *See* Legal & Monetary & Capital Mkts. Dep'ts of the Int'l Monetary Fund (IMF), *IMF Membership in the Financial Stability Board*, at 3, 6 (Aug. 10, 2010) [hereinafter *IMF Membership*], *available at* http://www.imf.org/external/np/pp/eng/2010/081010.pdf ("The FSB Charter is an informal and non-binding 'memorandum of understanding' for cooperation adopted by its 'members'" that "incorporates the possibility for the FSB to make recommendations to its members on policy issues" and

that non-binding legal rules can be hugely influential and that participation with the FSB increases peer pressure "to align domestic policies with the views of the consensus."[68] By providing information to other governments about each member's progress in implementing commonly agreed upon regulatory standards, the FSB institutionalizes peer pressure at a level that non-governmental regulators could not reach.

In implementing its decisions, the Plenary gets significant support from the Steering Committee, as well as additional ad hoc committees that it can create. The Steering Committee includes participants from all member states and international standard-setters, all at a seniority level equal or lower than that of the Plenary.[69] Some countries participate in the Steering Committee only with their central banks, while others include finance ministry representatives.[70] The Steering Committee meets more often than the Plenary (at least four times a year) and takes steps necessary to move forward with the implementation of the Plenary's decisions.[71] For example, the Steering Committee monitors the progress of the international standard-setters in implementing the Plenary's recommendations and provides related information to FSB members.[72] Through its preparatory work for FSB meetings, the Steering Committee can influence decision-making at the Plenary.[73] Also, the Steering Committee supervises the work of other committees and working groups set up by the Plenary.[74] Chief among these are the Standing Committee on Standards Implementation, the Standing Committee on Assessment of Vulnerabilities, and the Standing Committee on Regulatory Cooperation.[75] This governance structure is designed to help the FSB establish a strong presence in the international financial architecture and see that other international bodies follow the FSB's directions and guidance.[76]

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allows the FSB to "advise[] on the implications of market developments for regulatory policy . . . .").

68. *Id.* at 6. For a discussion on the pressure emanating from the adoption of a policy by other countries and from the recommendations of international organizations, see Katerina Linos, *Diffusion Through Democracy*, 55 AM. J. POL. SCI. 678 (2011) (arguing that information about these adoptions helps gain voter support for reforms); Ryan Goodman and Derek Jinks, *How to Influence States: Socialization and International Human Rights Law*, 54 DUKE L.J. 621 (2004) (arguing that countries become acculturated into certain norms).

69. *See FSB Steering Committee*, FIN. STABILITY BD. (Sept. 28, 2012), http://www.financialstabilityboard.org/about/steeringcommittee.pdf (listing all members of the Steering Committee and designating their seniority by providing their positions and home countries).

70. *Id.*

71. Charter, *supra* note 49, § III, arts. 9(1), 13(1)–(2).

72. *Id.* § III, art. 13(4)(a), (c).

73. *See* Lombardi, *supra* note 41, at 11–13 ("Although the Plenary is the formal decisionmaking body, in practice, the Steering Committee plays a very influential role . . . [It] shapes and in effect manages the FSB's agenda.").

74. *Id.* at 11.

75. *Id.* at 10.

76. *Overview*, FIN. STABILITY BD., http://www.financialstabilityboard.org/about/overview.htm (last visited May 24, 2012). Just like the FSF, the FSB also has a small permanent secretariat, hosted by the Bank of International Settlements (BIS) in Basel, Switzerland. *Id.* Staff are either paid by the BIS or are on loan from another international organization (such as the IMF or the World Bank). *IMF Membership*, *supra* note 67, at 5–6.

III. FSB'S RELATIONSHIP WITH THE G20

In redesigning the FSB's mission and governance structure, the G20 envisaged it as the institutional mechanism that would shape international financial regulation according to G20 decisions.[77] Through the FSB, the G20 reclaims for national governments some of the policymaking ground previously left to networks of independent regulators and private industry associations. However, the FSB does not replace pre-crisis regulatory networks; rather, it orchestrates their actions and directs their initiatives towards objectives determined by political leaders.[78]

The G20 achieves these goals by assigning various missions to the FSB. In some instances, G20 governments are looking to introduce reforms in standards already established by international rulemakers, such as the Basel capital adequacy rules.[79] In this case, the FSB focuses on monitoring rulemakers' progress and suggesting directions they can take. In other instances, the G20 might be looking to create a new regulatory framework, perhaps because it has identified a gap in pre-existing standards, or because it intends to coordinate government action more closely. Once the G20 wants to initiate a policymaking effort in a specific area, the FSB carries forward the implementation.[80] It typically sets up a special preparatory committee, enlists the help of one or more of its participating regulatory networks (such as the Basel Committee or IOSCO), provides input during the drafting stage, and monitors its progress.[81] Finally, the G20 recognized that to build robust financial systems across borders, not only does it have to endorse global standards, but it should also ensure that domestic regulators implement these standards.[82] Thus, the FSB heads efforts to examine whether governments actually implement these standards domestically.[83]

In carrying forward its mission, the FSB interacts regularly with the G20. The G20 receives regular reports from the FSB regarding developments in international

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77. *See* Lombardi, *supra* note 41, at 5 (discussing how the FSB, which was established to promote financial stability, had a stronger institutional basis than the FSF and was made accountable to G20 leaders).

78. *See* Stephany Griffith-Jones, Eric Helleiner & Ngaire Woods, *Introduction*, *in* THE FINANCIAL STABILITY BOARD: AN EFFECTIVE FOURTH PILLAR OF GLOBAL ECONOMIC GOVERNANCE?, *supra* note 9, at 6, 6–7 (detailing the FSB's responsibilities as a coordinator which reports to the G20 and orchestrates the work of national financial authorities and international standard-setting bodies).

79. *See* Basel Comm. on Banking Supervision, *Progress Report on Basel III Implementation*, at 2–5, 8 (Oct. 2012), *available at* http://www.bis.org/publ/bcbs232.pdf (stating that G20 governments asked jurisdictions to implement Basel III, which enhances the regulatory framework of Basel II and Basel 2.5 that has already been established in multiple jurisdictions).

80. *See, e.g.*, Cho & Kelly, *supra* note 7, at 527, 540 (discussing how, during the 2007–08 financial crisis, the G20 instructed the FSB to coordinate exit strategies for bailout plans and to urge the United States and the European Union to resolve inconsistencies among their CRA regulations).

81. *See* Charter, *supra* note 49, § III, art. 11 (detailing the ability to establish committees to support its missions); *e.g.*, *infra* text accompanying notes 96–99 (discussing the FSB's monitoring of efforts by international rulemakers concerning the convergence of accounting standards).

82. *See Declaration*, *supra* note 5, at 1 (discussing the G20's principles of "strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international cooperation" and how the G20 is establishing the FSB to "pursue the maintenance of financial stability . . . and implement international financial standards"); Charter, *supra* note 49, § I, art. 2(1)(d) ("As part of its mandate, the FSB will . . . monitor best practice in meeting regulatory standards.").

83. Fin. Stability Bd., *Improving Financial Regulation*, 12 (Sept. 25, 2009) [hereinafter *Improving Financial Regulation*], *available at* http://www.financialstabilityboard.org/publications/r_090925b.pdf.

financial regulation. The FSB also submits full progress reports to the G20, typically twice a year.[84] In the interim, the FSB Chairman often submits letters to the G20, informing it of any developments.[85] This common interaction with the G20 is a key characteristic of the period after 2008, which marked the transition from the FSF to the FSB. Indeed, such interactions between the G20 and the FSF were much more rare before 2008.[86] The FSB also takes part in G20 summits, where leaders have created a special Finance Track.[87]

The paragraphs below outline briefly some of the most important initiatives the FSB has undertaken since its establishment. While the discussion below is not exhaustive, it showcases the various modes of cooperation between the FSB and other international rulemakers, domestic regulators, national governments, and the G20.

A. *FSB Action Concerning Pre-existing Sets of Standards*

The 2007–08 financial crisis revealed significant weaknesses in many banks' risk profile assessment and capital reserves. Thus, the revision of the Basel Committee's capital adequacy framework is one of the centerpieces of post-crisis reforms. Since its inception, the FSB has worked with the Basel Committee towards revising these standards. In its first report to the G20, the FSB described its cooperation with the Basel Committee and highlighted the directions in which they have agreed to act.[88] They decided to increase minimum capital requirements over time and to harmonize the definition of Tier 1 capital across borders while raising transparency.[89] More importantly, the report states that the Basel Committee has agreed with the FSB to introduce a leverage ratio as part of its capital adequacy requirements.[90]

The introduction of the leverage ratio in the Basel framework is an example of how government politicians have increased their influence on the work of independent regulatory networks, such as the Basel Committee. The leverage ratio, which represents the ratio of Tier 1 capital to a bank's assets, was previously used only in the U.S. and Canada.[91] The proposal for including a leverage ratio in the Basel rules was put forward by the G20, which first called for expanding the use of the leverage ratio across borders in its April 2009 Declaration on Strengthening the Financial System.[92] The FSF responded to the G20's call by including this recommendation in its 2009 report on procyclicality.[93] By September 2009, the Basel

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84. *See Publications*, FIN. STABILITY BD., http://www.financialstabilityboard.org/list/fsb_publications/index.htm (last visited Aug. 24, 2012) (listing the FSB's progress reports that are available to the public).

85. *Id.*

86. For example, there were only three progress reports from the FSF to the then G7 from 1999 to 2007. *Id.*

87. *The Finance Track*, G20, http://www.g20.org/index.php/en/financial-track (last visited Oct. 27, 2012).

88. *Improving Financial Regulation*, *supra* note 83, at 4–5.

89. *Id.* at 4.

90. *Id.* at 4–5.

91. D'Hulster, *supra* note 11, at 2.

92. The Declaration states: "risk-based capital requirements should be supplemented with a simple, transparent, non-risk based measure which is internationally comparable, properly takes into account off-balance sheet exposures, and can help contain the build-up of leverage in the banking system." *Declaration*, *supra* note 5, at 2.

93. Fin. Stability Forum, *Report of the Financial Stability Forum on Addressing Procyclicality in the*

Committee had agreed to follow this recommendation.[94] Indeed, the Basel Committee fully endorsed the leverage ratio in the public announcement of its proposals for banking sector reforms in December 2009.[95] The trajectory of the leverage ratio proposal demonstrates how, in post-crisis international financial regulation, a network of independent regulators—the central bankers of the Basel Committee—adjusts to recommendations by political entities, such as the political leaders of the G20 and the finance ministers participating in the FSB.

Another area where the FSB's approach consists mostly of closely monitoring international rulemakers' efforts is the convergence of accounting standards. Since its establishment, the FSB has called for IASB and FASB to reinforce their efforts for convergence and to take measures to limit the procyclicality of accounting methods.[96] In its follow-up report to the G20, the FSB provided a detailed discussion of the specific issues that present challenges to the IASB/FASB convergence effort, such as addressing different approaches on impairment of financial assets and valuation uncertainty in fair value measurement guidance.[97] Later, the FSB continued to provide follow-up to this report.[98] That accounting inspires this level of detail in a report to government leaders is, on its own, a fascinating development. Before the 2007–08 financial crisis, politicians had very little interest in accounting convergence, an issue handled exclusively by low-level officials in domestic regulators.[99] This reporting suggests that IASB and FASB do not operate in an institutional vacuum, as was the case before, but rather under the watchful eye of political actors, who are eager to see results from these rulemakers.

B. FSB Policymaking Initiatives at G20's Request

One of the most important initiatives that the FSB undertook as the leading policymaker concerns the establishment of a regulatory framework for global systemically important financial institutions, or G-SIFIs. The FSB developed the G-SIFI framework in response to a request by the G20 to address the "too big to fail" problem that became so evident during the 2007–08 financial crisis.[100] The G-SIFI

Financial System, at 2 (Apr. 2, 2009), *available at* http://www.financialstabilityboard.org/publications/r_0904a.pdf.

94. *Improving Financial Regulation*, *supra* note 83, at 4–5.

95. *See* Basel Comm. on Banking Supervision, *Strengthening the Resilience of the Banking Sector*, at 2 (Dec. 2009) *available at* http://www.bis.org/publ/bcbs164.pdf (stating the Committee will introduce a leverage ratio as a supplementary measure to the Basel II risk-based framework).

96. *Improving Financial Regulation*, *supra* note 83, at 7.

97. *G20 Recommendations (2010)*, *supra* note 14, at 8.

98. *See, e.g.*, Fin. Stability Bd., Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability, at 22–23 (Nov. 4, 2011) [hereinafter G20 Recommendations (2011)], available at http://www.financialstabilityboard.org/publications/r_111104gg.pdf (detailing the strides that have been made upon the FSB's recommendations to address the issues of the IASB and FASB convergence effort).

99. For example, the Roadmap that initiated the convergence effort between U.S. GAAP and IFRS was proposed by an SEC official, the agency's Chief Accountant, rather than the Commission itself. *The Politics of Competition*, *supra* note 20, at 479. For a discussion of the decision for convergence between US GAAP and FASB, see *id.* at 477–80.

100. Fin. Stability Bd., *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: Interim Report to G20 Leaders*, at 2 (June 18, 2010), *available at* http://www.fsa.go.jp/inter/fsf/20100702/05.pdf.

framework showcases the FSB's importance because addressing this regulatory issue requires the cooperation of regulators from different sectors—banking, securities, and insurance—in different countries as well as at the international level. Only a body with the FSB's wide membership could bring such a project to fruition.[101]

To put together the G-SIFI framework, the FSB first developed a set of recommendations that outline the framework's key components.[102] These recommendations demonstrate the multiple levels that need to work together for such a project. From a substantive law standpoint, the FSB calls for stricter capital requirements for G-SIFIs to ensure higher capital-loss absorbency, and for laws outlining swift resolution procedures for G-SIFIs that face default.[103] From a supervisory perspective, the FSB calls for more intense supervision efforts by domestic regulators and for the creation of supervisory colleges over G-SIFIs with regulators of different national origins.[104] To ensure implementation of these recommendations, the FSB sets specific deadlines for member states and requires them to participate in a specialized G-SIFI peer review process.[105]

The FSB's initial recommendations left many open questions, which the FSB addressed by enlisting the cooperation of various regulatory bodies, both domestic and international. To help the FSB determine which financial institutions qualify as G-SIFIs, various sectorial international bodies, such as the Basel Committee and the IAIS, have proposed methodologies.[106] Moreover, the FSB established specific working groups and committees to develop various elements of the framework, such as the working groups for developing *Key Attributes of Effective Resolution Regimes* and for developing *Essential Elements of Effective Recovery and Resolution Plans*.[107] After reviewing the recommendations of its working groups, the FSB recognized that implementation of the framework would require legislative changes in many jurisdictions to ensure that national authorities have all the necessary powers.[108] In effect, jurisdictions would have to establish regulatory bodies that bring many domestic regulators around the same table, similar to the Financial Stability Oversight Council in the United States. Thus, the FSB established a Peer Review Council in order to monitor the full and consistent implementation of the G-SIFI measures across borders.[109] Meanwhile, the G20 showed great interest in the FSB's

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101. In fact, the United States showed strong support for the introduction of the G-SIFI framework through the FSB. *See* Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 YALE J. ON REG. 91, 113–14 (2012) (stating that the United States is implementing the Dodd-Frank Act to address the problems created by SIFIs and should continue to do so).

102. Fin. Stability Bd., *Reducing the Moral Hazard Posed by Systemically Important Financial: FSB Recommendations and Time Lines*, at 2 (Oct. 20, 2010), *available at* http://www.financialstabilityboard.org/publications/r_101111a.pdf.

103. *Id.*

104. *Id.*

105. *See id.* at 11–12 (outlining peer review and other processes for implementing the FSB's recommendations and listing respective timelines for completion of these processes).

106. Fin. Stability Bd., *Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*, at 2 (Apr. 10, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110415a.pdf.

107. *Id.* at 3.

108. G20 Recommendations (2011), *supra* note 98, at 2.

109. *Id.* at 6.

progress, asking for regular updates on the progress of reforms and endorsing the FSB's recommendations.[110]

Another important policymaking initiative launched by the FSB concerns the regulation of over-the-counter derivatives markets. During the 2007–08 financial crisis, derivatives were blamed for magnifying uncertainties regarding the health of financial institutions because the extent of a financial institution's exposure to other institutions' failure was hard to ascertain. To address this problem, the G20 endorsed in 2009 a proposal to mandate the trading of standardized derivatives on exchanges or other trading platforms and the clearing of these trades through central counterparties.[111]

To implement this proposal, the FSB followed a process similar to the one developed for the G-SIFI measures described above. First, the FSB created a working group led by representatives of the Committee on Payment and Settlement Systems, IOSCO, and the European Commission.[112] The working group developed a framework with regulatory recommendations, which were included in the FSB's October 2010 report.[113] Again, the FSB recognized that implementing these recommendations would require significant regulatory changes, and asked its working group to monitor the progress of domestic legislators.[114] While domestic legislators moved quickly in some respects, there were delays in others. For example, by November 2011, only the United States had enacted legislation on organized platform trading, one of the FSB's recommendations.[115] The FSB's most recent report shows that there has been significant progress since, particularly in the United States, the European Union, and Japan.[116]

C. FSB and Standard Implementation at the Domestic Level

While global standards mark an important step in the effort to coordinate financial laws around the world, implementation of these standards may vary from country to country. Recognizing this problem, international organizations, such as the IMF and the World Bank, spearheaded initiatives to monitor the implementation of standards in jurisdictions around the world, such as the World Bank's Financial

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110. *See* Press Release, Fin. Stability Bd., *FSB Issues International Standard for Resolution Regimes*, (Nov. 4, 2011), http://www.financialstabilityboard.org/press/pr_111104dd.pdf (stating that FSB SIFI policy measures have been "endorsed by the G20 leaders"); G20, *G20 Leaders Declaration*, para. 42 (June 18–19, 2012), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131069.pdf (stating the G20 request that the FSB report on further progress on its SIFI reforms).

111. G20, *Leaders' Statement: The Pittsburgh Summit*, at 9 (Sep. 24–25, 2009) http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

112. *G20 Recommendations (2010)*, *supra* note 14, at 6.

113. *See OTC Derivatives Market Reforms*, *supra* note 13, at 1–2 (summarizing the recommendations made by the FSB OTC Derivatives Working Group).

114. *See id.* ("[G]iven the continuous innovation in the OTC derivatives markets, this report identifies areas where monitoring will need to continue and exploration of additional measures is recommended. The FSB OTC Derivatives Working Group will monitor implementation of these recommendations.").

115. G20 Recommendations (2011), *supra* note 98, at 17.

116. Fin. Stability Bd., *OTC Derivatives Market Reforms, Third Progress Report on Implementation*, at 1 (June 15, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120615.pdf.

Sector Assessment Program (FSAP).[117] However, these organizations did not always make their findings public. Recognizing the need to follow up with the implementation of regulatory standards at the domestic level, the G20 asked the FSB to create a framework that would strengthen compliance with the standards.[118]

The FSB responded to the G20's request by proposing reforms that reinforce peer pressure among jurisdictions to comply. In the new system, FSB member jurisdictions are expected to "lead by example"[119]; they should be quick in implementing global standards. To provide to other jurisdictions credible evidence of their commitment to international standards, FSB member states will not only be subject to FSAP assessments, but they will also publish the detailed IMF and World Bank analyses of their domestic regulatory systems.[120] As the goal of the program is to increase compliance among countries that are not necessarily members of the FSB, the FSB proposed to revisit the FSAP program by reshaping the selection criteria for participating jurisdictions and improving the evaluation process.[121] As the program goes into effect, the FSB has selected and plans to have reviewed about sixty jurisdictions between 2010 and 2011.[122]

Apart from relying on programs led by other international institutions, the FSB also put together its own program.[123] FSB members will take part in a peer review effort, led by experts from other FSB member jurisdictions and international bodies.[124] The peer review has two features. First, it is complementary to FSAPs as it expands the assessment process into areas not previously covered.[125] Second, it creates a new, highly interactive process of cross-border reviews among regulators in the leading markets in the world, since many reviewers are themselves agency officials in their home countries.[126] The FSB experts collect information primarily on the basis of questionnaires completed by the authorities of the country under review, and may hold interviews with them.[127] The expert team submits a preliminary report for comments first to the country under review,[128] and then to the FSB's Standing Committee on Standards Implementation (SCSI),[129] which is comprised of regulatory

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117. Paul Hilbers, *The IMF/World Bank Financial Sector Assessment Program*, INT'L MONETARY FUND (Feb. 2001), http://www.imf.org/external/np/vc/2001/022301.htm.

118. *See generally Declaration*, *supra* note 5.

119. *Strengthening Adherence*, *supra* note 15, at 1.

120. *Id.*

121. *Improving Financial Regulation*, *supra* note 83, at 12.

122. Fin. Stability Bd., *Global Adherence to Regulatory and Supervisory Standards on International Cooperation and Information Exchange*, at 2 (Nov. 2, 2011) *available at* http://www.financialstabilityboard.org/publications/r_111102.pdf.

123. *See Improving Financial Regulation*, *supra* note 83, at 12 ("The FSB will put in place by the end of 2009 a framework to strengthen adherence to international regulatory and prudential standards.").

124. *Strengthening Adherence*, *supra* note 15, at 2.

125. *See* Fin. Stability Bd., *Handbook for FSB Peer Reviews*, at 3 (Dec. 19, 2011) [hereinafter *Handbook*], *available at* http://www.financialstabilityboard.org/publications/r_120201.pdf ("FSB peer reviews will build on—and avoid duplicating—existing assessment mechanisms, such as FSAPs . . . .").

126. *See id.* at 3–6 (describing the teams who conduct the peer reviews and how they will be composed of experts from FSB members, including both state authorities and international bodies, and describing the prioritization, preparation, consultation, and evaluation processes they participate in during the peer reviews).

127. *Id.* at 8.

128. *Id.* at 10.

129. *Id.*

officials from most FSB member jurisdictions.[130] After discussion and feedback by the SCSI, the revised draft report goes to the Plenary, which discusses it again and approves it.[131] Having received the Plenary's vote, the report becomes publicly available.[132]

This multi-stage process provides many opportunities for the exchange of information among regulators and can spark discussions about regulatory failures, successes, and appropriate responses. Repeated interactions allow domestic regulatory officials to acquire hands-on experience on another country's regulatory framework, help build mutual trust, and can come in handy at moments of crisis. The fact that FSB member jurisdictions become accountable not just to an international organization but also to each other aims to deepen the commitment to international standards among the ranks of domestic officials—the ones responsible for enforcing these standards on the ground.

While the review process ends with publication of the reports, the FSB's role extends beyond that. The SCSI continues to monitor each jurisdiction's progress in implementing the reforms suggested to remedy the weaknesses identified in the peer review report.[133] In addition to peer reviews, which analyze a jurisdiction's overall regulatory framework, the FSB can also conduct thematic reviews, which focus on a specific regulatory problem and study how it has been addressed in various jurisdictions.[134]

CONCLUSION

This Article argues that by creating the FSB, governments in the most important jurisdictions in the world have sent a strong signal about the future of international financial regulation. Before the 2007–08 financial crisis, political leaders had typically shied away from the technical intricacies of the financial system, assigning the role of regulator to independent agencies composed of industry experts and praising the work of private non-profit entities in standard setting. When independent regulators and industry professionals from various jurisdictions formed transnational regulatory networks and associations, politicians readily incorporated their rulemakings into the domestic legal order. After the crisis, the G20 combined diverse regulatory networks, private entities, and independent regulators that have dominated rulemaking in the past thirty years into one council, the FSB, under the watchful eye of domestic finance ministers. In the few years of its existence, the FSB has successfully channeled G20 preferences into international financial regulation. It has asked networks of independent regulators, such as the Basel Committee, to incorporate specific measures in their body of standards. It has launched completely novel rulemaking initiatives, such as the G-SIFI framework, requiring independent regulators and regulatory networks to work closely with each other. And it has reinvigorated assessments of individual jurisdictions' implementation efforts, so as to

130. *See Members of Standing Committee on Standards Implementation* 1–2, FIN. STABILITY BD. (2012), http://www.financialstabilityboard.org/about/scsi.pdf (listing members of the SCSI, which include regulatory officials, and their respective countries).

131. *Handbook*, *supra* note 125, at 11–12.

132. *Id.* at 12.

133. *Id.* at 13.

134. *Id.* at 1–2.

provide better information to the international community and increase peer pressure towards non-complying countries.

This Article argues that the shift away from the ideals of regulatory independence towards a model of greater political intervention in financial regulation mirrors developments in domestic laws. As argued elsewhere, many jurisdictions reformed their domestic laws to address shortcomings brought to light by the 2007–08 financial crisis and granted more powers to politicians directly elected by voters or other officials accountable to them. This trend shows the salience and urgency that financial regulation has gained after 2008, which triggered an increased political commitment to better safeguard the financial system. This greater involvement of political leaders in international financial regulation suggests a fundamental change in the creation of global rules in this area and a new political economy for finance. Watching the next moves of the FSB will be fascinating.

Organizational Choices of Banks and the Effective Supervision of Transnational Financial Institutions

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I. TRANSNATIONAL CHALLENGES IN BANKING REGULATION AND SUPERVISION

A. *The Regulatory Challenges Associated with Integrated Cross-Border Banking Groups*

The conventional wisdom in banking theory suggests that allowing financial institutions to provide their services across jurisdictions generates significant benefits for society.[1] Efficiency gains accrue with regard to banks' core function as financial

1. *See, e.g.*, Michael H. Moskow, *Cross-Border Banking: Forces Driving Change and Resulting Regulatory Challenges*, *in* CROSS-BORDER BANKING: REGULATORY CHALLENGES 3, 4–5 (Gerard Caprio, Jr., Douglas D. Evanoff & George G. Kaufman eds., 2006) (discussing the potential benefits of cross-border banking activity including economies of scale and scope, other efficiency gains in the banks' operations, etc.); Jonathan Fiechter et al., *Subsidiaries or Branches: Does One Size Fit All?* 5 (Int'l

intermediaries: economies of scale lower the costs of bringing together capital surpluses with capital needs. The demand-side benefits from improved access to credit where the funds stem from a larger pool of capital under management. The supply-side sees savings allotted to the best investment opportunity picked from those available not only in the domestic market but in many countries. The latter makes banks' portfolios more diverse and hence decreases the dependence of lending on local business cycles. Moreover, local capital markets also receive a boost from the arrival of international actors who bring with them advanced technologies of risk management, payments, and other service offerings as well as methods of information analysis and distribution that local competitors can replicate.[2]

On the other hand, the trade-off associated with the advantages of cross-border banking is also straightforward: financial systems around the world become more and more interconnected, which in turn expands the potential for negative spillover effects in times of crises.[3] Exogenous shocks can affect national economies, which originally did not face any problems in their banking sector. The availability of credit may decline, either because institutions troubled at home (or elsewhere) confine their activities on foreign markets where they formerly played a prominent role in providing finance to local businesses[4] or because international banks cut back on lending in their home country as a consequence of losses incurred abroad.[5] In the

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Monetary Fund, Working Paper SDN/11/04, 2011), *available at* http://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf (discussing the benefits of cross-border banking including lower operating costs, greater access to credit, and more efficient allocation of global savings, etc.). *But see* GERMAN COUNCIL OF ECONOMIC ADVISORS, ANNUAL REPORT 2011/2012 130 (2011), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_four_ 2011.pdf (pointing to the mid-2011 deposit withdrawal of U.S. banks and money market funds and the resulting liquidity problems of European banks in the highly integrated, global financial system).

2. *See* Stijn Claessens, Asli Demirgüç-Kunt & Harry Huizinga, *The Role of Foreign Banks in Domestic Banking Systems*, *in* THE INTERNATIONALIZATION OF FINANCIAL SERVICES: ISSUES AND LESSONS FOR DEVELOPING COUNTRIES 117 (Stijn Claessens & Marion Jansen eds., 2000) (exploring how foreign bank presence has positively impacted domestic banking markets in eighty countries); Stijn Claessens, Asli Demirgüç-Kunt & Harry Huizinga, *How Does Foreign Entry Affect Domestic Banking Markets?*, 25 J. BANKING & FIN. 891 (2001) (showing an increase in technical efficiency at domestic banks subsequent to the arrival of foreign banks in a sample of eighty countries); *see also* Douglas D. Evanoff & Evren Ors, *The Competitive Dynamics of Geographic Deregulation in Banking: The Implications for Productive Efficiency*, 40 J. MONEY FIN. & BANKING 897 (2008) (showing the same effect on incumbent banks following a competitor's out-of-state merger in the U.S. banking sector between 1984 and 1999 using a sample of 2,309 such business combinations).

3. *See* INT'L MONETARY FUND, CROSS-CUTTING THEMES IN ECONOMIES WITH LARGE BANKING SYSTEMS 11–12 (2010), *available at* http://www.imf.org/external/np/pp/eng/2010/041610.pdf (considering economies of various sizes with large banking systems and finding only a low risk of outward spillovers but a rather high risk of inward contagion from abroad).

4. *See, e.g.*, Ralph De Haas & Iman Van Lelyveld, *Multinational Banks and the Global Financial Crisis: Weathering the Perfect Storm?* (European Bank for Reconstruction and Development, Working Paper No. 135, 2011), *available at* http://www.ebrd.com/downloads/research/economics/workingpapers/wp0135.pdf (finding a slowdown in credit growth twice as rapid in a sample of the forty-eight largest multinational banks compared to a control group of 202 purely domestic banks). *But see* John P. Bonin, *From Reputation Amidst Uncertainty to Commitment Under Stress: More than a Decade of Foreign-Owned Banking in Transition Economies*, 52 COMP. ECON. STUDIES 466 (2010) (arguing that foreign banks largely sustained their commitment to the markets of ten European transition economies).

5. *See* Thomas Dietz, Tetiana Protysk & Erich Keller, *Similar but Different? The Financial Crisis in Matured Western and Emerging Eastern European Countries*, 4 BANKS & BANK SYSTEMS 20, 28 (2009) (arguing that Western European banks' significant engagement in Eastern Europe constitutes a potential for relapse in the ongoing financial crisis); Ewald Nowotny, *The Financial Crisis and the Role of Austrian*

latter case, the magnitude of the shocks originating overseas and the importance of the financial institutions affected may ultimately compel fiscally expensive[6] and politically unpopular government bailouts in order to avoid the disruptive consequences of a pivotal bank's failure.

Public policy hence faces the challenge of minimizing these potential downsides of cross-border banking without impeding its upside. One key element of the institutional framework targeted at this ambitious goal is the prudential supervision of banks.[7] The distinctive feature in the context of cross-border banking is that policymakers and regulators operate in a quintessentially transnational setting where legislative intervention and its enforcement on a national level almost naturally create externalities,[8] e.g., if a country deploys resources to facilitate the adequate micro-prudential[9] supervision of banks incorporated under its jurisdiction this will also benefit all other countries where the respective financial institutions conduct

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Banks in Central, Eastern and Southeastern Europe, 17 ECON. & FIN. REV. 3 (2010) (showing that the credit risk provisioning by Austrian banks' Central, Eastern, and Southeastern European subsidiaries rose sharply as a result of the 2008 financial crisis occurring on those foreign markets); *see also* Már Gudmundsson & Thorsteinn Thorgeirsson, *The Fault Lines in Cross-Border Banking: Lessons from the Icelandic Case*, *in* CONTAGION AND SPILLOVERS: NEW INSIGHTS FROM THE CRISIS 141 (Peter Backe, Ernest Gnan & Philipp Hartmann eds., 2010) (describing the events leading to the collapse of the Icelandic banking sector as a result of its disproportionate and mismanaged cross-border activities).

6. *But see* Gérard Hertig, *Governments as Investors of Last Resort: Comparative Credit Crisis Case-Studies*, 13 THEORETICAL INQ. L. 385, 391 (2012) (showing positive returns of 2.6%–22.5% on government equity stakes acquired in the bailouts of JP Morgan Chase, Wells Fargo, Goldman Sachs, Crédit Agricole, BNP Paribas, and Société Géneral for the years 2008 and 2009, and thus presenting preliminary evidence that the recent bank bailouts during the financial crisis were not as costly for governments as originally perceived and suggested by the enormous figures used in the recapitalizations).

7. *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 756 (Roy Hutcheson Campbell & Andrew S. Skinner eds., Clarendon Press 1976) (1776) (espousing the general rationale of sovereign supervision of banks, which *in grosso modo* aims at minimizing the probability and the impact of financial distress in the sector under the assumption that these goals are inadequately achieved through market discipline alone). For modern economists arguments, compare MILTON FRIEDMAN, A PROGRAM FOR MONETARY STABILITY 4 (1959); MATHIAS DEWATRIPONT & JEAN TIROLE, THE PRUDENTIAL REGULATION OF BANKS (1994); George J. Benston & George G. Kaufman, *Is the Banking and Payments System Fragile?*, 9 J. FIN. SERVICES RES. 209 (1995); PETER D. SPENCER, THE STRUCTURE AND REGULATION OF FINANCIAL MARKETS 193–208 (2000); Charles W. Calomiris, *Blueprints for a New Global Financial Architecture*, *in* INTERNATIONAL FINANCIAL MARKETS 259 (Leonardo Auernheimer ed., 2003); for a critical account of the history of banking regulation see CHARLES W. CALOMIRIS, UNITED STATES BANK DEREGULATION IN HISTORICAL PERSPECTIVE 1–79 (2000); for the libertarian skepticism regarding the legitimacy of any regulatory interference in the banking sector see FRIEDRICH AUGUST HAYEK, DENATIONALIZING MONEY 9 (1976); DAVID GLASNER, FREE BANKING AND MONETARY REFORM (1989); KEVIN DOWD, THE STATE AND THE MONETARY SYSTEM (1989).

8. *See* Maximilian J.B. Hall & George G. Kaufman, *International Banking Regulation*, *in* THE STRUCTURAL FOUNDATIONS OF INTERNATIONAL FINANCE 92 (Pier Carlo Padoan, Paul Brenton & Gavin Boyd eds. 2003) (speaking to the reason banks were traditionally regulated on a national level).

9. This term refers to a regulatory approach that aims at securing individual financial institutions resilience *vis-à-vis* external shocks and diverges in this limited goal from a macro-prudential approach that is targeted towards the soundness and viability of the financial system as a whole and accepts the existence of risk originating within the system. *See, e.g.*, Claudio Borrio, *Towards a Macro-prudential Framework for Financial Supervision and Regulation?* 2–3 (Bank for Int'l Settlements, Working Paper No. 138, 2003) (arguing that the macro-prudential approach can be used naturally to measure rational and compelling situations, whereas applying the micro-prudential approach is impossible under the same circumstances); Samuel G. Hanson, Anil K Kashyap & Jeremy C. Stein, *A Macro-Prudential Approach to Financial Regulation*, 25 J. ECON. PERSP. 3, 4–7 (2011) (demonstrating that the macro-prudential approach aims to counter-balance the actual crisis).

business. Yet, if these other countries engage in supervisory activities themselves, redundancies and frictions in the legal framework, turf-wars among authorities etc. will raise the costs of doing business abroad and may compromise the effectiveness of the regulatory regime to which cross-border banks are subjected.[10]

The latter is all the more important as a pivotal determinant of the regulatory framework seems endogenous from the perspective of the supervised financial institutions. As will be discussed in more detail,[11] currently the applicable supervisory regime hinges upon how banks choose to organize their international activities. In principle, a financial institution faces two alternatives if it seeks to establish a continuous and meaningful presence in a foreign market.[12] It can either organize its foreign operations as a subsidiary, a legally independent, yet wholly owned entity incorporated under the laws of the foreign jurisdiction, or it can establish a branch, a legally dependent satellite of its main establishment fully recognized under the laws of the foreign country where the banking services will be provided.[13] Clearly, where the applicable law depends on choices of the regulated entities, concern over potential regulatory arbitrage looms.[14] Recent intra-group restructurings that at least coincided with some tightening in the regulatory regimes applicable to banks operating across borders at first glance seem to corroborate these apprehensions.

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10. For a pre-crisis view on the regulatory challenges that cross-border banking posed to the emerging markets to which banks extend their business, *see* Guillermo Ortiz, *Cross Border Banking and the Challenges Faced by Host-Country Authorities*, *in* CROSS-BORDER BANKING: REGULATORY CHALLENGES, *supra* note 1, at 11, 14–18 (identifying differences in regulation and stakeholder interests, the lack of market discipline, and the problems of cross-border crisis management as critical aspects).

11. *See infra* Part IV.

12. The additional option to set up a representative office that can provide some auxiliary services abroad to the bank's main operations is also well established under WTO rules. *See* General Agreement on Trade in Services art. XXVIII (g) footnote 12, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183 [hereinafter GATS] ("Where the service is not supplied directly by a juridical person but through other forms of commercial presence such as a branch or a representative office, the service supplier (i.e., the juridical person) shall, nonetheless, through such presence be accorded the treatment provided for service suppliers under the Agreement."). Yet, a representative office may be well-suited to serve niche-markets, but it is practically inapt to establish a presence that broadly competes with domestic firms. This is even more true with regard to providing banking services directly across borders as permitted under The Treaty on the Functioning of the European Union art. 56, Mar. 30, 2010, 2010 O.J. (C 83) 47 [hereinafter TFEU].

13. *See* Eugenio Cerutti, Giovanni Dell'Ariccia & Maria Soledad Martínez Pería, *How Banks Go Abroad: Branches or Subsidiaries*, 31 J. BANKING & FIN. 1669, 1685–91 (2007) (identifying tax rates, regulatory barriers, diverging business models—commercial versus retail banking—and economic and political risks as driving forces behind banks' organizational choices in a sample of the world's 100 largest banks' operations in Latin America and Eastern Europe).

14. On the generally negative connotation of the term that indicates a race for laxity in regulatory standards, see Amir N. Licht, *Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets*, 38 VA. J. INT'L L. 563, 567 (1998) ("Regulatory arbitrage traditionally indicates a phenomenon whereby regulated entities migrate to jurisdictions imposing lower regulatory burdens. By doing so they exert a downward pressure on those jurisdictions that want to retain the regulated activity within their borders."); Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 32, 52 (2007) ("As a consequence [of regulatory arbitrage], issuers and other market participants may be tempted to relocate to jurisdictions with less costly regulation, since the market mechanisms that might normally punish such behavior are suppressed.").

B. *Intra-Group Restructurings as a Sign of Regulatory Arbitrage?*

1. Europe

In Europe, several transactions occurred very recently that followed a common template: In certain jurisdictions, the activities of large cross-border banking groups were transformed from subsidiaries into branches.[15] The transactions were executed through a cross-border merger of the thus far independent foreign subsidiary into the parent corporation[16] that instantaneously assigned the received assets to the newly established foreign branch on its balance sheet. As a consequence, the real-world appearances of the banks' foreign operations were not affected by the legal maneuver. Yet, the regime of prudential bank regulation and supervision of the respective host countries ceased to apply.[17] The restructurings caught the attention of the business press where they were regarded as blatant acts of regulatory arbitrage

> European Banks are restructuring their businesses outside their home countries in ways that mute the impact of tough new regulations that were adopted as a response to the financial crisis. In the U.S., U.K. and Portugal, at least a handful of large European banks have altered their legal structures or shifted assets and business lines between units, partly in an attempt to avoid local rules and oversight, according to bank disclosures and people familiar with the matter.[18]

In stark contrast, the banks involved invoke efficiency considerations as the main motive for converting their subsidiaries into branches when they declare a simplification of the group structure[19] and a more efficient allocation of resources as key objectives of the conversion-schemes.[20]

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15. *See, e.g.*, Press Release, Deutsche Bank ZRt., Transformation of Deutsche Bank ZRt. into a branch of Deutsche Bank AG (May 31, 2011), *available at* https://www.db.com/hungary/docs/Branch_client_communication_letter.pdf (announcing the conversion of Deutsche Bank in Hungary from a subsidiary to a branch); Lawrence G. Goldberg, Richard J. Sweeney & Clas Wihlborg, *From Subsidiary to Branch Organizations of International Banks: New Challenges and Opportunities for Regulators* 1 (Nov. 14, 2005), *available at* http://openarchive.cbs.dk/bitstream/handle/10398/6783/wplefic042005.pdf?sequence=1 (describing the shift of Nordea from operating in subsidiaries to branches); *see also* FRANKLIN ALLEN ET AL., CENTER FOR ECONOMIC POLICY RESEARCH, CROSS-BORDER BANKING IN EUROPE: IMPLICATIONS FOR FINANCIAL STABILITY AND MACROECONOMIC POLICIES, 26–27 (2011) (showing a general rise in the number of foreign branches in the European Union).

16. Such cross-jurisdictional transactions are facilitated by Directive 2005/56 of the European Parliament and of the Council of 26 October 2005 on Cross-Border Mergers of Limited Liability Companies, 2005 O.J. (L 310) 1 and its implementation in the Member States' merger statutes.

17. Regulatory and supervisory competences in international banking are tied to the legal entities' banking licenses, e.g., where a banking group establishes subsidiaries in a multitude of jurisdictions, its operations will require several banking licenses. Hence, several regulators and supervisors will be tasked with the group's supervision and hence have to cooperate according to the ground rules laid down under the auspices of the Bank for International Settlements (BIS). *See* BASEL COMMITTEE ON BANKING SUPERVISION, CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION 40–42 (1997) (discussing cross-border banking and the obligations of home and host country supervisors). For a more detailed account, see *infra* Part IV (discussing the host country's supervisory role depending on whether the bank uses a subsidiary or branch organizational model).

18. Patricia Kowsmann, David Enrich & Laura Stevens, *Banks Find New Wrinkle in Regulatory Arbitrage*, WALL ST. J. (Dec. 2, 2011), *available at* http://online.wsj.com/article/SB40001424052970204397704577072423856961212.html.

19. *See* Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial*

2. United States

Similar concerns were voiced in the aftermath of restructurings that involved the U.S. operations of some global banking groups headquartered in Europe, to wit U.K.'s Barclays and Germany's Deutsche Bank. The criticized transactions sought to avoid the status of a "financial holding company" for the respective groups' top U.S. units under the Bank Holding Company Act of 1956.[21] The critical reform in this regard was promulgated in the course of the Dodd-Frank Act overhaul[22] and invariably requires any bank holding company to be well capitalized itself. In particular, the tightened legislation cancels the prior exemptions granted to large intermediate holding companies of international banking groups[23] which may be backed by a strong financial institution outside the United States and hence do not necessarily depend on their own funds to be sufficiently resilient as a stand-alone U.S. holding company does. Estimates gauged the additional capital requirements one of the intermediate financial holding companies faced under the new regulation at $20 billion.[24] The rather simple move to avoid this massive burden of having to inject new capital into the group's U.S. business was to transfer the shares of the wholly owned U.S. depository bank from the intermediate holding company to the mother company registered outside the United States. As a result, the groups' U.S. intermediate holding companies were left with equity stakes only in subsidiaries that conduct non-depositary financial activities. Hence, they no longer fall under the Bank Holding Company Act's definition of a bank holding company.[25]

Again, the momentous change in the applicable regulatory and supervisory regime could be achieved in an instant without altering the cross-border banking groups' real-world appearances. No wonder that leading business newspapers unanimously regarded the changes in the involved groups' legal structures as aimed at "avoiding" stricter regulation;[26] a reputable German daily even characterized the

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Conglomerates: Complexity and Its Implications for Safety and Soundness, *in* THE OXFORD HANDBOOK OF BANKING 197, 214 (Allen N. Berger, Phillip Molyneux & John O. S. Wilson eds., 2012) (showing that the sixteen largest financial institutions in the world have two and a half times more subsidiaries than the sixteen largest non-financial firms).

20. *See, e.g.*, Deutsche Bank, Transformation of Deutsche Bank ZRt. into a branch of Deutsche Bank AG (May 31, 2011), *available at* https://www.db.com/hungary/docs/Branch_client_communication_letter.pdf (discussing the conversion of the Deutsche Bank ZRt. into a branch of Deutsche Bank AG).

21. "Financial holding company" is defined as a company that has direct or indirect control over a depository banking subsidiary and meets the mandatory capital requirements. Bank Holding Company Act, 12 U.S.C. § 1841(a)(1), (p) (2011).

22. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Publ. L. No. 111–203, § 606(a), 124 Stat. 1376, 1607 (2010) (amending the Bank Holding Company Act of 1956 and requiring banks to remain well capitalized).

23. The substantive regulation is contained in the Federal Reserve's amendments to Regulation Y. 12 C.F.R. § 225.8 (2011). The amendments require large bank holding companies to submit capital plans that adhere to rigorous own funds requirements. *Id.*

24. David Enrich & Laura Stevens, *Deutsche Avoids Dodd-Frank Rule*, WALL ST. J., Mar. 22, 2012, at C1 [hereinafter *Deutsche*].

25. *See* David Enrich, Laura Stevens & Alexandra Berzon, *Deutsche Maneuvers Around New Law*, WALL ST. J., Apr. 13, 2012, at C1 (stating that "Deutsche is planning to change the status of Taunus so that it is no longer classified as a bank-holding company," allegedly to avoid compliance with the Dodd-Frank Act).

26. Tom Braithwaite & Shahien Nasiripour, *Deutsche Bank Avoids US Capital Rules*, FINANCIAL TIMES (Mar. 22, 2012), http://www.ft.com/cms/s/0/f2d96462-738e-11e1-94ba-00144feab49a.html#

transaction as "tricking" U.S. supervisors.[27] On the other hand, a spokesman of one of the banks involved justified the changes as a measure to enhance the efficiency of the groups' organizational structure.[28]

C. *Misconceptions and the Pivotal Question*

Even though the restructurings delineated above seem to be obvious cases of regulatory arbitrage at first glance, a critique focusing mainly on the circumvention of specific substantive rules still deals with rather peripheral aspects and ultimately misses the crucial issue at hand.

Stricter requirements regarding subsidiaries' or the banking groups' own funds and a design of executive compensation packages that rewards sustainable growth have been duly identified as mechanisms that can enhance banks' resilience and do away with detrimental incentives for excessive risk taking.[29] However, it seems implausible that a strategy geared at avoiding particularly austere national regulations promulgated in certain European countries[30] actually motivated the branch conversions described above. When the restructurings were initiated, a general tightening and further harmonization of the pertinent E.U. regimes had already become visible on the international horizon and in critical part even arrived prior to the closing of the restructurings.[31] These restructurings were hence inapt to escape from the regulators' tighter grips in the longer run.

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axzz25qXHviPi; *Deutsche*, *supra* note 24.

27. Moritz Koch, *Tricksen mit Taunus* [*Tinkering Around with Taurus*], SÜDDEUTSCHE ZEITUNG, Mar. 23, 2012, at 26. For another harsh critique from the perspective of a U.S. trade union, compare Letter from Marty R. Leary of Unitehere! to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, *available at* http://www.federalreserve.gov/SECRS/2011/August/20110831/R-1425/R-1425_080411_87623_491541684764_1.pdf.

28. *See Deutsche*, *supra* note 24 ("Action, which does not diminish any of our regulatory oversight, allows us to streamline our organizational structure, strengthening an already strong institution.") (quoting Deutsche Bank spokesman Duncan King).

29. How ill-designed executive pay in banks contributed to the financial crisis has been broadly analyzed, mostly with regard to the short-term orientation of high-powered incentive schemes. For an account of the broad consensus in this respect, see Lucian A. Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1917–19 (2010). With regard to more structural issues in the banking sector, see, e.g., Günther Franke & Jan Pieter Krahnen, *The Future of Securitization*, *in* PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN 105, 126–39 (Yasuyuki Fuchita, Richard Herring & Robert E. Litan eds., 2009) (presenting evidence on how non-negative bonus payments induce high leverage ratios that increase default-risk and potentially threaten financial stability); Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, GEO. L.J. 247, 255–74 (2010) (analyzing how equity-based incentive compensation induces a managerial bet on the bank's highly levered assets).

30. *See* Financial Stability Forum, *Principles for Sound Compensation Practices* (Apr. 2, 2009), *available at* http://www.financialstabilityboard.org/publications/r_0904b.pdf (providing an overview of the European reforms implementing the international consensus on sound compensation practices achieved among the G20 nations); *see also* Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks*, 64 VAND. L. REV. 431, 453–54, 483–96 (2011) (providing an overview of the approaches to compensation through the crisis implemented by particular European countries).

31. *See generally* Parliament and Council Directive 2010/76, As Regards Capital Requirements for the Trading Book and for Re-securitizations, and the Supervisory Review of Remuneration Policies, 2010 O.J. (L 329) 3 [hereinafter CRD III] ("In order to address the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals, the requirements of Directive 2006/48/EC should be supplemented by an express obligation for credit institutions and investment firms to establish and maintain, for categories of staff whose

Similarly, the efforts to avoid the pertinent Dodd-Frank reforms do not necessarily indicate the affected banks' proclivity to race for laxity at all cost. The pivotal fact under the reform legislation, that some international banks' organizational structure features an intermediate holding corporation that controls the groups' incorporated U.S. depository banking units, ties the massively augmented capital requirements to rather formal aspects. The severely tightened own-funds requisites neither hinge upon the actual risk structure of the group nor upon its supervisory regime. Thus, they outright negate the possibility that the U.S. intermediate holding may benefit from the support of an overseas parent that is itself subject to a rigid regime of consolidated banking supervision which also accounts for the risks that accrue from the U.S. business entity. Seen from this vantage, submitting to the Dodd-Frank reforms could also be regarded as generating a windfall profit for the U.S. banking system as a result of a quasi-protectionist legislation that intentionally disregards the transnational nature of cross-border banking groups.

As a consequence, the reproach that transnational banking groups engaged in regulatory arbitrage when they restructured their organizations should not be based on a narrow analysis that constricts the view on the applicability of specific rules of the supervisory regime prior to and after the restructurings. Regardless of the merits of discrete substantive rules, the more momentous question that should be posed in light of the delineated developments is whether the organizational choices of cross-border banking groups in general are adequately resorbed by the applicable regime of prudential supervision in a transnational context. This implies that the supervisory architecture should neither drive opportunistic choices nor hamper an efficient organization of transnational banking groups.

This Article explores precisely this fundamental question against the background of the ongoing sovereign debt crisis in the euro area. The short sequence of financial disasters that were neither prevented nor mitigated in a meaningful way under the current E.U. regime of shared responsibility among Member States reveals significant shortcomings. Recently promulgated and currently proposed reforms tackle the deficiencies in an insufficient manner. This is all the more worrying as the euro crisis together with the ramifications and sequels of the Lehmann-debacle highlight the importance of effective "normal-times" prudential supervision. The latter is, and will remain, a key determinant when it comes to enhancing the resilience of a transnationally intertwined financial system

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professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management."). Moreover, as is well known, an even more fundamental reform, aimed at completely leveling the playing field for E.U. banks by basing prudential supervision on a single, harmonized rulebook is also in the making. *See generally Commission Proposal for a Directive of the European Parliament and the Council on the Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms and Amending Directive 2002/87/EC of the European Parliament and of the Council on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate*, COM (2011) 453 final (July 20, 2011) [hereinafter CRD IV Directive] ("For the sake of clarity and in order to ensure a coherent application of those provisions, it would be desirable to merge these provisions into new legislation applicable to both credit institutions and investment firms."); *see generally Commission Proposal for a Regulation of the European Parliament and the Council on Prudential Requirements for Credit Institutions and Investment Firms*, COM (2011) 452 final (July 20, 2011) [hereinafter CRD IV Regulation] (further elaborating on solutions to the regulatory shortcomings).

where market discipline in its most pristine occurrence as the exit of failing participants is partly unavailable.[32]

With this in mind, this Article evaluates the impending European Banking Union[33] and outlines a relatively easy-to-implement reform-alternative for the supervision of transnational banking groups in the European Union that is no longer based on legal form but more on the actual risk structure of the pertinent financial institutions. It also aims at paying close attention to the economics of public administration and international relations in allocating competences among national and supranational supervisory bodies. Before detailing its own proposition, Part II of this Article looks into the relationship between sovereign debt and banking crises that drive regulatory reactions to the financial turmoil in the euro area that *inter alia* affirm effective prudential supervision as a pivotal element of their implementation. In order to arrive at a more informed idea as to which determinants apart from a perceived appetite for regulatory arbitrage drive banks' organizational choices, Part III scrutinizes the merits of either a branch or subsidiary structure for the cross-border business of financial institutions. In doing so, it also considers the policymaker's perspective. The analysis shows that no one-size-fits-all organizational structure is available and concludes that banks' choices should generally not be second-guessed, particularly because they are subject to at least some market discipline. Part IV describes and evaluates how competences in prudential supervision are currently allocated among national and supranational supervisory authorities. In order to evaluate the findings the appraisal adopts insights from the economics of public administration and international relations. It argues that the supervisory architecture has to be more aligned with bureaucrats' incentives and that inefficient requirements to cooperate and share information should be reduced. Contrary to a widespread perception, shifting responsibility to a supranational authority cannot solve all the problems identified. Resting on these foundations, Part V finally sketches an independent solution that dwells on far-reaching mutual recognition of national supervisory regimes and allocates competences in line with supervisors' incentives and the risk inherent in cross-border banking groups.

II. THE IMPORTANCE OF MICRO-PRUDENTIAL SUPERVISION: LESSONS FROM THE ONGOING SOVEREIGN DEBT AND BANKING CRISES IN THE EURO AREA

Sovereign debt and banking crises frequently correlate in history, a finding that confirms the connections delineated in economic theory. These basic insights serve as a starting point to help understand not only the repercussions that the ongoing euro crisis exerts on the European banking system, but also how the calamities in the financial sector impacted on sovereign debtors. Finally, it provides the necessary background for conceiving the prudential supervision of transnational banking

32. *See infra* Section II.A.2 (describing how neither sovereign debtors nor systematically important financial institutions face the option of resolution or restructuring in bankruptcy).

33. *See* Explanatory Memorandum of the *Commission Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, COM (2012) 511 final (Sept. 12, 2012) [hereinafter *Commission Proposal SSM Regulation*] ("One of the key elements of the banking union should be a Single Supervisory Mechanism (SSM) with direct oversight of banks, to enforce prudential rules in a strict and impartial manner and perform effective oversight of cross border banking markets.").

groups as an important component of the European initiatives targeted at long-term hazard control.

A. *Sovereign Debt and Banking Crises Through the Ages*

1. Historical Anecdotes

The first documented sovereign debt crisis occurred when most of the municipalities of the Attic Maritime Association were unable to repay a loan from the Delos temple (377–373 B.C.).[34] But as early as in 1343 A.D., shock waves triggered by a sovereign debtor's woes were sent across Europe when King Edward III of England defaulted on his obligations at the largest Florentine banks, sending them into bankruptcy and thus causing the collapse of an entire financial system.[35] The scenario reoccurred in 1557 A.D. when King Philip II of Spain ruined the powerful merchant banks owned by the South German families of the Fuggers and the Welsers.[36] Yet Germans were not always the bereaved but also the bankrupts: During the 19th century German states defaulted five times on their debt jointly with Austria and Portugal, outdistancing Greece, which disappointed its lenders only four times.[37] All these events put severe stress or increased the already existing stress on the banking system, at least in the immediately affected economies.

2. Bailout Rationality and Moral Hazard

At the outset, major banking and sovereign debt crises share a critical common feature, because the option to force a failing debtor's restructuring or resolution in bankruptcy constitutes a credible scenario for neither systemically important financial institutions (SIFIs) nor for sovereign debtors. Moreover, where outside help is foreseeably available, market discipline is dulled and moral hazard occurs.[38]

With regard to sovereign debtors, the probability and magnitude of default in general do not depend critically on their ability to pay but on their willingness to pay; without an executable enforcement mechanism that coerces debt-servicing, sovereign debtors will default once the anticipated costs of doing so have become lower than

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34. MAX WINKLER, FOREIGN BONDS: AN AUTOPSY 22 (1933).

35. Meir Kohn, *Merchant Banking in the Medieval and Early Modern Economy* 20 (Dartmouth College, Dept. of Econ. Working Paper 99–05, 1999), *available at* http://www.dartmouth.edu/~mkohn/Papers/99-05.pdf.

36. *Id.*

37. Carmen M. Reinhart, Kenneth S. Rogoff & Miguel A. Savastano, *Debt Intolerance* 11 (NBER Working Paper 9908, 2003), *available at* http://www.nber.org/papers/w9908. The last German default occurred during the 1930s. *See* Eduardo Borensztein & Ugo Panizza, *The Costs of Sovereign Default* 44 (IMF Working Paper WP/08/238, 2008), *available at* http://www.imf.org/external/pubs/ft/wp/2008/wp08238.pdf (listing the default and rescheduling dates of sovereign debtors all over the world since the early nineteenth century).

38. *See* Jay C. Shambaugh, *The Euro's Three Crises*, BROOKINGS PAPERS ON ECON. ACTIVITY 32 (2012), *available at* http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2012_spring_bpea_papers/2012_spring_BPEA_shambaugh.pdf (discussing specifically the moral hazard that arose in the euro area when banks and sovereigns were not held responsible for their actions).

the costs of redeeming the obligation.[39] Moreover, sovereign debtors, although by their very nature fiscally independent bodies, can rely on outside help where other public actors deem their overall economic, social, and political costs of the default of a sovereign as too high, even though legal restrictions on sovereign bailouts may exist.[40]

SIFIs, as private business corporations, on the other hand, are in principle subject to insolvency proceedings. Yet, their market exit, by definition, sends ripples throughout the financial system that create incentives for policymakers to rescue failing banks, even if the handling of a systemic crisis in the banking sector was consciously left unclear to induce caution and discipline among SIFIs in an atmosphere of constructive uncertainty. Even though political decision-makers may have pledged not to bailout SIFIs, they tend to behave inconsistently over time and take rescue measures in order to prevent a chain reaction in the banking sector, which would ultimately lead to its total collapse.[41] The latter would precipitate severe negative consequences for the affected economy's production and employment. That is the case because in a major banking crisis financial institutions either go bankrupt or at least clamp down on loan approvals. Both the losses of assets dealt to institutional and private investors in the former event, as well as the decreased number of loan approvals in the latter, inhibit the propensity to invest and decrease consumer demand. Thus, they hinder macroeconomic output.

At the same time, the economic crunch exacerbates the crisis, as a recession makes it harder for sovereign borrowers to service their debt, which in turn will put banks even deeper into the quagmire. Finally, the political costs are high as well, as basically no elected government will survive the economic downturn, the decline in household income, and the ensuing asset losses.[42] On the other hand, the incentives to "gamble for resurrection"[43] are high for political actors, particularly because there is no external mechanism that can force sovereign debtors to declare insolvency in

39. *See generally* Jonathan Eaton, Mark Gersovitz & Joseph E. Stiglitz, *The Pure Theory of Country Risk*, 30 EUR. ECON. REV. 481 (1986) (explaining the concerns that exist in the relationship between sovereign debtors and their creditors). While the immediate costs of servicing debt simply consist of interest and redemption payments, the pertinent costs of default are more complex. The sovereign debtor will be excluded from international financial markets and will thus be unable to smooth consumption and face impediments to investments for a certain time. The magnitude of these effects depends on the period of exclusion. Yet, even after regaining access to international financial markets, risk premiums will be influenced by the sovereign debtor's prior default. Moreover, further costs are associated with the economic downturn that usually accompanies a sovereign default or trade sanctions in reaction to it.

40. The Founding Treaty of the European Union explicitly prohibits a bailout of Member States' central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings. *See* TFEU, *supra* note 12, art. 125(1). However, the massive sovereign bailouts in the euro area were not barred by this constitutional restriction. For a comprehensive discussion of the contested constitutional issue, see Jean-Victor Louis, *The No-Bailout Clause and Rescue Packages*, 47 COMMON MKT. L. REV. 971, 975–86 (2010); for a brief overview, see Bruno de Witte, *The European Treaty Amendment for the Creation of a Financial Stability Mechanism*, EUR. POL'Y ANALYSIS, June 2011, at 5–6 (2011), *available at* http://www.eui.eu/Projects/EUDO-Institutions/Documents/SIEPS20116epa.pdf.

41. *See* Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REG. 121, 123–29 (2012) (describing the economics of bailouts).

42. *See* Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1375–83 (2011) (discussing the reasons why pre-committed politicians will bail out SIFIs they deem too-big-to-fail).

43. For a discussion of the connection between sovereign debt and a "gamble for resurrection," see Anne O. Krueger & Sean Hagan, *Sovereign Workouts: An IMF Perspective*, 6 CHI. J. INT'L L. 203, 207–08 (2005).

order, for example, to apply for loans from the International Monetary Fund or other institutions.

The anticipation of such time inconsistencies leads to significant moral hazard and excessive risk-taking *ex ante*. There is an inherent market failure as a consequence of the lack of a predictable insolvency regime, which leads to incorrect debt-pricing.[44] Risk premiums hinge not only on the probability of default but also on the probability of declining a bailout, or at least asking for a private sector contribution to the rescue efforts.[45] Hence, risk premiums are distorted and the pricing mechanism fails to induce adequate risk-taking, such as when sovereign debtors and SIFIs can borrow too cheap as part of their liability is externalized. Moreover, the participation in the losses following the default of a sovereign debtor or a SIFI is attributed on a case-by-case basis that follows the specific political and institutional preconditions prevailing at the time insolvency is declared. Hence, it can hardly be predicted *ex ante*, thus handicapping a stringent ranking among groups of creditors. As an observable consequence, sovereign debtors—and SIFIs—face relatively low risk premiums for a long time, but interest rates spike in the vicinity of insolvency.[46] Hence, a debt crisis exhibits the typical elements of a self-fulfilling prophecy where a sudden change in market participants' expectations generates entirely different results although all other economic determinants remain unchanged;[47] as long as creditors expect other creditors to renew their existing loans or extend even larger ones, they will be willing to do the same. Investor panic may plunge debtors into a liquidity crisis, as long-term claims do not work to cover short-term liabilities. Where unfavorable refinancing conditions persist, a solvency crisis will ensue.

Moreover, bank bailouts put tremendous fiscal burdens on the rescuing country's budget,[48] which in turn may cast doubts on its ability to service its own debt.

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44. *See, e.g.*, Organisation for Economic Co-operation and Development [OECD], *The Third Meeting of the Latin American Corporate Governance Roundtable*, at 4, OECD Doc. 8–10 (2002), *available at* http://www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/2085780.pdf (discussing how the mispricing of debt capital, because of weak insolvency mechanisms, spread the risk of insolvency around the Asian economies in 1998).

45. *See* Giovanni Dell'Ariccia, Isabel Schnabel & Jeromin Zettelmeyer, *How Do Official Bailouts Affect the Risk of Investing in Emerging Markets?*, 38 J. MONEY CREDIT & BANKING 1689, 1690–92 (2006) (discussing the effect that the expectation of a bailout has on investors and debt markets).

46. *Id.* at 1699–1700; Mardi Dungey et al., *International Contagion Effects from the Russian Crisis and the LTCM Near-Collapse*, 7–10 (IMF Working Paper No. 02/74, 2002), *available at* http://www.imf.org/external/pubs/ft/wp/2002/wp0274.pdf (illustrating the bond spreads of different countries in which interest rates spike during times of crisis).

47. *See* Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401, 401–04 (1983) (demonstrating an economic model that explains how changed expectations about a bank run can result in a bank run); Jeffrey Sachs, *Theoretical Issues in International Borrowing* 38 (NBER Working Paper No. 1189, 1983), *available at* http://www.nber.org/papers/w1189.pdf ("If all banks suddenly expect all other banks to stop lending to the country, it will be rational for certain parameter values for each bank to stop lending as well on the basis of that expectation, with the result that it becomes self-confirming."); Paul De Grauwe, *The Governance of a Fragile Eurozone* 5 (CEPS Working Document, Working Paper No. 346, 2011), *available at* http://www.ceps.be/ceps/download/5523 (discussing the self-fulfilling prophecy of sovereign debtors becoming insolvent when investors fear insolvency).

48. Between October 2008 and May 2010 the twenty-seven Member States of the European Union spent a total of 236.1 billion euro ($288.6 billion) on bank recapitalizations, issued 957.7 billion euro ($1,175.6 billion) of guarantees for bonds and other debentures, and further asset support to safeguard banks financial stability amounted to an assumption of risk worth 346.5 billion euro ($425.4 billion). The

These doubts will lead to a rise in risk premiums and hence will make the country's future debt service even more burdensome. Once again the overall economic recession may add to the fiscal hassles. Finally, the sovereign debt crisis will backlash on the national banking system insofar as banks will typically be the main holders of a shaky country's bonds.[49] Hence, their financial stability will be severely impacted if a country declares its insolvency or restructures its debt. This so impact stands to be even more severe, as sovereign debtors will find it harder, or at least more expensive, to refinance themselves on international financial markets and consequentially will have the sovereign debt-load absorbed mainly by domestic banks. The collapse of a national banking system will affect the international banking system depending on its size and interconnectedness.[50]

B. *The Contemporary European Angle and One Regulatory Response*

The contemporary European angle of these general relationships between sovereign debt and banking crises followed this general pattern and threatened to spin out of control in July 2011. The events prompted coordinated regulatory reactions that *inter alia* highlight the relevance of effective prudential supervision.

1. Confidence Crisis July 2011

The events that occurred during the summer of 2011 elucidate the interconnection between the banking and the sovereign debt crisis in the euro area.[51] The crisis indicators in the banking sector flashed red alert again when the usually highly liquid interbank markets ran dry;[52] U.S. banks and money-market funds withdrew their deposits;[53] and the stock prices of European banks declined, while credit default swap spreads climbed.[54] The trigger for the resurging banking troubles

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pertinent figures for Eurozone members amounted to 160.1 billion euro ($196.5 billion) of recapitalizations, 735.2 billion euro ($902.5 billion) of guarantees, and 128.7 billion euro ($158 billion) of risk assumptions. Stéphanie Marie Stolz & Michael Wedow, *Extraordinary Measures in Extraordinary Times: Public Measures in Support of the Financial Sector in the EU and the United States*, at 24 tbl. 1 (European Central Bank Occasional Paper Series, No. 117, 2010), *available at* http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp117.pdf. (dollar conversions as of May 31, 2010).

49. *See* Jack Ewing, *Already Holding Junk, Germany Hesitates*, N.Y. TIMES, (Apr. 28, 2010), http://www.nytimes.com/2010/04/29/business/global/29banks.html?_r=1 (discussing the large amount of Greek debt held by German banks); Philip Aldrick, *UK Banks Face Huge Losses on Italian Debt*, THE TELEGRAPH, (Nov. 9, 2011), http://www.telegraph.co.uk/finance/financialcrisis/8879927/UK-banks-face-huge-losses-on-Italian-debt.html (discussing the large amount of Italian debt held by U.K. banks).

50. *See* Joseph E. Stiglitz, *Risk and Global Economic Architecture: Why Full Financial Integration May Be Undesirable*, 100 AM. ECON. REV. 1388 (2010) (providing an analytical framework that demonstrates the technological conditions under which financial autarky is preferable to full integration as the associated risk-sharing lowers expected utility).

51. *See* GERMAN COUNCIL OF ECONOMIC ADVISORS, ANNUAL REPORT 2011/2012 130–34 (2011), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_four_2011.pdf [hereinafter ANNUAL REPORT] (discussing the entanglement of banking with the sovereign debt crisis). For a general chronology of the main events during the euro crisis, see *id.* at 121–22, *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_three_2011.pdf (the chapters of this report are divided by separate web addresses).

52. *Id.* at 130.

53. *Id.*

54. *Id.*

was pulled when Greece was ostensibly facing the abyss. Rumors had it that the so called *Troika*, consisting of representatives from the European Commission, the European Central Bank (ECB), and the International Monetary Fund (IMF), would assess Greece negatively, thereby calling into question further fiscal aid and making a voluntary write-off of private sector creditors more likely.[55] Credit rating agencies had already announced that they would consider such a voluntary participation in Greece's rescue as a "selective default," which in turn would lead the ECB to no longer accept Greek bonds as collateral for refinancing purposes, sending the largest Greek banks immediately into bankruptcy.[56] Although the severe confidence crisis shaking the whole European banking system could be countered by short term measures of hazard control, the need for more fundamental reactions to eventually reestablish trust in the financial sector had become undeniable.

2. Micro-Prudential Regulatory Reactions

On October 26, 2011, European politics reacted to the dwindling confidence in the European banking system with far-reaching coordinated measures. *Inter alia*, a recommendation by the European Banking Authority (EBA)[57] sought to tighten relevant micro-prudential regulation to reestablish confidence in SIFIs' resilience.[58] At the time of the writing of this Article, it was thought that a core capital (Tier 1)[59] to risk-weighted assets ratio[60] of 9% should have been reached by June 30, 2012.[61]

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55. *Id.* at 131.

56. *Id.*

57. A formal recommendation addressed to Member States' banking supervisors is not legally binding but subject to a comply-or-explain mechanism. Parliament and Council Regulation 1093/2010 (EU) of November 24, 2010, art. 16, 2010 O.J. (L 331) 12, 27 [hereinafter EBA-Regulation]. The national authority has to declare its non-compliance within two months after the issuance of the recommendation and communicate its reasons to the EBA, which has to publish the fact that the national authority deviates from the recommendation and may choose to publish the reasons for doing so. *Id.* art. 16(3).

58. *See generally* EBA, EBA RECOMMENDATION ON THE CREATION AND SUPERVISORY OVERSIGHT OF TEMPORARY CAPITAL BUFFERS TO RESTORE MARKET CONFIDENCE (Dec. 8, 2011), *available at* http://stress-test.eba.europa.eu/capitalexercise/EBA%20BS%202011%20173%20Recommendation%20FINAL.pdf [hereinafter EBA-RECOMMENDATION] (explaining the formulas banks are supposed to use in order to create capital buffers).

59. *Id.* at 6. The definition of Core Tier 1 is based on existing E.U. legislation in the Capital Requirements Directive. For the E.U. legislation, see *infra* note 162. This definition of capital comprises the highest quality capital instruments (common equity) and hybrid instruments provided by governments. It strips out other hybrid instruments including existing preferred stock.

60. The risk-weighting of assets means that a bank's assets and its off-balance sheet exposure are valued according to the risk of depreciations. Asset classes with lower risk of devaluation can be deducted accordingly, the simplest example being a riskless (0% possibility of depreciation) asset that can be deducted entirely from a bank's risk-weighted assets. *See* David Enrich & Max Colchester, *EU Banks' Risk in Eyes of Beholder*, WALL ST. J. (June 22, 2012), http://online.wsj.com/article/SB10001424052702304441404577480443348931240.html ("Under the risk-weighting systems, banks are permitted to hold less capital against safer assets than they have to hold against riskier ones."); Sonali Das & Amadou N.R. Sy, *How Risky are Banks' Risk Weighted Assets? Evidence from the Financial Crisis* 3 (Int'l Monetary Fund, Working Paper WP/12/36, 2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp1236.pdf (discussing the importance of risk-weighted assets in the context of risk-based capital ratios).

61. EBA-RECOMMENDATION, *supra* note 58, at 6. *See generally* Hal S. Scott, *Reducing Systemic Risk Through the Reform of Capital Regulation*, 13 J. INT'L ECON. L. 763 (2010) (describing the significance of capital requirements in reducing systemic risk).

Furthermore, all banks with a capital shortfall as of September 30, 2011 according to the EBA's capital exercise[62] had to file a steps plan no later than January 20, 2012 that indicated how they would satisfy their capital needs, primarily by raising new capital in private markets and cutting dividends and bonuses.[63] Finally, an extraordinary buffer for risky sovereign bonds had to be put in place, e.g., the core capital requirement had to be met after the removal of the prudential filter on the sovereign assets in the available-for-sale portfolio and the conservative valuation of sovereign debt exposures in the held-to-maturity and loans and receivables portfolios, reflecting market prices as of September 30, 2011.[64] Banks that could not raise sufficient capital in private markets were to be compulsorily recapitalized with public funds from their home Member States that could borrow funds at the European Financial Stability Facility (EFSF) if they became overstrained or were put under severe pressure by financial markets as a consequence of such recapitalizations.

Even though significant steps to enhance the regulatory framework for SIFIs and reestablish market discipline have been taken in the meantime,[65] micro-prudential regulation will constitute a pivotal building block in the attempts to erect a stable and sustainable structure for the financial sector in the European Union. It is thus of critical importance to ensure an effective administration of these rules. This general assessment is corroborated by the fact that the first step in establishing the E.U. Banking Union will be the setting-up of a Single Supervisory Mechanism (SSM) to buttress the effectiveness of prudential oversight.[66] With the supervisory structure depending on a transnational banking group's legal structure,[67]

62. The EBA ultimately calculated the capital shortfall of all relevant European banks in its recapitalization exercise at 114 billion euro ($186 billion). *The EBA Publishes Recommendation and Final Results of Bank Recapitalisation Plan as Part of Coordinated Measures to Restore Confidence in the Banking Sector*, EBA (Dec. 8, 2011), http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-publishes-Recommendation-and-final-results.aspx. However, in June 2012, Spain acquiesced to a bailout package of 100 billion euro ($125 billion) to rescue its banks alone. Charles Forelle & Gabriele Steinhauser, *Latest Europe Rescue Aims to Prop up Spain*, WALL ST. J., June 11, 2012, at A1. The dependence on the methodology was already illustrated by the earlier estimations of the German Council of Economic Experts that based their gauges on the balance sheet positions published by the EBA in July 2011: The capital shortfall of European banks would amount to 106 billion euro ($150 billion) if a write-down of 50% was applied to Greek bonds. ANNUAL REPORT, *supra* note 51, at 132. If a mark-to-market approach was applied to all sovereign debt-positions, allowing for both depreciations and appreciations, the capital shortfall of European banks would rise to 137 billion euro ($194 billion). *Id.*

63. EBA-RECOMMENDATION, *supra* note 58, at 14.

64. *Id.* at 13.

65. *See, e.g.*, *Commission Proposal for a Directive of the European Parliament and Council Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010*, at 4, COM (2012) 280/3 (June 6, 2012) [hereinafter *Proposal Resolution Directive*] (establishing a cross-border crisis management framework in the banking sector and "equip[ping] authorities with common and effective tools and powers to tackle bank crises pre-emptively, safeguarding financial stability and minimizing taxpayer exposure to losses in insolvency"). This directive aims at establishing a cross-border resolution regime for SIFIs and a viable bail-in mechanism and, thus, goes to the heart of the moral hazard problem in the banking sector. *See supra* Section II.A.2 (discussing the moral hazard problem that occurs when the bailout of SIFIs is foreseeable).

66. *See Commission Proposal SSM Regulation*, *supra* note 33 (showing that the SSM Regulation aims at more effective prudential supervision of transnational financial institutions).

67. For a detailed analysis, see *infra* Part IV (explaining the supervision of cross-border banking groups).

organizational choices of banks impact the administration of these rules. This is why the next part turns to the basic characteristics of the available alternatives in order to evaluate the driving forces behind banks' pertinent decisions.

III. ORGANIZATIONAL CHOICES OF BANKS

Part III briefly reviews the most important characteristics of the organizational structures prevalent in cross-border banking.[68] Benefits and detriments associated with either the branch or the subsidiary model are rather scattered so that neither structure dominates over the other from the banks' or the policymakers' perspective. The findings corroborate the posit that the simple allegation of regulatory arbitrage underestimates the complexity of the choice of organizational form and misdirects the attention away from the central issue of how prudential supervision can best serve its end regardless of the legal structure banks opt for in their cross-border operations.

A. *Branches and Subsidiaries: Main Features of Prototypical Organizational Structures*

In an ideal world, the branch structure, under which all foreign operations are conducted from within a single legal entity, allows for a centralized organization where capital and liquidity flow freely across business units and across borders.[69] Capital is raised in the market where it is least expensive and deployed where it yields the highest return, thus offering cost-reducing arbitrage options across jurisdictions. In times of crisis, the integrated risk management can move excess capital and liquidity that is available anywhere within the group to the business unit under stress.

On the other hand, opting for an archetypical subsidiary structure under which foreign business units are legally independent, incorporated entities, entails decentralized operations subject to local capital and liquidity requirements. Legal restrictions on the transfer of capital and liquidity hamper respective intra-group transactions,[70] whereas the transfer of knowledge and technology is by and large unimpeded. Parent and subsidiaries are subject to the own funds and liquidity requirements of local jurisdictions.[71] Individual risk-management of the group's entities is required to make them resilient independently, as in times of crisis, financial aid is guaranteed neither from the parent nor from any other group

68. *See supra* Section I.A. (explaining that cross-border banking has created an interconnected global financial system in which banks operate through either subsidiaries or branches).

69. The closest real world example of such an idealized branch structure occurs in the European Union. *See infra* Section IV.B.1.b (stating that the regulatory framework "allows credit institutions to 'travel' on their domestic banking authorizations throughout the European Union without significant restrictions").

70. *See* EUR. BANK COORDINATION "VIENNA" INITIATIVE, WORKING GROUP ON BASEL III IMPLEMENTATION IN EMERGING EUROPE, REPORT TO BE SUBMITTED TO THE EBCI FULL FORUM (Mar. 2012) (explaining that restrictions might hamper the functioning of intra-group transfers of funds).

71. *See* Fiechter et al., *supra* note 1, at 7–9 (explaining the pertinent requirements for a subsidiary structure in cross-border banking groups).

affiliate.[72] In fact, capital maintenance requirements in corporate law serve as a weak form of ring-fencing,[73] which raises the operating costs of the transnational banking group requiring overall higher levels of capital.[74]

It has to be noted here that for the purpose of analysis simplifications are useful, although reality is significantly more complex. For instance, on a regulatory level, some jurisdictions treat foreign branches and subsidiaries alike when it comes to capital and liquidity requirements for the hosted business unit.[75] As will be discussed in more detail,[76] this is only one example where the legal differences between branch- and subsidiary models that are clear-cut at the outset are significantly mitigated with regard to micro-prudential supervision.

B. *The Bank's Perspective*

1. General Considerations

The principal characteristics of the organizational options translate into costs and benefits for a banking group that seeks to optimize the legal structure of its cross-border business.[77]

Intuitively, a branch structure entails lower costs of doing business for the banking group compared to operating under a subsidiary structure. Independent legal personality in principle requires subsidiaries to sustain themselves as stand-alone entities and thus leads to a need for higher capital and liquidity buffers.[78] Moreover, the latter have to be filled at higher lending costs for the individual entities.[79] The pertinent restrictions on the transfer of capital and liquidity attenuate

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72. *Id.* at 9.

73. Usually, the term signifies a separation of business units that aims at limiting the risk of contagion without proscribing their consolidation under the roof of a single financial institution. *See* Julian T.S. Chow & Jay Surti, *Making Banks Safer: Can Volcker and Vickers Do It?* 22–23 (Int'l Monetary Fund, Working Paper WP/11/236, 2011), *available at* http://www.imf.org/external/pubs/ft/wp/2011/wp11236.pdf (describing the objectives of the retail ring-fence). The most prominent proposal in this direction comes from a U.K. commission and seeks to shield domestic retail operations from the risks of international investment banking without prohibiting that these lines of business be organizationally united within a so called universal bank that arguably attains diversification benefits. *See* INDEPENDENT COMM'N ON BANKING, FINAL REPORT RECOMMENDATIONS 35–77, 76–77 (2011), *available at* http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf (describing retail ring-fence and recommending the development of individual retail ring-fence entities).

74. *See* Eugenio Cerutti et al., *Bankers Without Borders? Implications of Ring-Fencing for European Cross-Border Banks* (Int'l Monetary Fund, Working Paper WP/10/247, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1750736 (devising a stylized model that indicates that cross-border banking groups need larger capital buffers at the subsidiary and parent level under ring-fencing to survive a credit shock).

75. Fiechter et al., *supra* note 1, at 7 note 4.

76. *Infra* Section III.D.

77. *See* Fiechter et al., *supra* note 1, at 8–9 (explaining the benefits of both branch and subsidiary models for cross-border banks).

78. *Id.* at 8.

79. *See* Ata Can Bertay, Asli Demirguc-Kunt & Harry Huizinga, *Is the Financial Safety Net a Barrier to Cross-Border Banking?* 2 (World Bank Policy Research Working Paper No. 5947, 2012), *available at* http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2012/01/17/000158349_2012 0117092544/Rendered/PDF/WPS5947.pdf (showing that the "cost of funds raised through a foreign subsidiary is between 1.5% to 2.4% higher than the cost of funds for a domestic bank").

opportunities for arbitrage when capital is raised and deployed under a subsidiary structure.

Furthermore, the branch structure can strengthen the banking group's resilience if locally contained, adverse developments occur. Obviously, this constitutes an advantage from the bank's perspective if the banking group's survival in its current structure is deemed desirable.[80] The unimpeded transfer of funds allows the group to overcome country-specific negative shocks, as long as the magnitude of the adverse developments does not consume the group's entire capital and liquidity reserves. On the other hand, legal restrictions that can result from general corporate law (e.g., minimum capital requirements)[81] as well as specific regulations applying to banks,[82] may hamper the quick transfer of much needed funds under a subsidiary structure.[83]

Conversely, however, the subsidiary structure may facilitate the containment of losses that accrue at a single group unit. The crisis, or even the bankruptcy of a battered, legally independent affiliate or of the parent corporation, as a matter of principle does not affect the ongoing concern of other group entities.[84]

2. Assets and Drawbacks Depending on the Bank's Business Model

Some advantages accrue depending on the business model the banking group intends to pursue in its transnational expansion.[85] The branch structure allows corporate clients to borrow against the entire group's global balance sheet and hence to push large exposure limits[86] and to improve borrowing conditions.

80. *See* Fiechter et al., *supra* note 1, at 8 (explaining that the branch structure allows financial institutions to better withstand an adverse shock of this type).

81. For instance, European legislation prohibits any corporation to distribute funds if its net assets are or would fall—as a result of such distribution—below the amount of the subscribed capital established in the corporate charter. *See* Second Council Directive on the Coordination of Safeguards, Which for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the Treaty, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, with a View to Making such Safeguards Equivalent, art. 15, 1977 O.J. (L 26) 1.

82. *See supra* Section II.B.2 (listing stricter capital requirements applied to banks).

83. A group of experts assigned by the European Commission identified a multitude of restrictions on intra-group transfers that can form an obstacle to containing a banking crisis and thus proposed to lift these barriers under certain conditions. EUROPEAN COMMISSION, STUDY ON THE FEASIBILITY OF REDUCING OBSTACLES TO THE TRANSFER OF ASSETS WITHIN A CROSS BORDER BANKING GROUP DURING A FINANCIAL CRISIS 7 (proposal No. 1), 31–113 (2011), *available at* http://ec.europa.eu/internal_market/bank/docs/windingup/200908/final_report20091218_en.pdf. The Commission intends to follow the expert advice. *See Proposal Resolution Directive*, *supra* note 65, arts. 17–23 (proposing "overcom[ing] current legal restrictions" on intra-group transfers as a way to help "address developing financial problems within individual group members").

84. *See* Bonin, *supra* note 4, (providing a review of the empirical literature to indicate under which conditions banks retain their presence through subsidiaries in transition economies even in times of crisis).

85. *See* Fiechter et al., *supra* note 1, at 9–10 (discussing in more detail "[a] number of . . . benefits of the branch and subsidiary structures accrue only to banking groups following a particular business model").

86. In order to provide for a reasonable degree of diversification, micro-prudential regulation of banks restricts the permissible concentration of credit risk by setting a limit on how much a single counterparty can borrow from the bank, i.e. large exposure limits relate the maximum that is available for lending to a single borrower to the bank's total capital base. Basel Committee on Banking Supervision, *Measuring and Controlling Large Credit Exposures*, para. 17 (1991), *available at* http://www.bis.org/publ/bcbsc121.pdf.

On the other hand, only the subsidiary structure allows access to local deposit insurance schemes[87] and thus appeals to consumer confidence if the latter is rooted in a larger faith in domestic institutions.[88] Moreover, the advantages of a centralized liquidity- and risk-management structure may be smaller if the business model is focused on retail clients where local fund-raising and a deepened understanding of local markets seem more important.[89]

3. Business Judgment and Market Reactions

The noteworthy aspect of this brief overview—which does not aim at exhausting the subject[90]—lies in the observation that both the subsidiary and the branch-structure support sound business models and thus cannot be regarded as abusive or opportunistic, an observation that becomes even more stringent if the policymaker's perspective is taken into account in more detail.[91] Ultimately, the organizational choices seem to hinge upon the context-dependent business judgment of cross-border banks' decision-makers because no model clearly dominates the other in terms of effectiveness and practicality.[92]

After all, some market discipline can be expected at least with regard to palpably opportunistic choices. Although SIFIs do not face the terminal sanction of a forced market exit in bankruptcy,[93] their creditors face at least uncertainty and potential losses on the nominal value of their claims in the event of financial distress.

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87. For example, under current European legislation, credit institutions, e.g., incorporated entities, are covered by the Member State's guarantee scheme that issued their banking license with the institution's branches included in the pertinent national system. Directive 94/19/EC, of the European Parliament and of the Council of 30 May 1994 on Deposit-Guarantee Schemes, arts. 3(1), 4(1), 1994 O.J. (L 135) 5; *see also* Basel Committee on Banking Supervision & International Association of Deposit Insurers, *Core Principles for Effective Deposit Insurance Systems*, 3, 12 (2009), *available at* http://www.bis.org/publ/bcbs156.pdf (describing responsibilities within compulsory deposit insurance schemes in a cross-border context).

88. The euro crisis serves as a reminder that this need not be the case, with depositors from the troubled Member States at least engaging in a "bank jog" in which they transfer their funds to foreign banks as a consequence of their distrust in local guarantee schemes. *See* Noémie Bisserbe, *Greek Banks Under Pressure*, WALL ST. J., June 14, 2012 at A1 (reporting that Greek depositors have been withdrawing their funds from Greek banks). Note also how the Belgian press responded to Deutsche Bank's branch conversion that pointed to improvements for retail customers that came under the protection of the limitless German depositor guarantee scheme as a consequence of the intra-group restructurings. P.D-D, *Protection Sans Plafond*, LA LIBRE, Oct. 15, 2011, *available at* https://www.deutschebank.be/media/pdf/presse-libre-protection-sans-plafond-15-10-2011.pdf; F.M., *Les clients belges de Deutsche Bank protégés... en Allemagne* [*Belgian Clients of Deutsche Bank Protected . . . in Germany*], L'ECHO, Oct. 15, 2011, *available at* https://www.deutschebank.be/media/pdf/presse-echo-clients-proteges-15-10-2011.pdf.

89. Fiechter et al., *supra* note 1, at 10; *see id.* at 22 (attributing the organizational structure of Spanish cross-border banking to its retail-customer orientation).

90. An in-depth analysis identifies further determinations that account for the organizational choices in transnational banking and points to (i) the treatment of branches and subsidiaries in tax law in the home as well as in the host jurisdiction, (ii) the development and the structure of the foreign markets which may or may not provide sufficient opportunities to source capital, and (iii) macroeconomic and political risks abroad which may less severely affect branches than locally incorporated subsidiaries. Cerutti, Dell'Ariccia & Martínez Pería, *supra* note 13, at 1685–91 (scrutinizing the world's 100 largest banks' operations in Latin America and Eastern Europe).

91. *Infra* Section III.C.

92. *See* INT'L MONETARY FUND, *supra* note 3, at 9 (concluding that banks chose branches or subsidiaries based on the form of expansion).

93. On the underlying too-big-to-fail or too-interconnected-to-fail dilemma, see *supra* Section II.A.2.

As a consequence, it is plausible that a bank's choice of an inferior regime of prudential regulation and supervision will have a negative impact on its prospects.[94] The mounting distrust in certain countries' deposit guarantee schemes and the general public alertness *vis-à-vis* the details of such schemes supports this notion.[95] Furthermore, there is robust evidence that markets are sensitive with regard to the effectiveness of public enforcement of the regulatory framework designed to protect their interest.[96] Admittedly, with regard to banking supervision, this can only be extrapolated from certain studies that establish markets' general capacity to assess available information on banks' default risk correctly even in times of crisis.[97] However, if prudential regulation is at least potentially suited to mitigate the risk of bank failure, creditors should be attuned to its quality and enforcement. And it is precisely such awareness of market participants that has been particularly well-documented with regard to the enforcement of investor protecting securities laws.[98] As a consequence, choosing "bad" prudential supervision should be penalized by credit markets, which hence serve as a counterbalance to opportunistic choices.[99] It can be justified on these grounds to accept banks' organizational choices and design the supervisory regime accordingly instead of cramming them into certain structures in cross-border banking by alleging maneuvers of regulatory arbitrage.

C. *The Policymaker's Perspective*

To have the full picture, the policymaker's view on transnational banks' choices between the branch model and the subsidiary model must be assessed. The critical issues from the vantage of a cross-border bank's home and host country seem to be the relative growth perspectives under either organizational model and their

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94. *See, e.g.*, Andrea Sironi, *Testing for Market Discipline in the European Banking Industry: Evidence from Subordinated Debt Issues*, 35 J. MONEY CREDIT & BANKING 443, 443–72 (2003) (showing sensitivity to bank-risk among investors in subordinated notes and debentures). *But see* Robert P. Bartlett, III, *Making Banks Transparent*, 65 VAND. L. REV. 293, 311–22 (2012) (explaining the methods and difficulties associated with assessing default risk in loan portfolios).

95. *Supra* note 88; *see also* Maria Soledad Martinez Peria & Sergio L. Schmukler, *Do Depositors Punish Banks for Bad Behavior? Market Discipline, Deposit Insurance, and Banking Crises*, 56 J. FIN. 1029 (2001) (showing how depositors disciplined weak banks by withdrawing deposits and by requiring higher interest rates in Argentina, Chile, and Mexico during the 1980s and 1990s).

96. *See, e.g.*, John S. Jordan, Joe Peek & Eric S. Rosengren, *The Market Reaction to the Disclosure of Supervisory Actions: Implications for Bank Transparency*, 9 J. FIN. INTERMEDIATION 298, 307–17 (2000) (showing how increased disclosure of supervisory actions even during a banking crisis in the United States had no destabilizing effect but contributed to a more effective allocation of resources in the U.S. banking sector).

97. *Id.*

98. *See* John Armour, Colin Mayer & Andrea Polo, *Regulatory Sanctions and Reputational Damage in Financial Markets* (Oxford Legal Studies Res. Paper No. 62/2010, 2010), *available at* http://ssrn.com/abstract=1678028 (finding that fines administered by public enforcement agencies serve as clear signals to the market that subsequently punishes wrongdoers); Howell Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207 (2009) (establishing the correlation between public enforcement of securities laws and market development).

99. *But see* Joel P. Trachtman, *The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation*, 13 J. INT'L ECON. L. 719, 723–25 (2010) (giving a more pessimistic view but underestimating the significance of supervisory deficits and palpable opportunism).

respective impact on financial stability.[100] Once again, however, the findings remain ambiguous.

Intuitively, growth-hungry policymakers should prefer transnational banks branching into their economies, as the branch model potentially grants easier access to credit.[101] Yet, the empirical evidence with very successful transition economies being served through subsidiaries of large international banks casts doubt on the existence of such a clear-cut preference.[102] Moreover, if the subsidiary structure hampers the intra-group transfer of funds and hence compels more reliance on local deposits,[103] it can contribute to the development of credit markets in host countries. Yet, as has already been mentioned, where savings are limited due to market development, large exposure limits may quickly preclude corporate clients from borrowing from local subsidiaries[104] and in turn coerce these actors into bypassing local credit markets, thus handicapping their development.[105]

The competing organizational models' influence on financial stability reveals a dichotomy of interests between the banks' host and home countries. Assuming that the subsidiary model allows containing local crises,[106] greater resilience should result with regard to individual group members, if the shock is external. Conversely, under the branch model the readily available, group-wide support[107] should make it easier to weather the storm if the crisis has a domestic source. However, saving a foreign business unit puts stress on the banking group. As a result, policymakers will be reserved with regard to rescue obligations that originate abroad but weaken the institution and entail the risk of contagion.[108] Policymakers in a banking group's home country will thus prefer a subsidiary structure if the financial crisis arises abroad, and will prefer a branch structure if foreign entities will contribute to averting a crisis in the group's home country. The host country agenda is diametrical.

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100. *See* Fiechter et al., *supra* note 1, at 15–17 (claiming "key considerations for home or host authorities" are the "implications for growth and financial stability . . . of the two bank structures"); *see also* FRANKLIN ALLEN ET AL., CROSS-BORDER BANKING IN EUROPE: IMPLICATIONS FOR FINANCIAL STABILITY AND MACROECONOMIC POLICIES 47–53 (2011) (reviewing the literature regarding the effect of cross-border banking on financial stability and stating that cross-border banking "reduces the risk of bank failures" but, at the same time, exposes a country to "foreign shocks").

101. For the underlying reasons, see *supra* Sections III.B.1 and III.B.2.

102. *See* Ralph de Haas & Iman van Lelyveld, *Internal Capital Markets and Lending by Multinational Bank Subsidiaries*, 19 J. FIN. INTERMEDIATION 1, 10–16, 21 (2010) (finding evidence for the existence of internal capital markets that allow subsidiaries of financially strong parents to expand their lending faster than domestic competitors, i.e., access to credit is also enhanced significantly even though foreign banks opt for a subsidiary structure). *But see* Bonin, *supra* note 4, at 487 (suggesting policymakers have reason to be skeptical of transnational banks because the "potential for financial contagion from home-country shocks to host countries via the bank-lending channel" can be a major concern).

103. *See supra* Section III.B.2 (explaining that only the subsidiary structure allows access to local deposit insurance schemes).

104. *Id.*

105. *See* Fiechter et al., *supra* note 1, at 15 (explaining how the subsidiary model may hinder development for local markets).

106. *See supra* Section III.B.1 (stating that a "subsidiary structure may facilitate the containment of losses that accrue at a single group unit").

107. *Id.*

108. *See supra* Section I.A ("[T]he magnitude of the shocks originating overseas and the importance of the financial institutions affected may ultimately compel fiscally expensive and politically unpopular government bailouts in order to avoid the disruptive consequences of a pivotal bank's failure.").

This contrast of preference only varies in degree if a failing bank has to be rescued with public funds. Absent transnational burden-sharing arrangements,[109] host countries are under no obligation to participate in bailouts under the branch model, whereas home countries do not have to contribute to the rescue of a foreign incorporated affiliate under the subsidiary model.[110]

From the perspective of those responsible for public policy, there is no abstract preference for either organizational structure. This is particularly true once policy considerations are not ruthlessly confined to national interests: Where a polity reaps all the social gains from a branch's successful operations, it seems hard to justify and creates a free-rider problem if it is in fact under no obligation to contribute to alleviating distress originating at that very entity.

D. The Regulatory Arbitrage Debate Revisited

This brief survey indicates that neither from the banks' nor from the policymakers' perspective does one organizational model dominate the other. Importantly, many effects identified as core features of either organizational model can be molded in practice to a significant degree. For instance, centralized group financing and liquidity management typically involves independently incorporated affiliates, e.g., with qualified corporate and accounting counsel capital flows are largely independent of the group's legal structure.[111] Similarly, group-wide guarantees, or letters of comfort may create liability risks although the originally chosen subsidiary structure created firewalls between business units. The latter can also be undone if looming negative reputational effects of an affiliate's failure *de facto* compel its support.[112] Hence, it is not surprising that, in practice, rather complex organizational hybrids can be observed, mainly as a function of the cross-border banks' business models.[113]

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109. It is a critical feature of the recent reform initiatives in the European Union that such risk-sharing agreements will be concluded among the Member States involved in a bailout of a transnational financial institution. *See Proposal Resolution Directive*, *supra* note 65, art. 98 (stating that in case of group resolution, the Member States must ensure that the institutions contribute to the financing of the resolution); Charles Goodhart & Dirk Schoenmaker, *Fiscal Burden Sharing in Cross-Border Banking Crises*, 5 INT'L J. CENTRAL BANK 141 (2009) (discussing various models of *ex post* and *ex ante* agreements to achieve the recapitalization of failing banks in a cross-border banking crisis).

110. From the vantage of a small country that is the domicile of large international banking groups but has only confined fiscal firepower, it may be prudent to encourage a subsidiary structure. For a correspondent recommendation, see INT'L MONETARY FUND, *supra* note 3, at 23.

111. Fiechter, et al., *supra* note 1, at 5 ("In practice, most cross-border banking groups . . . run operations through a hybrid structure that includes both branches and subsidiaries in different jurisdictions."); *id.* at 15 ("There is no firm evidence that subsidiaries are characterized by more/less stable inter-affiliate cross-border capital flows than branches.").

112. *See* Herring & Carmassi, *supra* note 19, at 206 (discussing the risk of intra-group contagion once a subsidiary is sent into bankruptcy); Thomas C. Baxter, Jr. & Joseph H. Sommer, *Breaking Up Is Hard to Do: An Essay on Cross-Border Challenges in Resolving Financial Groups*, *in* Systemic Financial Crises 175, 187 (Douglas D. Evanoff & George G. Kaufman eds., 2005) (arguing that an affiliate's benefit from limited liability only comes at the expense of other group members).

113. *See* Fiechter, et al., *supra* note 1, at 13–14 (graphing data compiled from central banks, supervisory and regulatory authorities that proves the large nature of subsidiaries of foreign banks all over the world); *see also* Herring & Carmassi, *supra* note 19 (stating that among the sixteen international financial conglomerates identified by regulators as "large complex financial institutions (LCFIs)," each has several hundred majority-owned subsidiaries and half have over one-thousand subsidiaries).

All this affirms the perception that banks' organizational choices in their cross-border business cannot easily be identified as serving or militating against social welfare.[114] In general, they should be accepted, not least because banks will have to live with a variety of consequences other than their choices' impact on the regulatory framework.[115] As a result, the attention of policymakers should be turned to designing a supervisory architecture that achieves its stated goal of minimizing the probability and consequences of financial distress in the banking sector regardless of banks' organizational choices.

With this in mind, an important consequence of the discussion should not go unnoted. As polities are affected in different ways by the financial distress of independently incorporated or legally dependent business units of a transnational bank,[116] their incentives in prudential supervision diverge accordingly. If the failure of an affiliate or branch does not affect supervisors' economies, they will only have low-powered incentives to engage in preventive efforts. On the other hand, if the viability of the respective business units impacts on the economy, public policy has reasons to seek influence in their prudential supervision and execute it adequately. This observation is important, because it indicates that charging authorities with responsibilities creates an externality problem if the benefits from reducing the risk of failure, or the damages from doing so sub-optimally, accrue in foreign economies. These external effects are exacerbated if the allocation of supervisory competence prevents authorities from contributing to prudential efforts even though their economies are massively affected.

Dwelling on these observations, the following part of this Article turns to the supervisory regime for E.U. transnational banking groups. It explains which shortcomings contributed to the current banking crisis and why the attempts to remedy the problems identified may be only a half-hearted step into the right direction.

IV. THE SUPERVISORY REGIME FOR E.U. CROSS-BORDER BANKING GROUPS

Public supervision of banks generally constitutes a reserve of sovereign countries, which requires at least some division of labor once banks expand their business across borders. However, organizational choices affect the institutional setup in a significant manner: Where an international banking group opts for the subsidiary model, host country supervisors get more clout in the cooperative game as the separate legal entity has to be furnished with a domestic license and is thus supervised by host country authorities, whereas under a branch structure host country watchdogs are largely deemed to remain idle.[117]

Tying the whole supervisory regime to the distinction between organizational choices seems somewhat stuck in nineteenth century formalism. Moreover, it stands

114. *Supra* Section III.B.3.

115. *See* Fiechter et al., *supra* note 1, at 7–10 (describing the different considerations involved in a bank's decision on its organizational model, such as restrictions on asset transfers, risk management, types of services for core clients, and costs of doing business).

116. *Supra* Section III.C.

117. *See infra* Section IV.B (discussing the E.U. architecture of banking supervision structured in accordance with international standards).

in stark contrast to the efforts made elsewhere in current banking law to gear micro-prudential supervision towards the actual risk posed by the regulated institution's business.[118] To bolster this argument, the general determinants of the division of competences between the national supervisors involved will be outlined in Section A, before turning to the E.U. regime in more detail in Section B, and evaluating the findings in Section C.

A. General Determinants

A basic concept for the effective supervision of cross-border banking groups was laid out in the Basel Concordat,[119] and later transformed into rather lofty ground rules in the Basel Core Principles (BCP)[120] devised by the Basel Committee on Banking Supervision (BCBS) at the BIS. The BCP have been reviewed repeatedly without material alteration in pertinent respect, the current version dating to September 2012 (BCP 2012).[121]

BCP 23 obliges home country supervisors of internationally active banking groups to "practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries."[122] Furthermore, BCP 24 underlines that a "key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities."[123] Correspondingly, pursuant to BCP 25 host country supervisors "must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision."[124]

It is worth noting that the pertinent section of the BCP underscores the importance of unconfined cooperation between home and host country authorities and at this juncture does not distinguish between the different organizational structures of cross-border banks.[125]

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118. *See infra* Section IV.B.4.a (chronicling the harmonization of European substantive banking and financial laws, including prudential supervision of credit institutions and discussing the overall end of the underlying, so-called Basel I, II, and III Accords).

119. Basel Committee on Banking Supervision & Offshore Group of Banking Supervisors, *The Supervision of Cross-Border Banking* (1996), *available at* http://www.bis.org/publ/bcbs27.pdf.

120. Basel Committee on Banking Supervision & Offshore Group of Banking Supervisors, *Core Principles for Effective Banking Supervision* (1997), *available at* http://www.bis.org/publ/bcbs30a.pdf.

121. Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (2012), *available at* http://www.bis.org/publ/bcbs230.pdf.

122. *Id.* at 40.

123. *Id.*

124. *Id.* at 41.

125. *Id.* at 41–42. An identical cooperative regime is delineated in Principles 12 and 13 of the BCP 2012, Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision*, 35–37 (2012), *available at* http://www.bis.org/publ/bcbs230.pdf.

B. *The E.U. Architecture of Micro-Prudential Banking Supervision*

The European regulatory framework responds to the BCP and transforms them into supranational law that binds E.U. Member States.[126] To this end, supranational law makes rather detailed prescripts when it comes to delineating national authorities' competences that leave Member States little to no latitude in implementing the pertinent directive. With regard to cross-border banking groups, European law frames an elaborate regime that governs both the monitoring of individual business entities and the consolidated supervision of the whole group. In that, it makes a pivotal distinction between subsidiaries and branches. In general, the supervisory architecture requires a relatively high degree of cooperation and the constant exchange of information between national authorities. The necessary coordination shall generally be facilitated by colleges of supervisors as well as supranational authorities established on the E.U. level where most recently initiated reforms will significantly alter the scenario.

1. Supervision of Individual Business Entities

The prudential supervision of individual business entities is linked directly to the authorization of the pertinent activities: The competent authority that granted the banking license is responsible for the institution's ongoing supervision, e.g., where cross-border activities require no separate authorization, national banking supervision encompasses permanent activities on foreign markets.

a. Subsidiaries

Independently incorporated business entities of a cross-border banking group constitute "credit institutions" within the scope of the pertinent supranational regulation[127] and hence have to be authorized by the Member State of incorporation.[128] As a consequence, these home Member States assume the primary responsibility for the pertinent institutions' prudential supervision regardless of their group-affiliation.[129]

The necessary coordination and cooperation between multiple supervisory authorities that are simultaneously tasked with controlling the cross-border banking groups' affiliates incorporated in different jurisdictions is supposed to be achieved on

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126. The relevant European directive prescribes to which ends and to what extent national laws shall be harmonized and obliges Member States to implement the specifications in their domestic legislation. TFEU, *supra* note 12, art. 288.

127. Directive 2006/48 of the European Parliament and the Council Relating to the Taking Up and Pursuit of the Business of Credit Institutions, arts. 4(1), 4(13), 2006 O.J. (L 177) 1 [hereinafter Banking Directive]. The allocation of competences is supposed to remain untouched in its substance under the Proposed CRD IV legislation, *supra* note 31. Future references to the CRD IV equivalents of the Banking Directive will be placed in brackets.

128. Banking Directive, *supra* note 127, art. 6 et seq.; [CRD IV Directive, *supra* note 31, art. 9 et seq.].

129. *See* Banking Directive, *supra* note 127, arts. 40(1), 4(7) (allocating supervisory competences to the home Member State that issued the banking license for the group member). The system will remain intact under CRD IV Directive, *supra* note 31, arts. 49(1), 4(61).

a macro-level within the European Financial Supervisory System and, for Europe's largest banks, on the micro-level within Colleges of Supervisors.[130]

This supervision of individual credit institutions, which at the outset considers each independently incorporated deposit institution as a stand-alone, is complemented by the consolidated supervision of the whole group that represents a duty of the competent authority that authorized the parent institution.[131]

b. Branches (E.U. Passport)

Banking Directive Article 40(1) [CRD IV Directive Article 49(1)] refers to Banking Directive Article 23 [CRD IV Directive Article 33], and thus indicates expressly that prudential supervision of a credit institution encompasses the cross-border activities carried out through a branch or the direct provision of services.[132] Correspondingly, Banking Directive Article 16 [CRD IV Directive Article 17] prohibits host Member States from requiring a separate authorization or to prescribe a specific capital endowment for the branches of those credit institutions that received a banking license from their home Member State. This regulatory framework warrants describing the banking license of the incorporated credit institution as a "European passport."[133] In fact, the latter allows credit institutions to "travel" on their domestic banking authorizations throughout the European Union without significant restrictions.[134] Transnational credit institutions merely have to notify host Member States' authorities prior to commencing their cross-border activities, with the depth of required disclosures varying between branch establishment and provision of services.[135]

As home Member States' competent authorities almost completely predominate in the prudential supervision of cross-border activities carried out through branches, host Member States' authorities are confined to providing information to facilitate home Member State supervision, although the duty to cooperate under Banking Directive Article 42 [CRD IV Directive Articles 146, 51(1)] is by design a mutual obligation. The home Member States' competent authorities are even authorized to conduct on-site-examinations, i.e., act in a sovereign capacity on foreign territory in order to obtain information pertinent to their supervisory activities that was not adequately supplied by host Member States' watchdogs.[136]

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130. *See infra* Section IV.B.4.b ("Despite ... advances in the harmonization of the substantive regulations, only consultative and coordinative functions are allocated on the supranational level.").

131. Banking Directive, *supra* note 127, art. 40(2); [CRD IV Directive, *supra* note 31, art. 49(2)]. *Cf. infra* Section IV.B.2 ("[E]ven though the transnational banking group is comprised of legally independent affiliates . . . it represents a business unit that is economically integrated and hence poses a variety of risks . . . .").

132. For a more detailed description on the various forms of cross-border activities, see *supra* note 12.

133. Banking Directive, *supra* note 127, arts. 23 & 25 et seq.; [CRD IV Directive, *supra* note 31, arts. 33, 35 et seq.] (describing the mechanisms by which a credit institution can establish a branch or provide services in a Member State).

134. *See* Commission Staff Working Document: Impact Assessment, Accompanying Document to the Proposal Amending Directives 98/78/EC, 2002/87/EC & 2006/48/EC, n.20, SEC (2010) 979 (Aug. 16, 2010) ("[T]he European passport allows financial institutions to provide financial services throughout the internal [European] market while being authorized in one of its member states.").

135. Banking Directive, *supra* note 127, arts. 25–28; [CRD IV Directive, *supra* note 31, arts. 35–38].

136. *See* Banking Directive, *supra* note 127, art. 43; [CRD IV Directive, *supra* note 31, art. 53]

After all, the competent authority of a branch's host Member State retains the responsibility *inter alia* for the supervision of the branch's liquidity.[137] However, these functions have to be exercised in cooperation with the home Member State's competent authority in accordance with the procedures laid out in Banking Directive Article 30.[138] The host Member State's authority may require a branch to improve on its liquidity endowment, but has to turn to the home Member State's supervisor in case the credit institution does not comply voluntarily. Only if the home Member State's authority fails to put an end to the branch's irregular situation may the host Member State's supervisor step in and enforce the required measures directly *vis-à-vis* the foreign credit institution.[139]

2. Consolidated Supervision

As recommended by the BCP,[140] a core feature of the European regulatory framework is consolidated supervision of the group. The prominence of this type of monitoring reflects the accurate perception that even though the transnational banking group is comprised of legally independent affiliates (incorporated parents and subsidiaries), it represents a business unit that is economically integrated and hence poses a variety of risks that warrant a comprehensive micro-prudential view on the group's operations.[141]

According to Banking Directive Article 125(1) [CRD IV Directive Article 106(1)], consolidated supervision is exercised by the competent authority of the Member State that authorized the parent credit institution of a cross-border banking

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(providing for "on-the-spot verifications" of information by home Member States).

137. Banking Directive, *supra* note 127, art. 41 also grants host Member State's authorities the necessary competences to implement national monetary policy where the latter is independent. Until January 1, 2015, CRD IV Directive Article 145 shall contain an identical rule. According to CRD IV Directive Article 140. Yet, CRD IV Directive Article 145 will be replaced by the more complex regime in CRD IV Directive Articles 41 and 43 that, except for emergency situations, gives host Member States generally less clout in monitoring a branch's liquidity as they can no longer act *vis-à-vis* the foreign branch but only induce the home Member State competent authority to take action or appeal to the EBA to settle a dispute. Under the Markets in Financial Instruments Directive (MiFID) the host Member State's competent authority is also tasked with supervising the proper business conduct of the branch. Directive 2004/39 of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments, art. 32(7), 2004 O.J. (L 145) 1, 26.

138. On January 1, 2015, CRD IV Directive Article 142 will give way to the division of labor outlined in CRD IV Directive Articles 41 and 43 that give home Member States (and the EBA) a stronger position. CRD IV Directive, *supra* note 31, art.140.

139. CRD IV Directive, *supra* note 31, art. 142

140. *Supra* Section IV.A.

141. A typical issue is the risk of intra-group contagion, which is not necessarily limited to scenarios where the original shield of limited liability that protects incorporated affiliates from financial distress at other group members has been undone, e.g., by a binding letter of comfort. Intra-group contagion can also occur if, even without direct mutual financial exposure, negative information on specific group members corrupts the confidence of creditors in other affiliates. Similar problems may occur when the group members' respective exposure to certain counterparties accumulates and constitutes a massive concentrated risk, even though individual large exposure limits are observed. *See, e.g.*, Ronald MacDonald, *Consolidated Supervision of Banks*, *in* 15 HANDBOOKS IN CENTRAL BANKING 11–14 (June 1998), *available at* http://www.bankofengland.co.uk/education/Documents/ccbs/handbooks/pdf/ccbshb15.pdf (explaining various supervisory problems with banking groups that operate in subsidiary structures).

group.[142] Banking Directive Article 126 [CRD IV Directive Article 106(3)–(6)] aims at a similar concentration of competence for consolidated supervision of a group's credit institutions if the head of the banking group itself is not a credit institution, which accepts deposits, but provides any of an array of financial services and is thus deemed to be an E.U. financial holding company.[143] The head of a financial holding company as such may also be included in consolidated supervisory activities pursuant to Banking Directive Article 127 [CRD IV Directive Article 114].

Moreover, consolidated supervision also affects the supervision of a cross-border banking group's subsidiaries and restricts the leeway for autonomous decision making of a Member State's supervisor that authorized affiliated credit institutions. The consolidating supervisor shall seek joint decisions with the competent authorities supervising the group's subsidiaries on key aspects of prudential group supervision, particularly the specifications on sufficient own-funds on both the consolidated as well as the entity level with regard to the application of Banking Directive Articles 123, 124, and 136(2) [CRD IV Directive Articles 72, 92(1)–(2), and 100].[144] The EBA may be consulted to reach a settlement if differences between the responsible authorities occur.[145] Yet, ultimately, the decision of the consolidating supervisor prevails.[146] Furthermore, competent authorities responsible for the supervision of controlled credit institutions are under the obligation to contact the consolidating supervisor prior to implementing approaches and methodologies in order to obtain pertinent information available at the top level.[147] Finally, competent authorities shall consult each other prior to taking any action with regard to certain critical issues at the supervised banks, in particular structural changes concerning a member of the banking group that require approval, major sanctions, and exceptional supervisory measures.[148]

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142. In a rather nested way, Banking Directive Articles 4(1), (2), (4), (14), and (15) define the parent credit institution of a cross-border banking group as the legal entity at the top of the cross-border banking group within the European Union. Thus, the top E.U. subsidiary of an international banking group where the global parent is domiciled outside the European Union is subject to E.U. consolidated supervision. In fact, this approach is pretty similar to that under the U.S. Bank Holding Company Act. *Cf. supra* Section I.B.2 (explaining intra-group restructurings in the United States and defining a financial holding company under the U.S. Bank Holding Company Act as a company that has either indirect or direct control over a depository banking subsidiary).

143. Whereas a "credit institution," as defined by Banking Directive Article 4(1), engages in classical banking business such as deposit and credit transactions, a "financial institution," within the scope of Banking Directive Article 4(5), provides any service from a broader array of financial activities listed in Banking Directive Annex I Numbers 2 through 12 and 15, ranging from consumer credit provision to investment banking and portfolio management. The same can be said for CRD IV Regulation Article 4(1), (3).

144. Banking Directive, *supra* note 127, art. 129(2), para. 1; [CRD IV Directive, *supra* note 31, art. 108(1)(a)].

145. Banking Directive, *supra* note 127, art. 129(2), para. 2; [CRD IV Directive, *supra* note 31, art. 108(2)].

146. Banking Directive, *supra* note 127, art. 129(2), para. 5; [CRD Directive, *supra* note 31, art. 108(3)].

147. Banking Directive, *supra* note 127, art. 132(2); [CRD IV Directive, *supra* note 31, art. 112(3)].

148. Banking Directive, *supra* note 127, art. 132(3); [CRD IV Directive, *supra* note 31, art. 112(4)].

	Home Member State	Host Member State
Subsidiary Structure	Authorization and supervision of parent; Consolidating supervision of group	Authorization and supervision of legally independent subsidiaries in cooperation with consolidating supervisor (home Member State authority); Participation in consolidating supervision
Branch Structure	Authorization and supervision of bank, including Foreign activities (on-site investigations, etc.)	No authorization (E.U. passport); Supervision of liquidity endowment in cooperation with Home Member State authority

Table 1: Home-/Host-Member State competence and cooperation in micro-prudential bank supervision according to the Banking Directive.

3. Colleges of Supervisors

Both the supervision of business entities and consolidated supervision of transnational banking groups require a good deal of cooperation or at least information exchange. European law mandates permanent bodies that constitute an institutional framework, which seeks to streamline and intensify but also keep flexible the procedures national supervisors follow in discharging their cooperative obligations.[149]

Colleges of Supervisors provide the framework that facilitates the exchange of information and coordination among the consolidating supervisors and the other competent authorities involved in the supervision of a cross-border banking group.[150] However, supervisors in host Member States where the group carries out its activities through branches are usually not members of these Colleges. Banking Directive Article 42a(3) [CRD IV Directive Article 52 (3)] provides a notable exception if a branch is deemed systemically important ("significant") from the perspective of its

149. Originally, the European Union advocated plans to establish global Colleges of Supervisors with a detailed proposal to the G20 Washington Summit in November 2008. *See* Tony Barber, *EU Calls for Tighter Financial Controls*, FIN. TIMES, Nov. 5, 2008, at 8 (reporting broad support among E.U. Member States for robust reform proposals in advance of the 2008 G20 summit in Washington). The idea also plays a prominent role in the envisioned regime for the resolution of cross-border banking groups where the Proposal Resolution Directive Article 81 mandates the establishment of European resolution colleges.

150. Banking Directive, *supra* note 127, art. 131a; [CRD IV Directive, *supra* note 31, art. 111]; *see also* Banking Directive, *supra* note 127, art. 131a(1)(a)-(f) (explaining the particular tasks of a College); Committee of European Banking Supervisors (CEBS), Guidelines for the Operational Functioning of Supervisory Colleges (GL 34) (2010), http://www.eba.europa.eu/documents/Publications/Standards---Guidelines/2010/Colleges/CollegeGuidelines.aspx (detailing guidelines on carrying out the relevant duties and responsibilities).

host Member State.[151] The critical determination whether a branch is significant is initiated by its host Member State and should be reached in consensus with the consolidating or home Member State supervisor. However, ultimately the assessment of the host Member State's competent authority prevails.[152]

Even where Colleges of Supervisors are established, they merely provide a forum for exchange between national authorities; that is, they have no power to interfere with a Member State's supervisory authority.[153]

4. Supranational Competences as an Insufficient Remedy

Obviously, where a cumbersome division of labor between national authorities potentially inhibits effective prudential supervision, elevating competences on a supranational level becomes appealing.[154] It is no wonder that U.S. fiscal federalism, starting with the reforms initiated by Alexander Hamilton, is analyzed as a template for Europe today.[155] Clearly, the European Union, with its long-standing history of ever closer economic integration and legal harmonization, provides an institutional framework that is, in theory, suitable in an unrivalled manner to follow down this road. However, until the very recent past, efforts to harmonize the regulatory framework of prudential bank supervision were largely limited to substantive law and established only marginal supranational competences in the pertinent laws' administration and enforcement. Bolder steps, taken just recently as a reaction to the still lingering crisis in the euro area's banking sector, aspire to establish a stronger supranational institution as a building block of a more closely integrated European fiscal union. Yet, the emerging structure of the supranational supervisor seems to have become only a somewhat half-hearted remedy for the shortcomings and pitfalls identified.

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151. Banking Directive, *supra* note 127, art. 42a(3); [CRD IV Directive, *supra* note 31, art. 52(3)]; Banking Directive Article 42a(1)(a)–(c) gives particular weight in determining the significance of a bank's foreign branch to a three-factor test and looks at (a) the branch's share in the deposit market (greater than 2%), (b) its relevance for market liquidity and the payment and clearing and settlement system, and (c) the number of clients it serves.

152. Banking Directive, *supra* note 127, art. 42a(1), para. 4.

153. *See id.* art. 131a(1) (stipulating that "[t]he establishment of and functioning of colleges of supervisors shall not affect the rights and responsibilities of the competent authorities under this Directive").

154. *See also* Jean Dermine, *European Banking Integration: Don't Put the Cart Before the Horse*, 15 FIN. MARKETS INSTITUTIONS & INSTRUMENTS 57, 97–98 (2006) (pointing to the shortcomings of the home country rule in bailout situations).

155. For an astute and differentiating essay that concludes *inter alia* with the recommendation to harmonize banking regulation, see C. RANDALL HENNING & MARTIN KESSLER, FISCAL FEDERALISM: U.S. HISTORY FOR ARCHITECTS OF EUROPE'S FISCAL UNION 31 (2012), *available at* http://www.bruegel.org/download/parent/669-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/file/1537-fiscal-federalism-us-history-for-architects-of-europes-fiscal-union/. For a macroeconomic analysis of the much broader topic of U.S. fiscal policy in general and its influence on Europe, see generally the Nobel lecture of 2011's laureate, Thomas J. Sargent, *United States Then, Europe Now* (New York University & Hoover Inst., Working Paper, 2011), *available at* https://files.nyu.edu/ts43/public/research/Sargent_Sweden_final.pdf.

a. Harmonization of Substantive Law

The critical importance of financial institutions for Europe's developed economies and the perceived need to foster competition by creating a level playing field accounted for an early start in a far reaching harmonization of substantive laws. The First Coordination Directive that harmonized the prerequisites for authorization was promulgated in 1977.[156] It was followed by a series of smaller legislative advances[157] until a Second Coordination Directive in 1989 was promulgated that facilitated cross-border banking through subsidiaries and branches in a meaningful way.[158] Prudential supervision of European credit institutions became early attuned to the recommendations of the BCBS with the transposition of the Basel I-Accord[159] in 1989.[160] This policy was maintained with the Basel II-Accord[161] becoming binding European law with the promulgation of the CRD in 2006.[162] These Directives were subsequently amended by the CRD II[163] and CRD III[164] reform packages that responded to lessons derived from the financial crisis.[165] Similarly, the most recent,

156. First Council Directive 77/780 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30.

157. *See* Peter O. Mülbert & Alexander Wilhelm, *Reforms of EU Banking and Securities Regulation After the Financial Crisis*, 26 BANKING & FIN. L. REV. 187, 194 (2011) (providing a brief account of the subsequent legislative directives).

158. Second Council Directive 89/646 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC, 1989 O.J. (L 386) 1–2.

159. *See generally* BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (July 1988), *available at* http://www.bis.org/publ/bcbs04a.pdf (setting out the content of the Basel I-Accord and reporting that the Accord had received widespread endorsement of the national supervisory authorities).

160. Council Directive 89/299/EEC of 17 April 1989 on the Own Funds of Credit Institutions, 1989 O.J. (L 124) 16.

161. BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (June 2004), *available at* http://www.bis.org/publ/bcbs107.pdf; *see also* BCBS, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (2006), *available at* http://www.bis.org/publ/bcbs128.pdf (incorporating the 2004 report into a more comprehensive version reflecting further amendments to the 1988 recommendations).

162. The Basel II-Accord and Its Implementation in the Banking Directive and the Parliament and Council Directive 2006/49 on the Capital Adequacy of Investment Firms and Credit Institutions, 2006 O.J. (L 177) 201 [hereinafter CRD]—jointly referred to as Capital Requirements Directive—aimed at improving the own-funds requirements by providing for a more accurate calculation of the risk actually inherent in a bank's business. Moreover, the new rules introduced two new pillars in prudential supervision, to wit ongoing supervision of internal procedures and disclosure to foster market discipline. *See generally, e.g.*, Jan H. Dalhuisen, *Financial Services, Products, Risks and Regulation in Europe After the EU 1988 Action Plan and Basel II*, 18 EUR. BUS. L. REV. 819, 1032–39, 1081–82 (2007); Razeen Sappideen, *The Regulation of Credit, Market and Operational Risk Management Under the Basel Accords*, 2004 J. BUS. L. 59, 90 (discussing the evolution of the Basel Accords up to the 2003 amendments, in an attempt "to transfer responsibility for risk management to banks and hold them accountable through the transparency of their actions").

163. Parliament and Council Directive 2009/111 Amending Directives 2006/48/EC, 2006/49/EC & 2007/64/EC as Regards Banks Affiliated to Central Institutions, Certain Own Funds Items, Large Exposures, Supervisory Arrangements, and Crisis Management, 2009 O.J. (L 302) 97.

164. Parliament and Council Directive 2010/76/EU of 24 November 2010 Amending Directives 2006/48/EC and 2006/49/EC as Regards Capital Requirements for the Trading Book and for Re-securitizations, and the Supervisory Review of Remuneration Policies, 2010 O.J. (L 329) 3.

165. *See generally* Mülbert & Wilhelm, *supra* note 157 at 202–07 (discussing the lessons learned by the E.U. banking regulators and supervisors as a result of the financial crisis and the regulatory response).

profound overhaul of the BCBS recommendations in reaction to the financial crisis (the Basel III-Accord[166]) will most likely make its way into ambitious European legislation that aspires to base prudential supervision on a single comprehensively harmonized and binding rule book.[167]

b. Current Supranational Competences in Micro-Prudential Supervision

Despite these long-standing and significant advances in the harmonization of the substantive regulations, only consultative and coordinative functions were allocated on the supranational level. In 2003 the Commission appointed the European Banking Committee (EBC)[168] and the Committee of European Banking Supervisors (CEBS)[169] to give expert advice to rule-makers and to coordinate the administration of the promulgated regulatory framework.

Following a proposal from an expert group headed by Jacques de Larosière,[170] the new European System of Financial Supervision (ESFS) was created.[171] With regard to the supervision of transnational credit institutions[172] the new architecture created several bodies at the European level, but without conferring sweeping competences in the ongoing supervision of banks to them. The EBA, based in London, became tasked with duties in micro-prudential supervision of individual financial institutions in January 2011.[173] A non-trivial function of the EBA lies in its power to draft both regulatory and technical implementing standards.[174] Still, to become binding, these standards require the formal endorsement of the Commission,

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166. BCBS, BASEL III: INTERNATIONAL FRAMEWORK FOR LIQUIDITY RISK MEASUREMENT, STANDARDS AND MONITORING (2010), *available at* http://www.bis.org/publ/bcbs188.pdf.

167. *Supra* note 31.

168. Commission Decision of 5 November 2003 Establishing the European Banking Committee 2004/10/EC, 2004 O.J. (L 3) 36.

169. *Id.* at 28.

170. THE DE LAROSIÈRE GRP., HIGH LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU (Feb. 25, 2009), *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

171. *See* Eddy Wymeersch, *The Reforms of the European Financial Supervisory System*, 7 EUR. COMPANY & FIN. L. REV. 240, 252–64 (2010) (providing a detailed description and assessment of the ESFS); Niamh Moloney, *EU Financial Market Regulation After the Global Financial Crisis: 'More Europe' or More Risk?* 47 COMMON MKT. L. REV. 1317, 1332–35, 1365–72 (2010) (describing the formation of the ESFS and its impact on the preceding infrastructure); Marco Lamandini, *When More Is Needed: The European Financial Supervisory Reform and Its Legal Basis*, 6 EUR. COMPANY L. 197, 199–202 (2009) (discussing the establishment of the ESFS and its salient features).

172. Identical structures were established for the supervision of securities markets, insurances, and occupational pension schemes. *See generally* Parliament and Council Regulation 1095/2010 (EU) of 24 November 2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), 2010 O.J. (L 331) 84 (establishing a supervisory authority to oversee securities markets in Europe); Parliament and Council Regulation 1094/2010 (EU) of 24 November 2010 Establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), 2010 O.J. (L 331) 48 (establishing a supervisory authority for insurance and occupational pensions in Europe).

173. Parliament and Council Regulation 1093/2010 (EU) of 24 November 2010 Establishing a European Supervisory Authority (European Banking Authority), 2010 O.J. (L 331) 12 [hereinafter EBA Regulation].

174. *Id.* arts. 8(1)(a), 10, 15. The former standards seek to ensure the consistent harmonization of national laws where E.U. Directives have been promulgated. TFEU, *supra* note 12, art. 290(1). The latter standards aim at a uniform application of E.U. Regulations. *Id.* art. 291(2).

which has the power to reject standards in part or amend them,[175] thereby depriving the EBA of its already limited ability for independent rulemaking.[176]

The EBA may further issue guidelines and recommendations addressed to Member States' supervisors to achieve a homogenous supervisory practice. Yet, to realize this goal, the EBA has to rely on a comply-or-explain mechanism and the pressure that emanates from publishing the mere fact of non-compliance by a Member State's competent authority.[177] Where disputes among Member States' competent authorities that supervise a transnational banking group arise, the EBA, at the request of a national authority or on its own initiative, serves primarily as a mediator. But it can ultimately, albeit after a lengthy "conciliation phase," settle the controversy and issue a binding decision that requires national authorities to take or refrain from action.[178] Only where the EBA acts to stabilize financial markets after the Council has determined that an emergency situation exists, may it bypass national supervisors who do not comply with binding emergency orders and take action directly *vis-à-vis* financial institutions.[179]

Finally, in order to improve macro-prudential supervision, another new body, the European Systemic Risk Board (ESRB) was established and charged with monitoring and assessing the systemic risks threatening financial stability thereby cooperating and coordinating with international and non-E.U. institutions.[180] The ESRB's main instrument to counter detected systemic risks in the financial system consists of warnings and recommendations addressed at either the European Union, the EBA, individual Member States, or the Member States' banking authorities that are subject to a largely confidential comply-or-explain mechanism.[181] Quite importantly, the ESRB receives its information within the network of the ESFS, which is supposed to link national and supranational authorities, making the ESRB dependent on the exchange of information and cooperation among these agents.

c. Banking Union 2012

In the wake of the once again flaring and more and more deteriorating banking crisis in Spain,[182] it became obvious that the counter measures taken so far were insufficient to break the vicious cycle between the sovereign debt crisis in the euro area and the distress in the European financial sector.[183] As already hinted by

175. EBA Regulation, *supra* note 173, art. 10(1), sub-para. 5.

176. Niamh Moloney, *The Financial Crisis and EU Securities Law-Making: A Challenge Met? in* FESTSCHRIFT FÜR KLAUS J. HOPT 2265, 2273 (Stefan Grundmann et al., eds., 2010).

177. EBA Regulation, *supra* note 173, art. 16(3).

178. *Id.* art. 19.

179. *Id.* art. 18.

180. Parliament and Council Regulation 1092/2010 (EU) of 24 November 2010 on European Union Macro-prudential Oversight of the Financial System and Establishing a European Systemic Risk Board, arts. 3 & 15, 2010 O.J. (L 331) 1 [hereinafter ESRB Regulation]; *see also* Mülbert & Wilhelm, *supra* note 157, at 200 (providing a critical assessment of the ESRB effectiveness); Giovanna De Mincio, *Regulators and Rules—President Obama's Reforms vs. Europe's Reforms*, 21 EUR. BUS. L. REV. 451, 454–57 (2010) (comparing the then proposed U.S. Financial Services Oversight Council with the ESRB).

181. ESRB Regulation, *supra* note 180, arts. 16–18.

182. *See* Forelle & Steinhauser, *supra* note 62 (explaining Spain's economic woes and its banking crisis).

183. *See supra* Section II.A.2. (explaining the interconnection between the problems of sovereigns and financial institutions who are facing severe financial strains and the role of the bailout process in

observers of the European developments,[184] the way forward was seen in a further integration that included as a critical component establishing a single European banking supervisor involving the ECB.[185] This is in line with the economic theory that relates the existence of international organizations to the desire to eliminate the risk of opportunism *ex post*[186]—a specter dreaded by Member States that effectively provide the bailout funds for other E.U. members with troubled and arguably insufficiently overseen banking sectors.[187] Moreover, it can be seen as a "regional version" that follows suggestions from commentators[188] and prominent transnational bodies.[189]

The Commission made detailed proposals on such a single supervisory mechanism in September 2012[190] that the Council—which generally endorsed the project of creating a Single Supervisory Mechanism (SSM)[191]—considered as a matter of urgency at the end of the year, and the Council proposed its own draft for a

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creating moral hazard).

184. *See* Dermine, *supra* note 154, at 32–33 ("An alternative development, which we favor, would be to take anticipatory action, that is, to transfer the supervision of international banks to a European regulatory agency.").

185. This political determination manifested for the first time at the Euro Area Summit on June 29, 2012. Press Release, Euro Area Summit Statement (June 29, 2012), *available at* http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf. Earlier, the Commission had expressed the top E.U. administration's conviction that a single financial supervisor was of critical importance in establishing an ultimately comprehensive Economic and Monetary Union. *See Commission Communication, Action for Stability, Growth and Jobs*, at 5, COM (2012) 299 final (May 30, 2012) (suggesting that "moving towards a banking union including an integrated financial supervision and a single deposit guarantee scheme" will facilitate the increased confidence necessary for the future of the E.U.'s economic and monetary union).

186. JOEL P. TRACHTMAN, THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW 150–95 (2008) (analyzing international organizations in line with the Coasean theory of the firm in institutional economics); Barbara Koremos, Charles Lipson & Duncan Snidal, *The Rational Design of International Institutions*, 55 INT'L ORG. 761, 762 (2001) (understanding international organizations as a network of contracts between sovereign agents); *see generally* Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 21 (1985) (suggesting the formation of a union, or integration, as a means to reduce the potential for opportunism in an anarchy).

187. *See* Francesco Guerrera, *A Fix for Europe Banks*, WALL ST. J., July 3, 2012, at C1 (explaining the package deal that couples further injection of funds into troubled Member States' banks with establishing a supranational supervisor).

188. *See, e.g.*, Henry Kaufman, *Structural Changes in the Financial Markets: Economic and Policy Significance*, 79 FED. RES. BANK OF KAN. CITY ECON. REV. 5, 13 (1994) (explaining that a new international institution is needed to establish uniform standards and to monitor the performance of institutions and markets); Brian Strawbridge, *A Ship Without a Captain at the Helm: The Need for the Development and Implementation of a Supra-national Prudential Supervisor to Oversee the European Union Financial Sector*, 20 IND. INT'L & COMP. L. REV. 111, 112 (2011) (arguing that a single, intra-E.U. regulatory body is necessary because financial supervision at exclusively a national level is no longer tenable).

189. *See* FINANCIAL STABILITY FORUM, REPORT ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 52 (2008), *available at* http://www.financialstabilityboard.org/publications/r_0804.pdf ("Authorities should build on the existing sharing of information, in both regional and wider international fora, to extract such good practices. Individual countries should then review how to incorporate these lessons so as to enhance their existing planning."); Press Release, European Council, 2901st Council Meeting Economic and Financial Affairs 7 (Nov. 4, 2008), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/103804.pdf.

190. *Commission Proposal SSM Regulation*, *supra* note 33.

191. Press Release, European Council, 3181st Council Meeting Economic and Financial Affairs 8 (July 10, 2012), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131686.pdf.

Regulation.[192] This proposal served as the basis for the political compromise that was reached in a trialogue between the Commission, the Parliament and the Council Presidency on March 19, 2013.[193] As observers had predicted earlier,[194] the cumbersome quest for a politically viable common position leaves significant reservations of Member States' competence intact despite the creation of a supranational watchdog. The SSM will indeed only cover Europe's largest banks, leaving the oversight of mid-sized banking groups, despite their considerable cross-border operations, in the national domains.

Initially, the Commission sought to establish the ECB[195] as an omnipotent supranational authority in charge of all relevant tasks in the prudential supervision of credit institutions established in the euro area[196] and equip the ECB with the pervasive power to issue instructions *vis-à-vis* national competent authorities who were basically relegated to providing auxiliary assistance.[197] Yet, even this sweeping centralization would have retained the system of shared responsibilities in prudential supervision[198] in important respect even within the European Union. In anticipation of massive political headwind mainly from the United Kingdom,[199] the proposal intended to cover only banks established in the euro area[200] or in a non-participating Member State that expressly opted in to the SSM.[201] In fact, in relation to non-participating Member States (and third countries) the ECB should only assume the

192. *Council Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, 2012/242 (CNS) (Dec. 14, 2012) *available at* http://register.consilium.europa.eu/pdf/en/12/st17/st17812.en12.pdf [hereinafter *Council Proposal SSM Regulation*].

193. Press Release, European Parliament, Banking Supervision Deal Struck by EP Negotiators and Irish Presidency (March 19, 2013), *available at* http://www.europarl.europa.eu/news/en/pressroom/content/20130318IPR06653/pdf.

194. *See* Matina Stevis & Stephen Fidler, *Tighter Control for Euro Banks*, WALL ST. J. (July 9, 2012), http://online.wsj.com/article/SB10001424052702303292204577514811150107308.html (explaining senior Eurozone officials' creation of a new agency to police the largest banks in the currency union).

195. *See* Rishi Goyal et al., *A Banking Union for the Euro Area* 14 (Int'l Monetary Fund, Working Paper SDN/13/01, 2012), *available at* http://www.imf.org/external/pubs/ft/sdn/2013/sdn1301.pdf (describing the advantages of ECB involvement that stem from the synergies with its mandate for monetary policy and lender of last resort duties).

196. *See Commission Proposal SSM Regulation*, *supra* note 33, art. 4(1) (providing for the exclusive ECB competence in licensing and authorizing credit institutions, ensuring compliance with own funds requirements, monitoring internal capital adequacy assessment processes etc.).

197. *See id.*, art. 5(4) (compelling national competent authorities to follow ECB instructions). Within the SSM national supervisors autonomous responsibility would have been confined to protecting consumers and fighting money laundering. *But see id.* ("The proposal recognises that within the SSM national supervisors are in many cases best placed to carry out such activities, due to their knowledge of national, regional and local banking markets, their significant existing resources and to locational and language considerations, and therefore enables the ECB to rely on national authorities to a significant extent.").

198. *See supra* Section IV.B.1 & 2 (describing the current supervisory regime for E.U. transnational financial institutions that is characterized by far reaching cooperative element under either a subsidiary or branch structure).

199. *See also* Goyal et al., *supra* note 195, at 12 (describing functional reasons for an initial limitation of the SSM to the euro area).

200. *See Commission Proposal SSM Regulation*, *supra* note 33, art. 2(1) (defining a participating Member State as one whose currency is the euro).

201. *See id.*, art. 6 (describing the preconditions under which "close cooperation between the ECB and the national competent authority" can be established in order to vest the competence for prudential supervision in the ECB).

role of host/home authority for branches and subsidiaries in the (consolidated) supervision of transnational banks under the Banking Directive.[202]

During the legislative process the ECB's role was further weakened. Its overriding competence was ultimately confined to the supervision of the euro area's most important institutions while a stronger role of participating Member States' competent authorities within the SSM was maintained.[203] For all less significant banks, the system of shared responsibility between national competent authorities as established by the Banking Directive in principle remains in force, although ECB-coordination and oversight is supposed to ensure enhanced consistency and integration of actual supervisory practices.[204] It is noteworthy, however, that the ECB will not only be exclusively competent to supervise each participating Member State's three largest credit institutions[205] or those that received public financial assistance from supranational coffers[206] but can also assume, on its own initiative, such competence from the outset with regard to institutions that have significant cross-border activities.[207] Moreover, the ECB may at any time, on its own initiative, take over the supervisory responsibility for less significant institutions to ensure consistent supervision,[208] thus permitting ad hoc interventions particularly when conflicts or disagreements among national competent authorities hamper effective supervision of transnational banking groups. Yet, the most important characteristic of the SSM with regard to this Article's focus is that the ECB, even where it will have sweeping competences in prudential supervision, will depend on the assistance and support of national competent authorities,[209] although it can compel their cooperation via direct instructions.[210]

However, the successful political maneuver to couple further state aid for the banking sector with a groundbreaking reform to achieve its more rigid supervision exhibits a seemingly justified deep mistrust in the existing supervisory architecture.

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202. *See id.*, art. 4(1)(i), (2) (describing the ECB's the role vis-à-vis consolidating and home supervisors where banks established in non-participating Member States have subsidiaries or branches in the euro are).

203. *See Council Proposal SSM Regulation*, *supra* note 192, arts. 4(1), 5(4)–(6) (ascribing the competences for prudential supervision according to the banking group's significance defined by (a) its size, (b) its importance for the economy of the European Union or any participating Member State, and (c) its cross-border activities).

204. *See id.*, art. 4(5)(a), (c), (e) (empowering the ECB to issue regulations, guidelines, or general instructions to national competent authorities, monitor the functioning of the SSM, and request information from national competent authorities on the performance of their supervisory tasks).

205. *See id.*, art. 5(4) ("[T]he ECB shall carry out the tasks conferred upon it by this regulation in respect of the three most significant institutions in each participating Member State.").

206. *Id.*, art. 5(4)(b).

207. *See id.*, art. 5(4)(a) (empowering the ECB to declare an institution to be significant if it has subsidiaries in at least two participating Member States and these subsidiaries have assets or liabilities in significant proportion to the banks total assets or liabilities).

208. *See id.*, art. 5(4)(b) (granting the ECB the right to exercise direct supervisory power with regard to less significant banks if the consistent application of high supervisory standards so requires).

209. *See Council Proposal SSM Regulation*, *supra* note 192, art. 5(7), (9) (obliging the ECB to delineate the framework for its interplay with national competent authorities and admonishing all parties to cooperate closely); *see also* Commission Proposal SSM Regulation, *supra* note 33 ("[E]ven for the tasks conferred on the ECB, most day-to-day verifications and other supervisory activities necessary to prepare and implement the ECB's acts could be exercised by national supervisors operating as an integral part of the SSM.").

210. *See Council Proposal SSM Regulation*, *supra* note 192, art. 8(1) sub-para. 3 (allowing the ECB to issue instructions to force national competent authorities to use their powers in national law).

C. *Evaluation*

In order to assess if the current or evolving European supervisory architecture provides or will provide an effective tool for micro-prudential supervision in light of banks' organizational choices, agencies should not be treated as black boxes. Instead, incentives of agents who actually discharge the duties of the supervisory authorities, who either offer or refuse to exchange information and collaborate with due diligence, have to be examined closely. To this end, general considerations on the political economics of both public administration and international relations prove helpful and can serve as an analytical basis to reach a final evaluation of the E.U. supervisory architecture.

1. Political Economics of Both Public Administration and International Relations

If the success of the supervisory architecture depends on incentives of public officers (bureaucrats) in charge at the competent authorities, it is important to remember the motivating forces identified in the line of research that applies methodologies from organizational theory to the political and administrative process.[211] The line-up under scrutiny can be framed using the analytical inventory of agency-theory: Bureaucrats constitute agents who not only have some discretion that allows them to adapt the political system to unforeseen contingencies,[212] but also grants them leeway to take hidden action and pursue their own interest instead of that of their ultimate principals, the citizens.[213] The intrinsic motives that are commonly identified as driving agency personnel in their exercise of office account for actions that serve the principals' interest only sub-optimally.[214]

Importantly, another source of departure from the social goal of effective supervision of cross-border banking groups typical in the transnational context

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211. For programmatic articles, see generally Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress*, 96 J. POL. ECON. 132 (1988) (providing a theory of legislative institutions that parallels the theory of the firm and the theory of contractual institutions); Terry M. Moe, *Politics and the Theory of Organization*, 7 J. L. ECON. & ORG. 106, 127 (1991) (arguing that the "task is to transform the economic theory into a political theory" since the "basic aspects of politics ... promote a very different perspective on organization than the one economists now embrace"); Gordon Tullock, *The Politics of Bureaucracy*, 11 ADMIN. SCIENCE Q. 488, 488 (1966) (illustrating how a bureaucrat's desire for advancement "requires actions contrary to the attainment of the objectives of the organization").

212. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 80–81 (1990) (explaining how "adaptive efficiency ... provides the incentives to encourage a development of decentralized decision-making processes that will allow societies to maximize the efforts required to explore alternative ways of solving problems").

213. *See* TIMOTHY BESLY, PRINCIPLED AGENTS? 98–172 (2006) (providing an overview of various political agency models). Bounded rationality of principals—ultimate (citizens) or intermediate (legislators)—who cannot devise complete contingent constitutions and laws to secure the proper pursuit of the common good, plays a prominent role in all these models. *Id.*

214. *See generally* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971) (describing how small groups of people influence regulation for their own benefit); Canice Prendergast, *The Motivation and Bias of Bureaucrats*, 97 AM. ECON. REV. 180 (2007) (analyzing how bureaucrats biases does not necessarily serve their principals). For the role of cognitive biases that tend to aggravate the deviation from desirable outcomes, see Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 2 (2003). For an analysis with a particular view to the governance of financial supervisors, see Luca Enriques & Gérard Hertig, *Improving the Governance of Financial Supervisors*, 12 EUR. BUS. ORG. L. REV. 357, 362–63 (2011).

results from the observation that the obligations of national authorities to share information and to cooperate in micro-prudential supervision can, by and large, only be enforced through informal institutions that sanction non-cooperative behavior.[215] If these insights are related to the prior findings on the political economics of bureaucracies, it can be concluded that reputational losses,[216] the threat of reciprocity in case of breach,[217] and further retaliation[218] will only serve as a motivation if these sanctions not only exist in the relation between authorities, but also translate into concurrent incentives of individual personnel.

According to standard analysis[219] bureaucrats are driven by a desire to increase their personal power and to augment their prestige. They thus seek to enlarge their agency's size, competence, and right to intervene in the affairs of those falling within the scope of its mandate. They will discharge their duties in a way that allows them to acquire a favorable reputation among their peers, in the general public, and in the media. Moreover, opportunities to advance their future career in administration, politics, or the private sector motivate their behavior, which makes them prone to promoting the interests of those who offer the most desirable job opportunities in the long term and can result in regulatory capture.[220] Finally, agency personnel seek to avoid liability for false actions or forbearance and will consequentially have a proclivity to follow approved practices that can be verified in any review, even if new developments occur.

To be sure, the identified incentives do not necessarily warrant a pessimistic perception of bureaucrats' effectiveness[221] (e.g., their desire for prestige can constitute a powerful incentive to do a good job), but it may also revert to a less desirable eagerness for media presence.[222] These observations only highlight the fact

215. *See* ANDREW T. GUZMAN, HOW INTERNATIONAL LAW WORKS: A RATIONAL CHOICE THEORY 33–48 (2008) (providing a general analysis of the self-enforcing mechanisms in international law from an economist's perspective).

216. *See* Lester G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27, 29 (1980) (discussing parties' interest in protecting the appearance of honesty).

217. GUZMAN, *supra* note 215, at 45.

218. *Id.* at 48; *see also* ROBERT AXELROD, THE EVOLUTION OF COOPERATION 13–14 (1984) (describing a tit-for-tat game where agents behave cooperatively in the first round and act in the second round as the counterparty did in the first).

219. *See* WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 36–42 (1971) (describing bureaucrats' ultimate goal as maximizing their bureau's budget in order to maximize prestige and power).

220. *See* Jean-Jacque Laffont & Jean Tirole, *The Politics of Government Decision Making: A Theory of Regulatory Capture*, 106 Q.J. ECON. 1089, 1089 (1991) (explaining a general theory of how and when interest groups dominate regulatory decision processes); Daniel C. Hardy, *Regulatory Capture in Banking* (Int'l Monetary Fund, Working Paper WP/06/34, 2006), *available at* http://www.imf.org/external/pubs/ft/wp/2006/wp0634.pdf (describing regulatory capture as resulting in regulatory fragmentation across jurisdictions as each promulgates prudential standards that best serve its incumbent financial institutions).

221. For at least ambiguous assessments of the complex web of incentives and its inherent trade-offs, see Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest and the Public Agenda: Toward a Synthesis*, 6 J. L. ECON. & ORG. 167, 167–68 (1990) (discussing the goals of regulation and regulators' motivations and incentives in the context of different policy theories); Gordon Tullock, *A (Partial) Rehabilitation of the Public Interest Theory*, 42 PUBL. CHOICE 89, 89 (1984) (examining the public interest as an aspect of democratic politics).

222. *Cf.* Luca Enriques, *Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's View*, 30 U. PA. J. INT'L L. 1147, 1149–50 (2009) (showing the ambivalence of regulators' intelligence).

that these individuals are not robots that are automatically programmed to serve the public interest by quasi-mechanically enforcing regulation free of self-interest.

2. Supervision of Cross-Border Banking Groups in Particular

The convoluted hierarchies and the necessary exchange of information and cooperation that the current E.U. supervisory architecture mandates[223] create particularly suboptimal incentives for decision-makers of the authorities involved and are prone for "turf wars" among supervisors with diverging preferences. This can be illustrated with regard to those cross-border banking groups that have organized according to the subsidiary model, but it also holds—albeit to a lesser degree—with respect to transnational branch-structures. Currently evolving supranational institutions may provide some improvement but no ultimate cure to the problems identified.

a. Subsidiaries

An extraordinary dedication to performing supervisory functions that at least in part contribute to the benefit of foreign economies does not yield immediate gains in power or prestige for the bureaucrats of the competent authority, particularly when compared to similar efforts in purely domestic line-ups. This is not only true with regard to a (subordinate) competent authority that is supposed to contribute to effective consolidated supervision but also with respect to consolidating supervisors. To some extent, their duties also ensure the viability of group affiliates abroad.[224] Obviously, the benefits to foreign economies[225] accrue as a consequence of the operations of for-profit organizations whose success at least in part redounds to the incentives of bureaucrats at the consolidating supervisor: The growth of the supervised transnational financial institution can be associated with an increase in the regulator's importance and reputation, and therefore its bureaucrats' prestige. Yet, the bulk of the advantages connected to a bank's transnational activities constitutes positive externalities (growth perspectives, market development, etc.) and is thus neither fully reproduced in the bank's yields nor in the incentives that the consolidating supervisor and its officers incur. To a similar effect, good practices that are at least in part of an auxiliary character and mainly happen in the background do not naturally boost careers.

Furthermore, incentives to cooperate and share information with other competent authorities are also suboptimal because lapses *mutatis mutandis* create negative external effects for the foreign economy where the group affiliate does business. Legal consequences are not a credible threat in the transnational context—even within the rather tightly integrated E.U. supervisory regime no liability is attached to a breach of a competent authority's duties. Moreover, it cannot be expected that reputational mechanisms or the threat of reciprocity make authorities and bureaucrats internalize errors automatically or exhaustively. Importantly, where

223. *Supra* Section IV.B.

224. *See supra* Sections IV.B.1.a and IV.B.3 (discussing how subsidiary-structure supervision and colleges of supervisors facilitate supervision of a cross-border banking group).

225. On the benefits of cross-border banking for market development, access to credit, etc., see generally *supra* Sections I.A and III.C.

financial difficulties occur, and hence information sharing and cooperation become pivotal, bureaucrats face strong motives not to reveal their private knowledge—which would amount to a confession of shortcomings in their own realm—but to exploit informational asymmetries instead.[226]

To be clear, the incentive problem identified is not that of an outright blockade between Member States' supervisors or even of mutual sabotage. Yet, the lack of motivation to go the extra mile in order to facilitate the socially optimal outcome should worry policymakers enough if it is recalled what is at stake.[227]

b. Branches

The E.U. supervisory regime applicable under a branch structure[228] exhibits some of the problematic characteristics discussed for transnational banks that adhere to a subsidiary organization. This is particularly true with regard to the suboptimal incentives to cooperate and share information as a result of positive and negative externalities: The home Member State supervises the whole entity and thereby generates benefits and costs for the host Member State whereas the host Member State's limited power and information sharing obligations have the same effect *vice versa*. Yet, it should not be overlooked that under the branch structure a clearer allocation of responsibilities occurs as a result of the E.U. passport making the home Member State's competent authority a stronger player that is less dependent on cooperation than the consolidating supervisor under a subsidiary structure.

Another core feature of the supervisory regime covering branch structures deserves attention. It appropriately augments the participation rights, where the branch's operations are significant from the host Member State's perspective, that is, where the externalities of exclusive home Member State supervision become large and the host Member State's bureaucrats have better incentives to participate (e.g., by communicating macro-economic threats unforeseen by remote home Member State supervisors), as their efforts to protect their national economy from the failure of a systemically important branch are likely to be honored more adequately. Hence, the criteria set out in Banking Directive Article 42a that warrant a stronger involvement of host Member States' competent authorities are more attuned to the actual risk and incentive structures than those under the subsidiary model where the momentous host Member State participation is indiscriminately linked merely to the authorization of the affiliates.

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226. Gérard Hertig, Ruben Lee & Joseph A. McCahery, *Empowering the ECB to Supervise Banks: A Choice-Based Approach*, 7 EUR. COMPANY & FIN. L. REV. 171, 178 (2010); *see also* Cornelia Holthausen & Thomas Rønde, *Cooperation in International Banking Supervision* 16–22 (ECB Working Paper No. 316, 2004), *available at* http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp316.pdf (showing that host country supervisors have incentives to misreport private information if their preference for liquidating a bank's operations diverge from those of the home country supervisor responsible for the decision).

227. *Supra* Section II.

228. *Supra* Section IV.B.1.b.

c. Supranational Cure

The reforms promulgated thus far remedy the shortcomings of the current E.U. supervisory regime only insufficiently, as they leave the competences in micro-prudential supervision by and large vested with Member State's authorities.[229] As a result, the need for extensive cooperation and information sharing persists and the incentives of bureaucrats remain substantially unaltered. Supervisory Colleges may in fact have some impact in this respect as personal acquaintance among the responsible bureaucrats adds a stronger relational element to their interaction and makes the adherence to cooperative strategies more likely at the margin.[230] Yet, the effect can cut both ways and should not be overestimated anyway—the Colleges of Supervisors are no country clubs!

In principle, the evolving European SSM[231] could avoid many of the incentive deficits identified in respect of the current regime of micro-prudential supervision if, and to the extent its competence in fact makes cooperation with national authorities superfluous. Yet, the brief analysis of the forthcoming SSM Regulation indicated that the ECB as the designated supranational supervisor will have to rely on a good share of cooperation and information sharing with national supervisors, ESFS authorities, etc.[232] It is a problematic feature of the SSM that national competent authorities have an indispensable role in the regime's daily operation but are relegated to auxiliary functions where its bureaucrats would arguably have the strongest incentives to engage in expedient supervision: it is precisely the participating Member States largest, most-visible banks where the ECB is in full command, relegating national competent authorities to second-rate functions in preparing and implementing ECB decisions.[233] In fact, removing supervisory responsibility from the national realm largely destroys the incentives of bureaucrats in national competent authorities to cooperate. Hence, centralization as a means to achieve higher standards in supervision should be comprehensive and unconditional; whereas piecemeal supranationalization creates a severe trade-off that potentially calls the overall efficiency of the regime into question.[234] If, however, for political reasons, a sharing of responsibilities is inevitable, its design should be as closely aligned with bureaucrats' motivations as possible, making the allocation of power to implement macro-prudential tools an interesting case in point: according to Council Proposal SSM Regulation Article 4a(1), national competent authorities have the autonomous competence to address systemic risks a bank poses for their economy, e.g., by requiring countercyclical capital buffers. The ECB still has the right to

229. *Supra* Section IV.B.4.b.

230. For more on relational elements as a core characteristic of self-enforcing (contractual) relationships, *see generally* Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 426 (1976); Oliver E. Williamson, *Franchise Bidding for Natural Monopolies—in General and With Respect to CATV*, 7 BELL J. ECON. 73 (1976).

231. *Supra* Section IV.B.4.c.

232. *See id.* (discussing the competences of the ECB and national competent authorities on participating and non-participating Member States); *see also Council Proposal SSM Regulation*, *supra* note 192, art. 3(1) (requiring the ECB to "cooperate closely" with the ESFS authorities).

233. *See supra* Section B.4.c. (highlighting the ECB's exclusive competence for the euro area's largest banks and its dependence on national competent authorities in discharging its duties).

234. *See* Goyal et al., *supra* note 195, at 14 (describing the advantages of a more systemic, macro-prudential, coordinated, and consistent application of supervisory standards and the reduced risk of regulatory capture under an optimally designed SSM and pointing to the perils of an ill-designed allocation of tasks and competences).

assume such competence, particularly when systemic risks overshoot a single participating Member State's economy.[235] Yet, national competent authorities can address local problems directly and hence their bureaucrats retain the incentives to do their job well.[236] At large, it is questionable, whether the backslide into the thickets of inter-agency cooperation under the SSM will prove temporary. The legislative process has indicated that the political will does not suffice to create an omnibus supranational agency.[237] Moreover, the SSM Regulation will not provide for an opt-in solution for individual banks established in non-participating Member States that some commentators have advocated as a generally desirable regime.[238] As a consequence, the sharing of responsibilities between euro area and other E.U. Member States' supervisors will be maintained to a significant extent.[239]

All in all, it seems warranted to still think about improvements of the existing framework that will in any case remain applicable to those transnational banks that will not fall within the ambit of E.U. supervision. Such alternative solutions are all the more relevant as the option of supranational concentration is not readily available on a global level. Hence, cooperation and exchange between national or—for that purpose—supranational authorities remains the only viable road to pursue.[240] As a consequence, the Financial Stability Board recommends with a view to global SIFIs that "[j]urisdictions should provide for a national supervisory framework that enables effective consolidated supervision by addressing ambiguities of responsibilities, impairments related to information gathering and assessment when multiple supervisors are overseeing the institution and its affiliates."[241] The

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235. *See Council Proposal SSM Regulation*, *supra* note 192, art. 4a(2) (giving the ECB the right to apply higher capital buffers than participating Member States' supervisors).

236. *See supra* Section IV.C.1 (arguing that bureaucrats are driven by the desire to acquire a favorable reputation among their peers, in the general public, and in the media, which depends on the visibility and relevance of their activities).

237. *See id.* (pointing to the watering down of the far more ambitious Commission proposal in the Council); *see also* Stevis & Fidler, *supra* note 194 (reporting political concerns about a conflict of interests should the ECB's role extend).

238. *See* Ivan Mortimer-Schutts, *EU Regulatory and Supervisory Convergence: The Case for a Dual System with Choice* (Am. Enter. Inst. Working Paper No. 39, 2005), *available at* http://www.gem.sciences-po.fr/content/publications/pdf/IMS_1205_Dual_EU_Reg_Struct.pdf (discussing a dual system and the choice financial institutions would face under it between national and European regulation and supervision); Martin Čihák & Jörg Decressin, *The Case for a European Banking Charter* 12–15 (Int'l Monetary Fund, Working Paper No. WP/07/173, 2007), *available at* http://www.imf.org/external/pubs/ft/wp/2007/wp07173.pdf (arguing for an optional European Banking Charter that "would be equivalent to a 28th regime for the operation of financial institutions in Europe"); Hertig, Lee & McCahery, *supra* note 226, at 181–89, 194–210 (favoring a solution that allows only individual jurisdictions to opt into supranational supervision).

239. *See supra* Section B.4.c (describing the distribution of competences between SSM-authorities and non-participating Member States' supervisors).

240. *See* Chris Brummer, *How International Financial Law Works (and How It Doesn't)*, 99 GEO. L.J. 257, 312–15 (2011) (noting the implausibility of a global financial regulator, and *mutatis mutandis* supervisor). *But see* Eric J. Pan, *Challenge of International Cooperation and Institutional Design in Financial Supervision: Beyond Transgovernmental Networks*, 11 CHI. J. INT'L L. 243, 273–83 (2010) (advocating an international administrative law agency for financial supervision).

241. Fin. Stability Bd., *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions, Recommendation No. 33* (Oct. 20, 2010), *available at* http://www.financialstabilityboard.org/publications/r_101111a.pdf. For the various institutions facilitating global coordination of financial regulators, see Pan, *supra* note 240, at 246–64 (discussing the various institutions facilitating global coordination of financial regulators).

institutional framework for such cooperative supervisions should be designed as efficiently as possible.

V. SKETCHING AN ALTERNATIVE APPROACH TO TRANSNATIONAL BANKING SUPERVISION

In light of the aforesaid, attempts to improve prudential supervision through law reform that compels closer cooperation and improved exchange of information between national and supranational supervisors will only be successful if the pertinent formal institutions are basically in line with the acting bureaucrats' incentives and minimize inefficient cooperative elements.[242]

At the outset, competences in micro-prudential supervision should be allocated to one national or supranational competent authority as unambiguously as possible to capitalize on the expertise of established supervisors.[243] In fact, it is structurally possible to establish precisely the strong authority that is arguably required to break through the vicious cycle of banking and sovereign debt crises[244] on the national level, if the effective powers of such a single authority are mutually recognized,[245] at least between E.U. Member States. As a consequence, national authorities that are the home of a transnational banking group can function as de facto pan-European supervisors.[246] If the group is domiciled within the euro area the ECB can assume this role. Importantly, the sole competence of such a pan-European supervisor should, in principle, be independent from the cross-border banking group's legal structure. Hence, subjecting the supervision of independently incorporated subsidiaries to the consolidating supervisor's authority[247] deserves approval; yet it does not go far enough in this subordination. It is preferable to generally follow the branch model when it comes to defining the competences in prudential supervision which gives host Member State authorities only very limited scope in monitoring ongoing operations.

As an exception, additional competences should be given to host Member States where the banking group's activities are deemed significant from the perspective of the foreign economy. Once again, the branch model can serve as the principal template where host Member States' authorities are granted an additional

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242. *See Katharina Pistor, Host's Dilemma: Rethinking EU Banking Regulation in Light of the Global Crisis* (Eur. Corp. Gov. Institute - Finance Working Paper No. 286/2010, 2010) *available at* http://ssrn.com/abstract=1631940 (proposing an "effect based" regime of supervision where competences correspond with the systemic relevance of financial institutions).

243. *See Proposal Resolution Directive*, *supra* note 65, at 169–71 (stating the Commission's estimation that the very limited task of drawing-up new standards and guidelines to coordinate the administration of the European framework for the recovery and resolution of financial institutions—not the administration itself that would be left to the Member States—would require hiring sixteen new employees, costing a total of 5.2 million euro ($6.5 million) in 2014 and 2015 alone).

244. Press Release, Euro Area Summit Statement (June 29, 2012), *available at* http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

245. *See* Pierre-Hugues Verdier, *Mutual Recognition in International Finance*, 52 HARV. INT'L L.J. 55, 60–71 (2011) (addressing the theoretical foundations of the concept).

246. The home Member State can be determined along the criteria that are relevant in assigning the consolidating supervisor. *See* Banking Directive, *supra* note 127, arts. 125 & 126 (discussing how to determine competent authorities for consolidated supervision); *supra* Section IV.B.2 (discussing various articles of the Banking Directive that aim at concentration of competence for consolidated supervision).

247. *Supra* Section IV.B.2.

right to participate in Colleges of Supervisors if the branch is deemed significant.[248] However, in the latter case—and only in that case—host Member State authorities should receive competences like those that currently accrue generally with regard to subsidiaries. Moreover, the binding determination, if the group's activities on the pertinent market are in fact significant, should be made by a supranational authority like the EBA or—with regard to euro area banks—the ECB as the evolving predominant European supervisor for this subset of transnational financial institutions.

In the context of the evolving resolution regime for transnational banking groups, the Commission basically accepts the fundamental need for a strong (national) lead authority when it explicitly posits in its explanatory memorandum that it is of critical importance that ultimately a single decision prevails.[249] Of course, it strictly clings to the problematic distinction between a bank's subsidiaries and branches. Within the SSM the distinction is *de facto* mute with regard to the most significant banks and their euro area affiliates and branches because the ECB is both the home/consolidating supervisor and the host supervisor for all business entities involved.[250] Yet, this outcome is more of a coincidence than the result of an elaborate regulatory plan. It is thus no wonder that outside the euro area the regime of shared competences between national and—as the case may be—one supranational supervisor will be conserved without any improvement.[251]

The paradigm shift advocated here retraces the developments in the substantive law of prudential supervision that also went from a relatively inflexible approach to a set of rules that aims at capturing actual risks in banks.[252] It also suggests that, whether within the European Union or not, any potential for regulatory arbitrage by switching from one organizational model to the other is unwarranted. Furthermore, as banking supervision forces competent authorities to employ highly skilled personnel and compete with the private sector, it is doubtful that each and every Member State's agency can retain a sufficient number of qualified specialists. It may thus be a welcome side effect of the proposed regime that it also avoids redundancies and requires host Member States only to monitor significant activities more closely. Of course, the suggested architecture—like any regulatory and supervisory regime that relies on public agencies—assumes that national authorities have efficient governance structures that ensure a socially beneficial administration.[253]

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248. *Supra* Section IV.B.3.

249. *Proposal Resolution Directive*, *supra* note 65, at 6.

250. *Council Proposal SSM Regulation*, *supra* note 192, art. 4(1)(a)(aa)(i) (describing the ECB competences in authorization and supervision of credit institutions including their subsidiaries and branches).

251. *Supra* Section IV.B.1.–3. (describing the—in pertinent part—identical distribution of competences under the Banking Directive, *supra* note 127 and the Proposed CRD IV legislation, *supra* note 31).

252. *Supra* Section IV.B.4.a.

253. *See* Enriques & Hertig, *supra* note 214, at 365–73 (proposing that financial supervisory agencies should be treated more like professional firms with monitoring boards, a strong CEO, and a flattened hierarchy); *see also* Anita Anand & Andrew Green, *Regulating Financial Institutions: The Value of Opacity*, 57 MCGILL L.J. 399, 408–22 (2012) (arguing for an opaque and insulated design of financial supervisors).

Amending the National Constitutions to Save the Euro: Is This the Right Strategy?

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INTRODUCTION

Economists have long debated whether the euro is based on solid foundations. They have discussed, in particular, whether the European Union (EU) complies with the conditions that need to be met for a region to become an "optimal currency area."[1] One of those conditions, the existence of an intense flow of commerce among

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1. *See generally*, Martina Fürrutter, *The Eurozone: An Optimal Currency Area?*, IFIERPAPERS (Feb.

states, seems to be fulfilled.[2] But there are serious doubts about two other conditions that are also relevant: the possibility for labor to move freely from one place to another, and the establishment of an institutional system that ensures a deep fiscal integration.[3] EU law does protect the free movement of workers,[4] but there are cultural and linguistic barriers that make it unlikely that people will change their places of residence for economic reasons.[5] As to fiscal integration, the capacity of the European Union to tax and spend is very limited.[6] It is basically the states' responsibility to provide citizens with public services and goods, and to obtain the necessary resources to pay for them through the pertinent national taxes. The EU's budget, in contrast, is very reduced.[7]

In spite of these difficulties, the euro is viable, according to "[s]ome academics and journalists."[8] What is necessary, they claim, is to achieve a certain measure of coordination of national budgetary policies.[9] Some convergence needs to be attained at the state level in order to compensate for the limited capacity of the European Union to enact its own fiscal policies from above. That is the whole point of the Stability and Growth Pact (the Pact), which comprises a set of legal instruments that seek to control national budgets and coordinate economic policies.[10]

It is for economists to figure out what needs to be done, ultimately, to ensure the stability of the euro. The task for constitutional scholars is of an instrumental nature. If we assume that constraining the public debt and the public deficit of the different states whose currency is the euro is the right path to take, as many economists seem to believe, then the constitutional question is what are the best institutional arrangements to guarantee that such constraints will be observed? What procedures should be set up to ensure compliance with the Pact? What, in particular, is the right distribution of responsibility between the European Union and the national authorities?

The current structures have important shortcomings. The European authorities play too small a role in enforcing the fiscal constraints that states must respect under the treaties. The European Commission, for example, can open proceedings against a state that fails to observe the Pact, but it is not entitled to make any final decision—

2012), http://igeuropeanresearch.files.wordpress.com/2012/02/paper_ifier_martina_fuerrutter_feb2012.pdf (discussing whether or not the Eurozone is an optimal currency area).

2. *See id.* at 6 ("In 1999 EU intern trade amounted among 10 and 20% of the EU member states' total trade. This is a fairly high number . . . .").

3. *Id.* at 6–7.

4. *See* 4 Kristina Touzenis, *Free Movement of Persons in the European Union and Economic Community of West African States: A Comparison of Law and Practice,* UNESCO MIGRATION STUDIES 18 (2012), http://unesdoc.unesco.org/images/0021/002171/217101e.pdf (noting that one of the four freedoms of the EU is the "free movement of persons").

5. Fürrutter, *supra* note 1, at 7.

6. *Id.*

7. *EU Budget Versus that of Member States,* EUROPEAN PARLIAMENT, http://www.europarl.europa.eu/news/en/headlines/content/20121211FCS04528/1/html/EU-budget-versus-that-of-member-states (last visited Jan. 30, 2013). For an introduction to the debates on this issue, see PAUL KRUGMAN, END THIS DEPRESSION NOW 166–87 (2012).

8. RAYMOND J. AHEARN ET AL., CONG. RESEARCH SERV., THE FUTURE OF THE EUROZONE AND U.S. INTERESTS 2 (2012).

9. *Id.* at 17.

10. *Id.* at 6–7.

it merely makes proposals for the European Council to consider.[11] The crisis of November 2003 illustrates the weakness of the system.[12] The Commission agreed, at that time, that France and Germany were in breach of the Pact, but the Council decided not to impose any sanctions on them.[13] Instead of following the recommendations submitted by the Commission, the Council issued its own recommendations. The European Court of Justice (ECJ) was asked to decide the controversy between the two institutions, and it held that the Commission had the sole right to make recommendations, which the Council was free to reject.[14]

The role of the ECJ is also very marginal under current EU law. The state that the Commission deems to have transgressed the Pact cannot be made to answer before the Court.[15] This is an important exception to the general principle that EU law must be made to bear on states through the appropriate judicial proceedings.

Any progress towards a more effective system of enforcement depends on the expansion of the powers of the supranational bodies. The current system is too weak in that it basically relies on peer pressure. The ministers sitting in the Council are in a conflict of interest when deciding what to do against a state that has violated the Pact.[16] We need to reduce the political discretion that the Council currently enjoys by bringing the Commission more squarely into the picture. The ECJ, in its capacity as the supreme interpreter of EU law,[17] should be empowered to intervene, to ascertain whether a state is indeed in breach of the fiscal principles, and to determine the pertinent measures and sanctions that are to be imposed, at the request of the Commission.

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11. Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union art. 126, Mar. 30, 2010, 2010 O.J. (C 83) 99–100 *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:FULL:EN:PDF [hereinafter TFEU]. Article 126 of the Treaty on the Functioning of the European Union (TFEU) provides that it is for the Council to decide, on the basis of a proposal submitted by the Commission, whether an excessive deficit exists. *Id.* art. 126(6). If the Council decides that this is the case, it must adopt recommendations addressed to the state concerned. *Id.* art. 126(7). If the recommendations are not followed, the Council may then choose to give notice to the state to take certain measures. *Id.* art. 126(9). If the measures are not complied with, the Council is authorized to do various things: it may require the state to publish certain information, before issuing bonds and securities; it may invite the European Investment Bank to reconsider its lending policy towards the state concerned; it may require that state to make a non-interest-bearing deposit of an appropriate size with the Union until the deficit has been corrected; and it may impose fines of an appropriate size. *Id.* art. 126(11). The Council votes by qualified majority when making these decisions. *Id.* art. 126(13).

12. Mark Tran, *What is the Stability and Growth Pact?*, THE GUARDIAN (Nov. 27, 2003), http://www.guardian.co.uk/world/2003/nov/27/qanda.business/.

13. *Id.*

14. *See* Case C-27/04, Commission of the European Communities v. Council of the European Union, 2004 E.C.R. I-6699 (noting that "failure by the Council to adopt acts provided for in Article 104(8) and (9) EC that are recommended by the Commission cannot be regarded as giving rise to acts open to challenge").

15. *See* TFEU, *supra* note 11, art. 126 (stating that the infringement proceedings of article 258 and 259 do not apply, meaning neither the Commission nor the states can bring a state before the ECJ on the grounds that it has violated the norms limiting deficit or debt).

16. Jean-Victor Louis, *The Review of the Stability and Growth Pact*, 43 COMMON MKT. L. REV. 85, 104–06 (2006).

17. Michael Rosenfeld, *Comparing Constitutional Review by the European Court of Justice and the U.S. Supreme Court*, 4 INT'L J. CON. LAW 618, 618 (2006).

This does not necessarily mean that the fiscal constraints should be expressed in a categorical manner. The Pact was actually modified in 2005 to introduce some exceptions and qualifications to the general rules that limited public deficit and debt.[18] While some experts claimed it was a bad idea to soften the Pact in this way,[19] others argued that the Pact would be enforced more effectively under its new version, precisely because the set of constraints it established was more nuanced.[20] Indeed, we may have to introduce a certain level of flexibility when it comes to enforcing the austerity principles. The important point is that supranational institutions are in a better position than the domestic bodies to impose whatever fiscal discipline is thought to be appropriate.

For the Commission and the ECJ to come to play a larger role under EU law, an amendment of the treaties is required, meaning that all the member states must agree. "Before and even during [the 2011] Council meetings, there were serious discussions and a push to amend the treaties."[21] "[T]he UK did not get all the safeguards it wanted and refused to sign . . . ."[22] The other states thus chose to adopt international treaties that are not part of EU law.[23] The overall result is unfortunate, as we will see.

Two relevant treaties are on the table now: the Treaty Establishing the European Stability Mechanism, which was signed on February 2, 2012 by the eurozone member states; and the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)—which includes the so-called "fiscal compact"—which was signed on March 2, 2012 by twenty-five EU member states (all but the UK and the Czech Republic).[24] These instruments bring about some notable changes. The new TSCG, in particular, establishes new obligations that states must observe, in addition to those that already exist under EU law. The basic requirement is that the budget position of the general government must be balanced or in surplus.[25] This is the so-called "golden rule."[26] To press towards compliance, as of

18. *See* Waltraud Schelkle, *EU Fiscal Governance: Hard Law in the Shadow of Soft Law?*, 13 COLUM. J. EUR. L. 705, 708–10 (2007) (outlining the differences between the new and old Stability and Growth Pact).

19. *See, e.g.*, Lucas Papademos, Vice President, Eur. Cent. Bank, The Political Economy of the Reformed Stability and Growth Pact: Implications for Fiscal and Monetary Policy, Speech at the Conference "The ECB and Its Watchers VII" 2 (June 3, 2005), *available at* http://www.ecb.int/press/key/date/2005/html/sp050603_1.en.html ("The reform even relaxes certain rules. For example, the softening of the exceptional circumstances clauses and the list of other relevant factors are indicative of the increased discretion and potential relaxation of fiscal discipline. . . . This is a cause for serious concern.").

20. *See* Schelkle, *supra* note 18, at 709–10 (claiming that the 2005 reform weakened the obligations imposed on states yet also led to stronger legalization of the Pact by enlarging the surveillance role of the Commission and framed the rules in a more precise manner).

21. Anna Hyvärinen, Opening Statement in Debate on the Fiscal Compact Treaty (Feb. 16, 2012), *in Another Legal Monster? An EUI Debate on the Fiscal Compact Treaty* 8 (Anna Kocharov ed.) (Eur. Univ. Inst. Dep't of Law, EUI Working Papers, LAW 2012/09, 2012), *available at* http://ssrn.com/abstract=2068674.

22. *Id.*

23. *Id.*

24. *Factsheet: Treaty Establishing the European Stability Mechanism*, EUR. COMM'N, http://ec.europa.eu/economy_finance/economic_governance/documents/127788.pdf (last visited Sept. 11, 2012); *Treaty on Stability, Coordination and Governance Signed*, EUR. COUNCIL (Mar. 2, 2012), http://www.european-council.europa.eu/home-page/highlights/treaty-on-stability,-coordination-and-governance-signed?lang=en.

25. Treaty on Stability, Coordination and Governance art. 3.1, Mar. 2, 2012, http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf [hereinafter TSCG].

March 1, 2013, any granting of financial assistance under the European Stability Mechanism (ESM) is only allowed if the recipient state has ratified the TSCG.[27]

The TSCG, moreover, tries to reduce the political discretion of the Council. It provides that the contracting states whose currency is the euro must commit themselves to supporting the proposals or recommendations submitted by the Commission, after considering that the deficit criterion had been breached by a state.[28] This obligation does not apply, however, when a qualified majority of those states is opposed to the decision proposed or recommended.[29]

There is one crucial piece in the new arrangement that has drawn much political and public attention: the obligation that states incorporate the golden rule in their constitutions (or equivalent norms). The TSCG provides that the rules on fiscal discipline shall take effect in the national law of the contracting states, at the latest, one year after the entry into force of the treaty, "through provisions of binding force and permanent character, preferably constitutional, or otherwise guaranteed to be fully respected and adhered to throughout the national budgetary processes."[30] The balanced-budget rule thus must be incorporated into a domestic source of law that is sufficiently rigid to limit the power of legislative majorities in the national parliament.

There are two ways the new treaty seeks to ensure that states will incorporate the golden rule in the proper manner. The first one has to do with financial assistance. From one year after the entry into force of the TSCG, financial assistance under the ESM is conditional on a country having introduced such a balanced-budget rule in its domestic law.[31] The second way to ensure compliance is the authority the ECJ has now been granted to determine whether states have duly incorporated the golden rule.[32] Only states, however, have standing to sue another state before the ECJ, for these purposes. The Commission has not been empowered to initiate the process. And only the states can request that the ECJ impose the pertinent financial sanctions on a state that refuses to take the necessary measures to comply with the ECJ's judgment.[33]

It is important to highlight the fact that the TSCG is not part of EU law. The ECJ therefore gets jurisdiction, not as the supreme interpreter of EU law, but on the basis of Article 273 of the Treaty on the Functioning of the European Union, which provides that "the Court of Justice shall have jurisdiction in any dispute between Member States which relates to the subject matter of the Treaties if the dispute is submitted to it under a special agreement between the parties."[34] The clause in the

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26. Petr Blizkovsky, *Does "the Golden Rule" Translate into "Golden" EU Economic Governance*, LEE KUAN YEW SCHOOL OF PUBLIC POLICY – POLICY BRIEF SERIES, Issue 7, Apr. 2012, at 3.

27. *See* Treaty Establishing the European Stability Mechanism, recital 5, Feb. 2, 2012, *available at* http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf (listing opening statements and conditions to the Treaty) [hereinafter ESM].

28. *See* TSCG, *supra* note 25, art. 7 (stating requirements of signatories to the TSCG).

29. *See id.* (creating an exception to the above requirements).

30. *Id.* art. 3.2.

31. ESM, *supra* note 27, at 7.

32. *See* TSCG, *supra* note 25, art. 8 (announcing the ECJ's ability to review a country's compliance with the TSCG).

33. *Id.*

34. TFEU, *supra* note 11, art. 273.

TSCG that grants jurisdiction to the Court is a "special agreement."[35] As Bruno De Witte explains, this possibility of giving extra competences to the ECJ has been used repeatedly in the past.[36] The most famous example is the Brussels Convention on jurisdiction and recognition of judgments, which was a separate convention concluded between the member states of the European Community.[37] The idea, however, is for the necessary steps to be taken in the future, with the aim of incorporating the substance of the TSCG into the legal framework of the European Union, within five years (at most) of its entry into force.[38]

Now, is this reliance on national constitutions (or equivalent norms) the right strategy to pursue in order to guarantee that states will observe the austerity principles? In what follows, I argue that the answer is no. It would have been better to center all the political energy on fortifying the European structures through more radical steps than those embodied in the new treaty. In particular, the ECJ should have been bestowed the power to check whether states have failed to comply with the golden rule established in the TSCG. The authority it has instead been given—that of verifying whether states have failed to incorporate the golden rule into their national legal systems—is too marginal.

As I will try to show, there is not much to be gained from amending the domestic constitutions (or equivalent norms) to save the euro. The benefits that this strategy can bear are likely to be small, while the degree of legal complexity it will generate is quite high. I will first explain why introducing the golden rule into the national constitutions (or similar norms) is not likely to produce large benefits. I will then highlight the various legal problems that will have to be confronted.

I. DO WE NEED CONSTITUTIONAL RIGIDITY AT THE NATIONAL LEVEL TO PROTECT THE EURO?

At first glance, it may seem appropriate for the TSCG to require states to adopt an internal rule of a "permanent character" that implements the fiscal restrictions that flow from European legal norms. Given the existence of constitutions in the domestic legal systems, moreover, it seems right for the new treaty to establish that the internal rule must preferably be of a constitutional nature. The TSCG clarifies, in any case, that the rule must be embodied in a source of law that guarantees its observance by the national authorities in charge of approving the budget, even if such a source is not technically part of a constitution.

But is it really necessary to impose this requirement? Is it going to contribute much?

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35. TSCG, *supra* note 25, art. 8.3.

36. Bruno De Witte, Opening Statement in Debate on the Fiscal Compact Treaty (Feb. 16, 2012), *in Another Legal Monster? An EUI Debate on the Fiscal Compact Treaty* 8 (Anna Kocharov ed.) (Eur. Univ. Inst. Dep't of Law, EUI Working Papers, LAW 2012/09, 2012), *available at* http://ssrn.com/abstract=2068674.

37. *Id.*

38. TSCG, *supra* note 25, art. 16.

A. *The Authority of European Union Law*

We should take into account, first of all, that EU law has a normative authority of its own. Once properly enacted, it prevails over the contrary decisions made by the states.[39] The limits on public deficit and debt that are part and parcel of the Pact have the same force that attaches to EU law. As has already been noted, the mechanisms that have been laid down so far to react against states that infringe the Pact have proven to be weak. But nothing in the nature of EU law prevents states from changing the treaties and improving those mechanisms.

Resorting to the national constitutions for help, in contrast, is not a natural move to take. Over the years, EU law has generated a large number of obligations. Sometimes, these obligations are directly operative. Quite often, however, the states are required to implement the relevant provisions through national measures.[40] As is well known, the normative structure of the European Union is a complex one in that it usually demands the cooperation of states to issue provisions that develop EU laws or that guarantee their application and enforcement through the pertinent procedures and sanctions. But even in such cases, no need has been felt to require states to implement EU law through the national constitutions. The states have been expected to use ordinary legislative and administrative means to implement EU law, not constitutional means.

It is true that national constitutions have been amended in various countries, at different times, to make it possible for the successive treaties to be validly ratified. But these constitutional changes have been imposed from below, not from above. They have arisen from the need some states have felt to make sure their fundamental national charter is in harmony with the changes that are embodied in the various treaties that have gradually changed the architecture and the competences of the European Union.[41] But no constitutional amendments have been forced on states as a way to implement EU norms.

Take, for example, the case of central banks. The launching of the euro was thought to require the establishment of a system of central banks that would have certain characteristics. In particular, both the European Central Bank and the national central banks were to be granted institutional independence to allow them to carry out their functions in the right way without yielding to the pressures of the political branches. The independence of the European Central Bank was directly guaranteed through a set of EU laws that regulated its structure and functions.[42] As to the national central banks, the treaties enshrined the principle of independence, and the states were to adjust their domestic laws to satisfy that principle in light of the norms that the European Union established for these purposes.[43] The typical

39. Case 6/64, Costa v. ENEL, 1964 E.C.R. 585, 600.

40. TFEU, *supra* note 11, art. 288.

41. *See* Alfred E. Kellermann, *Preparation of National Constitutions of Candidate Countries For Accession*, ROM. J. EUR. AFF., vol. 2, no. 1, 2002, at 74, 75 *available at* http://www.ier.ro/documente/rjea_vol2_no1/RJEA_Vol2_No1_Preparation_of_National_Constitutions_of_Candidate_Countries_for_Accession.pdf (stating that "some constitutions of applicant countries [need to be adapted] in order to be able to ratify the Treaty of the European Union").

42. TFEU, *supra* note 11, arts. 127–33.

43. Thus, article 130 of TFEU establishes that national central banks cannot receive instructions issued by the governments or any other organs. TFEU, *supra* note 11, art. 130. Article 131 requires states

cooperation between EU law and domestic law was once again relied upon. Yet, in spite of the importance of this issue, EU law did not compel states to constitutionalize the independence of their central banks at the national level. The expectation was that such independence would be ensured through ordinary legislative and administrative instruments. There was no need to introduce any clause in the constitutions for these purposes. If states were ever to undermine the independence of their central banks, EU law would affirm its normative authority, and the pertinent procedures could be brought against the offending states.

Thus, under current law, the ECJ has jurisdiction to check whether a state has designed its central bank in accordance with the applicable European norms.[44] It has jurisdiction, moreover, to settle "disputes concerning fulfillment by . . . national central bank[s] of their obligations" under EU law.[45] The European Central Bank, in particular, can file an action before the ECJ.[46] It also bears mentioning that the Protocol on the Statute of the European System of Central Banks and of the European Central Bank, after establishing that "a [g]overnor [of a national central bank] may be relieved from office only if he no longer fulfills the conditions required for the performance of his duties, or if he has been guilty of serious misconduct," introduces an effective procedural guarantee.[47] It provides that "[a] decision to this effect may be referred to the Court of Justice by the Governor concerned or the Governing Council on grounds of infringement of [the] Treat[y] or any rule of law relating to [its] application."[48]

This does not mean that what the national constitution says about the national central bank is irrelevant. If a constitution, for example, provided that the central bank must follow the instructions of the Minister of Finance, it would be at odds with EU law. The latter would prevail, and the country might even be obliged to change its constitution on that point. The national constitution is not a privileged norm, in the eyes of EU law: like the rest of domestic legal provisions, it must respect the higher authority of EU law.[49] But it is one thing to say that national constitutions cannot include clauses that undermine the independence of central banks. It is quite another to require them to embody a clause protecting their independence. No such requirement has been imposed so far, nor is it necessary.

There is an important contrast to note in this connection. While primary EU law establishes the European Central Bank, and its independence is thus protected

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to make sure that national legislation, including the statute that regulates their central bank, is compatible with the Treaties and the Statutes of the European System of Central Banks and the European Central Bank. TFEU, *supra* note 11, art. 131. The Protocol on the Statute of the European System of Central Banks and of the European Central Bank, in turn, reiterates this mandate that national laws on the central bank be compatible with EU legal provisions. It also specifies that the term of office of a Governor of a national central bank shall be no less than five years. Protocol on the Statute of the European System of Central Banks and the European Central Bank, art. 14.2, 2010 O.J. (C 83) 5.

44. TFEU, *supra* note 11, arts. 258–60.

45. Protocol on the Statute of the European System of Central Banks and the European Central Bank, art. 35.6, 2010 O.J. (C 83) 11.

46. *Id.*

47. *Id.*

48. TFEU, *supra* note 11, art. 14.2.

49. *See* Case 11/70, Internationale Handelsgesellschaft mbH v Einfuhr - und Vorratsstelle für Getreide und Futtermittel, 1970 E.C.R. 1134 ("[T]he validity of a Community measure or its effect within a Member State cannot be affected by allegations that it runs counter to either fundamental rights as formulated by the constitution of that State or the principles of a national constitutional structure.").

against secondary law, national central banks, in contrast, have traditionally been regulated by ordinary legislation.[50] EU law, however, has never imposed on states the duty to constitutionalize the independence of their central banks.

Spain is an interesting case in this regard. No provision in the Spanish Constitution deals with the central bank. There is a general principle in the Constitution, however, that says that the government directs the public administration.[51] To the extent that the Spanish central bank is part of the public administration, that principle might be read to authorize the government to issue instructions to the bank. There is a certain consensus, however, that the principle referred to has to be interpreted in light of EU law, and that an exception has to be read into that principle, therefore, to safeguard the independence of the central bank. Insofar as the Constitution is constructed in this way, no problem arises. The ordinary legislation that is in place, moreover, is in full compliance with European requirements.[52]

Actually, even the irreversible character of a country's decision to join the euro is protected by EU law alone. There is some controversy as to the possibility for a country to withdraw from the monetary union while remaining a member of the European Union.[53] The better argument seems to be that a state cannot get out of the euro unilaterally. Instead, it would have to negotiate an agreement with the rest of the EU states, which would have to grant an opt-out (similar to the one that the United Kingdom and Denmark obtained before the monetary union started). Whatever the correct interpretation of EU law is, the point is that the European Union has never relied on national constitutions to buttress a state's commitment to become, and remain a member of, the Eurozone.

So why should things be different when it comes to the fiscal constraints established by the Pact? Why is it not sufficient for states to be told that they must observe those constraints in their domestic decision-making processes? If the right mechanisms are designed at the EU level to police state performance, why should states take the further step of including the austerity principles in their constitutions?

In a way, the European Union exhibits weakness, rather than strength, when it forces states to constitutionalize certain obligations that are already embodied in EU law. If the idea is to send a message to the markets, the effort may backfire: the more the European Union confesses its need to use national constitutions to make states comply with its laws, the more it publicizes its own institutional limitations.

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50. *See* Chiara Zilioli & Martin Selmayr, *The Constitutional Status of the European Central Bank,* 44 COMMON MKT. L. REV. 365, 370 (2007) (discussing the difference in formation between the ECB and national central banks, specifically the regulation of the *Deutche Bundesbank* by the German Constitution, which guaranteed in Article 88 the existence of a federal central bank, but not its independence).

51. Constitución Española, B.O.E. n.97, Dec. 29, 1978 (Spain).

52. *See* ARTEMI RALLO LOMBARTE, LA CONSTITUCIONALIDAD DE LAS ADMINISTRACIONES INDEPENDIENTES [THE CONSTITUTIONALITY OF THE INDEPENDENT GOVERNMENT] 82–95 (2002) (regarding the need to read article 97 of the Spanish Constitution in light of EU law).

53. Regarding this debate, see generally Hannes Hofmeister, *Goodbye Euro: Legal Aspects of Withdrawal from the Eurozone,* 18 COLUM J. EUR. L. 111 (2011); Jens Dammann, *The Right to Leave the Eurozone,* 48 TEX. INT'L L.J. 125 (2013).

B. Two Models of Constitutional Rigidity

There is another problem we should pay some attention to. All constitutions constrain the ordinary legislature, but the spirit that animates their rigidity may basically be of two different types. As we will see, the distinction matters when the goal that is being sought is the enforcement of austerity measures.

Sometimes, constitutional rigidity is at the service of popular will. The constitution tries to preserve the choices of the people over their representatives. Typically, a referendum is required for new clauses and amendments to be introduced in the constitution. If ordinary majorities in parliament are limited by the constitution, this is so that the will of the people prevails over the will of politicians elected in ordinary elections.

In other cases, in contrast, the rigidity of the fundamental charter has an anti-populist character. If the majorities in parliament are constrained by the constitution, this is not to preserve the capacity of citizens to make the ultimate choices, but to protect certain interests that are thought to be in danger if placed in the hands of an unconstrained popularly elected parliament. Typically, supermajorities, or successive votes, are required to modify the constitution so that a majority that is sensitive to the popular pressures of the moment cannot do certain things.[54]

When the TSCG asks states to constitutionalize the golden rule on budgetary austerity, what kind of rigidity does it have in mind? It would be odd to think that the populist model is fine for these purposes. It would be naïve to believe that the austerity measures will be sufficiently protected if parliament needs to call a referendum to override them. The fact that a political party can appeal to the people to dismantle the golden rule in a referendum makes it likely that the austerity measures will be in peril when citizens suffer their effects in the middle of a difficult social and economic situation. The markets will certainly not be impressed by the fact that the austerity principles can only be overturned through a referendum. Remember what happened in the fall of 2011 when the Greek Prime Minister, Yorgos Papandreou, announced that he would submit to a popular vote the deal his government had just struck with the European authorities and the other governments to solve the Greek crisis? The markets (and the European governments) reacted badly to the news, and the plan to have a referendum was withdrawn.[55] In general, the fact that a parliamentary majority in the future will need to call a referendum to alter the golden rule entails an extra burden. But it is doubtful that the burden is in keeping with the nature of the golden rule, which is ultimately anti-populist. If the nation wants to tie its hands, as Ulysses did in order to hear the voices of the sirens without peril, requiring a referendum in the future for the nation to untie itself does not seem to be a good strategy.[56]

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54. JON ELSTER, ULYSSES UNBOUND 101–03 (2000).

55. *Greek Banker Papademos Joins Coalition Talks,* KYIVPOST (Nov. 10, 2011), http://www.kyivpost.com/content/world/greek-banker-papademos-joins-coalition-talks-116652.html (stating that the referendum plan "was swiftly withdrawn after an angry reaction from world markets and EU leaders").

56. On May 31, 2012, a referendum was held in Ireland to approve the TSCG. Corinne Deloy, *The Irish Largely Approve the European Budgetary Pact*, FONDATION ROBERT SCHUMAN 1 (May 31, 2012), http://www.robert-schuman.eu/doc/oee/oee-783-en.pdf. The Constitution has been amended to authorize Ireland to ratify the TSCG and to enforce it through national law. IR. CONST., 1937, art. 29. But, it

The other form of rigidity, the anti-populist one, is more congruent with the nature of the rule that needs to be protected. If, indeed, the rules on fiscal discipline are placed in a constitution that can only be altered through parliamentary supermajorities (or successive votes) that are hard to obtain, we can expect some protection from it. We should not exaggerate its importance, however. If the austerity measures really hurt, both the governing party and the main party in the opposition will be under strong popular pressure to soften fiscal discipline. Even parties that are in deep disagreement on other issues may find it inevitable to form the relevant parliamentary supermajority to change the basic rules, if the popular pressures are intense enough.

In this respect, the constitutional reform that was adopted in Spain in September 2011 is quite telling. The Spanish Constitution, which was enacted in 1978, had only been amended once, in 1992, to make it possible for Spain to ratify the Maastricht Treaty.[57] In spite of the many changes that the Constitution arguably needs, reforming it has been taboo for decades.[58] Because it was so difficult to agree on the constitutional text in 1977–78, political parties have come to the belief that it is better not to revise the document unless absolutely necessary.[59] There has been talk among constitutional scholars about the immaturity of a political community that does not dare to discuss and enact constitutional reforms as circumstances change.[60] To make things worse, Spanish politics have been highly polarized in the last years. It has been very hard for the government and the main party in the opposition to reach agreements on important issues.[61] Yet, in the middle of the turmoil in the European financial markets in August 2011, the President of the Government, José Luis Rodríguez Zapatero, and the leader of the main party in the opposition, Mariano Rajoy (who is now the President of the Government, after winning the general elections of November 2011) had a phone conversation where they agreed to change the Spanish Constitution.[62] New clauses on fiscal austerity were to be introduced, similar to the ones that the TSCG now calls for.[63] It took a few days only to have the two parliamentary chambers vote on the constitutional reform.[64] In this case, the pressures came from the markets and other governments. In the future, the pressures to change the constitutional rules may come from the people.

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remains to be seen whether the golden rule itself will be constitutionalized. Deloy, *supra* note 56, at 1.

57. C.E., B.O.E. n. 13(2), Dec. 29, 1978 (Spain).

58. Javier Pérez Royo, *Viene de Lejos* [*It Comes from Afar*], EL PAIS (Jan. 22, 2011) (Sp.) http://elcomentario.tv/reggio/viene-de-lejos-de-javier-perez-royo-en-el-pais-2/22/01/2011/.

59. *Id.*

60. *Id.*

61. *Id.*

62. *See* Giles Tremlett, *Spain Changes Constitution to Cap Budget Deficit*, THE GUARDIAN (Aug. 26, 2011), http://www.guardian.co.uk/business/2011/aug/26/spain-constitutional-cap-deficit (discussing how the two opposing political parties had agreed to change the constitution).

63. *Id.*

64. Only twelve days elapsed from the day the two main political parties (PSOE and PP) submitted their proposal of constitutional reform to the parliament (August 26, 2011), to the day it was finally approved by the Senate (September 7, 2011). *Spain Passes 'Golden Rule' Reform to Fend Off Debt Crisis*, FRANCE 24 (Sept. 7, 2011), http://www.france24.com/en/20110907-spain-passes-golden-rule-reform-fend-off-eurozone-sovereign-debt-crisis-parliament.

There is an irony here, of course: the point of the constitutional reform was to signal to the markets that Spain was taking its fiscal obligations seriously. Since the austerity principles are now enshrined in the Constitution, parliament has tied its hands. Can the markets really be impressed, however, by the rigidity of the Spanish Constitution once they discover how easy it has been to change the text to introduce those austerity principles?

Interestingly, what really ties the government's (and the country's) hands is the ratification of the TSCG itself. Through a treaty, in effect, states pre-commit themselves before each other. The national constitution, standing alone, does not offer much additional protection. States may be reluctant in the future to eliminate the golden rule incorporated in the constitution, but their reluctance will largely derive from external pressures at the international level and not so much from the technical rigidity of the domestic constitution.

It is sometimes argued that, if the austerity principles are enshrined in the national constitution, a sense of ownership is created.[65] The people and their representatives are more likely to honor those principles, since they are aware that it was their decision to put them in the national constitution. For this ownership effect to be produced, however, the decision to hammer out the austerity principles in the domestic fundamental charter must be truly free. The Germans, for example, introduced fiscal constraints in their Basic Law in 2009 out of their own free will.[66] The TSCG, in contrast, forces states to do so.[67] It is unlikely, therefore, that public opinion will see those constitutional amendments as an expression of a free, domestically driven political choice.

Actually, the integrity of the national constitution may be at stake. Domestic constitutions play a key role in connecting EU law and national law. On the one hand, they establish the internal conditions under which states are empowered to join the European Union. On the other hand, national constitutions have to accept the authority of EU law over national law, once states have become members of the EU, if uniformity in the application of EU law is to be achieved. This is a delicate, mediating function, and it is important to strike the right balance. It is one thing for a constitution to enable the state's membership in the European Union and to respect the higher authority of EU law. It is quite another for a constitution to be transformed into a mere instrument for implementing EU law. The special character of the document as the fundamental charter of a nation might be undermined if constitutional amendments are directly compelled by EU law.[68]

C. *The Reliability of National Institutions to Enforce Austerity Norms*

Suppose, however, that the constitutional rigidity that can be obtained at the domestic level is significant. For that rigidity to work in practice, an effective system

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65. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, BETTER REGULATION IN EUROPE: AUSTRIA 55 (2010).

66. Gesetz zur Änderung des Grundgesetzes [Law Amending Basic Law], July 29, 2009, BGBl. I at 2248–50 (Ger.).

67. TSCG, *supra* note 25, art. 3.1.

68. *See* PEDRO CRUZ VILLALÓN, LA CONSTITUCIÓN INÉDITA: ESTUDIOS ANTE LA CONSTITUCIONALIZACIÓN DE EUROPA [THE UNPUBLISHED CONSTITUTION: STUDIES ON THE CONSTITUTIONALIZATION OF EUROPE] 72–73 (2004) (discussing the need to preserve the "singular" character of national constitutions in their relationships with EU law).

must be in place to check and invalidate any legislative decision that offends the constitution. For the golden rule to get some extra protection through the domestic constitution, the national bodies in charge of enforcement must be trustworthy. Doubts arise, however, as to the capacity of such bodies to withstand internal political pressures.

In federal systems, it is not very difficult for the central government to impose sanctions or other measures on the regional or local entities that exceed the fiscal limits. But, it is more difficult for the central government itself to be effectively controlled. We need, for these purposes, independent institutions. Most states will probably rely on courts, though it is also possible to resort to non-judicial bodies, provided they are independent. In general, it is the role of courts to safeguard the constitution against the political branches. When it comes to reviewing the validity of legislation, the arrangements in place vary from country to country. In some nations, all courts have the power of legislative review, while in other jurisdictions only the constitutional tribunal is granted that power.[69]

For purposes of controlling the constitutionality of budgetary laws under the golden rule, there seems to be a significant advantage to a system of *a priori* and abstract review.[70] Under such a system, the judicial decision is rendered before the laws have produced their effects. An alternative arrangement is for constitutional review to take place after the laws have entered into force. But courts should then be empowered to issue interim measures, so that the effects of the laws are suspended (at least in part) while their constitutionality is being examined. In any case, courts should lay down their decisions rather promptly. Their intervention should make a difference in practice.[71]

Whatever the model of judicial review that is set up, however, it will be difficult for national courts to strongly enforce the discipline that comes from the golden rule. If the government itself has been pressed by tough economic and social circumstances to deviate from the austerity principles, courts will not exhibit much strength to transcend those circumstances and restore the rule. The fact, moreover, that it is possible under the TSCG to relax the fiscal rules in some special cases will

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69. For an overview of the different systems of judicial review in Europe, see VICTOR FERRERES COMELLA, CONSTITUTIONAL COURTS AND DEMOCRATIC VALUES: EUROPEAN PERSPECTIVE (2009), especially chapter 1.

70. *See* Riccardo Guastini, *Implementing the Rule of Law*, *in* ANALISI E DIRITTO 2001: RICERCHE DI GIURISPRUDENZA ANALITICA 97 (Paolo Comanducci & Riccardo Guastini eds., 2002), *available at* http://www.giuri.unige.it/intro/dipist/digita/filo/testi/analisi_2001/5guastini.pdf ("From the standpoint of legal certainty, the 'a priori' review presents a small (but remarkable) advantage.").

71. The Spanish system of constitutional review, for example, is not functioning well. It is not possible in Spain for any laws to be challenged before they are enacted. Nor is it possible, under any circumstances, for the Constitutional Court to suspend the application of state laws while it reviews their validity. The main problem, however, is the amount of time the Court often takes to submit its judgments. In some cases, it has taken up to thirteen years to finally speak to the constitutionality of a statute that was impugned. *See* Enrique Guillen Lopez, *Judicial Review in Spain: The Constitutional Court*, 41 LOY. L.A. L. REV. 529, 546 (2008) (stating that deciding cases can take up to ten years from the filing of an appeal). Arguably, Spain will be in breach of Article 3.2 of the TSCG if it does not correct these defects. It would be preposterous to interpret that the TSCG is only interested in the states incorporating the golden rule in their national constitutions, no matter how badly the domestic system of constitutional review is performing. The TSCG relies on the constitutions, on the assumption that there is in place a system of judicial review (or something equivalent) that is working reasonably well in practice.

push national courts to be very deferential to the government, if the latter resorts to the exceptions in an abusive manner.

The ECJ, in contrast, is better situated to confront a national government. The judges on this court are appointed by common consent of the governments of all states, not directly by each of them.[72] They are not part of the national political system whose budgetary laws will have to be examined. The physical location of the court is in Luxembourg,[73] which, being far removed from the centers of domestic political power, helps judges acquire the requisite level of independence. Whatever its shortcomings, the ECJ is more likely than national courts are to gain an objective perspective on the issues that need to be decided under EU law, and to develop the disposition to exercise its powers in a robust way.[74] National courts, in contrast, will be more prone to accommodate the needs of the government, and will thus be reluctant to enforce the golden rule in an effective way, when the nation faces very hard times.

It is paradoxical that the task the TSCG entrusts the ECJ with is not the one you would expect, to determine whether states comply with the golden rule, but rather a more indirect one, to check whether states have incorporated the golden rule in their constitutions (or equivalent norms) in the right way. The supranational court is not asked to do what it should do: to control state decisions under the golden rule. It is instead used to perform a tangential task.

II. SOME COMPLICATIONS ON THE HORIZON

It is tempting to say that constitutionalizing the golden rule is a good step, even if it has limited effects. Any mechanism that contributes to enforcing the austerity principles should be welcome. Something is better than nothing, one might say.

The problem, however, is that there is a cost to this constitutionalization process: the legal system gets more complex. If the benefits are not large enough, the cost of complexity may not be justified, all things considered.

A. Different Levels of Constitutional Rigidity

The first complication is connected to the fact that national constitutions in Europe differ wildly with respect to their level of rigidity. Quite apart from the differences as to the nature of the principle that justifies rigidity, which may be more or less populist, as seen before, there are important variations as to the degree of rigidity each constitution exhibits. Some constitutions are much more difficult to amend than others. Requiring states to incorporate the golden rule in their

72. TFEU, *supra* note 11, art. 253.

73. *Court of Justice of the European Union*, EUROPA, http://europa.eu/about-eu/institutions-bodies/court-justice/index_en.htm (last visited Nov. 7, 2012).

74. On the various doctrines, strategies, and techniques that the ECJ has used to become a supreme court that preserves the EU supranational interests while engaging in dialogues with national judges, see generally KAREN J. ALTER, ESTABLISHING THE SUPREMACY OF EUROPEAN UNION LAW: THE MAKING OF AN INTERNATIONAL RULE OF LAW IN EUROPE (2001); and DANIEL SARMIENTO, PODER JUDICIAL E INTEGRACIÓN EUROPEA, LA CONSTRUCCIÓN DE UN MODELO JURISDICCIONAL PARA LA UNIÓN [JUDICIAL POWER AND EUROPEAN INTEGRATION, THE STRUCTURE OF A JURISDICTIONAL MODEL FOR THE UNION] (2004).

constitutions means that countries will be subject to domestic constraints that differ in their respective strength. Some states will be governed by a constitutional austerity clause that is relatively easy to change, while others will be subject to an austerity clause that is very difficult to alter. This lack of equality does not seem fair. The standards should be the same. The traditional advantage of non-constitutionalization of EU law is that EU law then operates on the basis of its own authority, and imposes its constraints on the states in an equal manner.[75] It may be the case that some of the countries that might be more tempted to violate the golden rule in the future are the ones that happen to have the most flexible constitutions, while those who are less prone to breach the rule have constitutions that are quite hard to amend.

One may object that this lack of equality is the natural result of the fact that each country is free to choose the level of rigidity it prefers in its constitution. The TSCG does not dictate which level is appropriate. It simply says that the golden rule must be constitutionalized at the domestic level.[76] If states think it is unfair to be subjected to more rigid constraints than other states, they are free to reduce the level of rigidity of their constitutions. The problem, however, is that the degree of rigidity a country may want its constitution to have is linked to domestic affairs. How difficult it should be for the national fundamental charter to be amended depends on a host of factors, such as the age of the constitution, the specificity of the language with which the rules and principles are framed, the system of political parties, the amount of power courts are to be given, and many others. A balance between stability and change is struck by each country, taking into account national factors. A particular arrangement that is fine at the domestic level may not be fine if the goal is to preserve the fiscal limitations that derive from European norms. It would be unreasonable to expect states to change their domestic constitutional structures and converge towards a similar level of rigidity, simply because of the need to implement the golden rule in a similar way.

The fact that states are given the alternative option of incorporating the golden rule in a different norm than the constitution alleviates this problem, because it introduces a measure of flexibility. But, then, a different problem arises. The TSCG gives the ECJ the authority to ascertain whether the states have transposed the balanced-budget principles in the right manner.[77] If a state decides not to include the golden rule in its formal constitution but in a different kind of law, how exactly is the ECJ going to determine whether that rule has been awarded a sufficient degree of rigidity in the national sphere? The difficulty is twofold. First, it is hard to tell what is the minimum level of rigidity. The treaty supplies no criteria to fix this. If it is very low, the whole enterprise makes no sense. It will end up being a great disappointment. Second, whatever that level of rigidity is, how should the ECJ decide if it is satisfied in a particular case? The analysis depends on a complex set of factors. The formal requirements that need to be met to change a norm have to be read in light of the particular political, cultural, and social characteristics of each country. Requiring a two-thirds majority in parliament to change a law, for example, may be an important hurdle in one country, but an easy-to-overcome obstacle in

75. *See* Case 6/64, Costa v. ENEL, 1964 E.C.R. 585, 597 (establishing that EU law prevails over contrary provisions of individual states).

76. TSCG, *supra* note 25, art. 3.2.

77. *Id.* art. 8.

another country. Will the ECJ get into this complicated analysis to determine whether the incorporation requirement has been fulfilled by the state?

And what happens, for example, when countries have stipulated more than one procedure to change their constitution? Suppose a relatively easy procedure is to be employed as a general rule, while a more burdensome procedure applies when certain important principles of the constitution are at stake. Is the country allowed to protect the golden rule through the easy procedure instead of the harder one? Should the ECJ be suspicious when it observes that the country has refused to incorporate the austerity principles in the more rigid part of the constitution?[78]

B. The Relationship Between National Law and European Austerity Principles

A second set of problems that will need to be faced concerns the relationship between the fiscal constraints that the TSCG embodies, on the one hand, and the austerity clauses that national constitutions and other domestic laws include, to comply with the incorporation requirement, on the other.

Suppose a state decides to incorporate the TSCG in the constitution by reference. A constitutional clause could say something like this: "The state shall comply with the public deficit and debt limitations established under the TSCG." The clause could actually be broader, to encompass any fiscal constraints fixed at the European level. This has the advantage that any future change at the European level is automatically incorporated into the national constitution. The clause looks a little strange though, since one might ask: what about the rest of EU law? Of course, the state must also comply with the rest of EU law.[79] But, then, what is the point of making explicit in the constitution only a portion of the obligations that states must honor as members of the European Union?

In any case, even that simple formula can give rise to some complications. Again, Spain is an interesting example. As was already indicated, the Spanish Constitution was amended in September 2011 to incorporate the golden rule of budgetary balance.[80] Article 135 now says, in paragraph 2, that Spain cannot incur a structural deficit that is larger than that allowed by the European Union.[81] It also indicates that an organic statute (which requires the approval of an absolute majority of the members of Congress) will specify the maximum structural deficit that is permitted.[82] In spite of the simplicity of this formula, various problems arise.

78. The Spanish Constitution, for example, establishes two different tracks of constitutional amendment. A relatively easy procedure (regulated in Article 167) applies as a general rule, while a more burdensome procedure (regulated in Article 168) needs to be followed when certain core parts of the Constitution are affected. Spain elected to put the austerity principle in the easier-to-amend part of the Constitution. The reason for this is connected to the symmetry between enactment and amendment. For the principle of austerity to be covered by the special amendment process of Article 168, it needs to be introduced through that same process. It is not possible to use the easy procedure of Article 167 to introduce the golden rule in the Constitution, and then establish that for that rule to be modified in the future the more difficult procedure of Article 168 will have to be followed. C.E., B.O.E. n. 167–68, Dec. 29, 1978.

79. *Internationale Handelsgesellschaft mbH*, 1970 E.C.R. 1134.

80. *Spain Passes 'Golden Rule' Reform to Fend Off Debt Crisis*, FRANCE 24 (Sept. 7, 2011), http://www.france24.com/en/20110907-spain-passes-golden-rule-reform-fend-off-eurozone-sovereign-debt-crisis-parliament.

81. *See id.* (outlining the changes of the constitutional amendment).

82. The organic law has already been enacted. *Ley Orgánica de Estabilidad Presupuestaria y*

First, the constitutional provision regarding public deficit will enter into force in 2020.[83] This is objectionable. Spain is perfectly entitled to defer to a later moment the applicability of purely internal domestic constraints, but it cannot decide when the pertinent limitations imposed by the European Union will start to apply. The latter is something for the European Union itself to decide. So we have to assume—even if that is not what the Constitution literally says—that the reference to 2020 applies to those limits that the Spanish parliament may establish through an organic statute, to the extent that they are more rigorous than the ones that are already fixed by current EU law (or by the TSCG).[84]

Second, paragraph 4 of Article 135 of the Spanish Constitution permits the limits of deficit and debt to be exceeded in certain exceptional circumstances.[85] These circumstances roughly coincide with those that EU laws (and the TSCG) already provide, but there is no general reference to European standards.[86] To avoid conflicts, it will be necessary to read this constitutional clause to mean what those standards establish. The clause is not, therefore, autonomous, appearances notwithstanding. The problem, however, is that the provision allows the Spanish Congress, by an absolute majority, to determine whether one of the exceptional circumstances are present.[87] What if Congress reaches a conclusion that is at odds with the relevant European norms? The Constitution will have to be interpreted in a restrictive manner to cabin the discretion of Congress so that any decision the latter makes can be checked under EU law through the applicable judicial processes.

So, even when states use a relatively easy formula to incorporate European principles and rules, some complications can easily arise.

If states do not use the easy formula, but instead freeze part of the content of the current European norms on austerity, then a further problem arises. What happens if European norms become less stringent in the future? States would still be under the duty to comply with the more constraining set of domestic rules, as a matter of internal constitutional law, until they are modified to be in harmony with European norms. This suggests that we may end up introducing too much rigidity into the system as a whole. Primary EU law (as well as treaties like the TSCG) is already very hard to amend. Any decision to relax the deficit and debt limitations in the future requires a complicated process at the European level to change the treaty provisions.[88] If, in addition, states have to change their national constitutions, as the

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Sostenibilidad Financiera ch. 3 art. 11 (B.O.E. 2012, 103) (Spain).

83. *See Spain Passes 'Golden Rule' Reform to Fend Off Debt Crisis*, *supra* note 80 (stating that the debt limit will be based on the gross domestic product from the year 2020).

84. TSCG, *supra* note 25, art. 3. *See, e.g.*, *Gesetz zur Änderung des Grundgesetzes* [Law Amending Basic Law], July 29 2009, BGBI I at 2248 (Ger.) (amending the German Constitution in 2009 to, among other things, cut its structural deficit to 0.35% of GDP by 2016). To the extent that this obligation is in addition to whatever constraints derive from European norms, there is no problem in this temporal schedule.

85. C.E., B.O.E. Reforma, Sept. 27, 2011 (Spain).

86. *Id.*

87. *Id.*

88. *See* PEADAR Ó BROIN, CENTER FOR EUROPEAN POLICY STUDIES, POLICY BRIEF NO. 215, HOW TO CHANGE THE EU TREATIES: AN OVERVIEW OF REVISION PROCEDURES UNDER THE TREATY OF LISBON 1–4 (2010) (explaining first the fours methods of amending EU treaty law, then stating that the simplified revision procedure was confined to Part Three of the TFEU and cannot be used to amend "protocols appended to the EU treaties"). Ordinary revision procedure and accession treaties require

European norms are modified, the overall level of obduracy of the system may be too high.

Whatever the formula of incorporation that is used, another question that needs to be addressed concerns the distribution of labor between national courts and the ECJ. When national courts are asked to decide whether the budgetary decisions at the domestic level are in compliance with the golden rule, can they sidestep the ECJ on the grounds that they are applying a provision of the domestic constitution? This would be a regression. The better reading is that, in spite of its being constitutionalized, the golden rule retains its character as part of European law. The problem, however, is that, for the moment, the TSCG is not part of EU law, and does not enjoy the benefits of direct effect and primacy.[89] It is doubtful that the national judiciary can employ the preliminary reference procedure to seek interpretive guidance from the ECJ. Things would change if, as anticipated, the TSCG ends up becoming part of the EU legal framework. Then the ECJ would be empowered to answer preliminary questions sent by national courts. Until that happens, the TSCG is a step towards an intergovernmental mode of solving problems, one that marginalizes the ECJ.

CONCLUSION

From the very beginning, the European Union has been based on a complex political and legal structure. A strong link has been established between the institutions of the European Union and those at the national level. EU law has always needed the help of national law to be implemented by domestic courts in many fields. This feature of the system has led scholars to discuss the existence of a plurality of legal systems, which interact in complicated ways. There is no easy principle that explains the relationship between EU law, national constitutions, and the rest of national law. Practitioners are familiar with the complexity of the regime. Still, there are limits to how much complexity a system can tolerate. The provision included in the new TSCG, which insists that states must incorporate the golden rule in their constitutions (or in norms of equivalent effect) is a new step that introduces unnecessary complications without yielding substantial benefits. A more straightforward path should have been taken. The authority of the Commission and the ECJ should have been expanded more radically for purposes of controlling the budgetary decisions of states. National constitutions cannot offer the help that seems to be necessary to support the austerity principles embodied in European norms.

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ratification by all member states, and the passerelle clause requires the unanimous agreement of the European Council, which any national parliament may veto. *Id.*

89. *See* TSCG, *supra* note 25, art. 16 (stating that the TSCG will be incorporated into the laws of the European Union within five years after the treaty enters force).

Narratives of the European Crisis and the Future of (Social) Europe

PHILOMILA TSOUKALA*

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INTRODUCTION

I would like to start with a few words about the *Texas International Law Journal* Euro Crisis Symposium's (the Symposium) excellently minimalist but evocative poster, which captures the ambient atmosphere in European politics since the 2007–08 financial crisis (the crisis).[1] Designed in what could perhaps be described as a gothic-influenced modernist style, the center of the poster is dominated by a black-grey structure, strongly reminiscent of the European Central Bank's (ECB) building in Frankfurt, rising high toward a sky dominated by grey and white clouds. The cloud-like figures are perfect circles, darker in color as they grow bigger in size, immediately invoking the now familiar way of representing national debt burdens in

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1. Poster, Tex. Int'l L.J., Symposium 2012: The Euro Crisis (Feb. 9–10, 2012), http://www.tilj.org/wp-content/uploads/2011/09/EuroCrisisImage.jpg.

some of the most popular graphics used in the press.[2] The general mood is one of an approaching, if not fully-fledged, storm raging at the financial heart of Europe. Finally, not to be missed are the letters announcing the Symposium, inscribed in *Star Wars*-like fonts, hinting at academia's deep connection with "the Force"—and hence a potential solution rising from Europe's own technocratic core. Beyond illustrating the general ambience surrounding the crisis, the Symposium poster also helps highlight two distinct underlying narratives about causes of—and therefore solutions to—the crisis, on which I would like to concentrate my comments. One could see the darkening clouds or debt burdens of the member states as the reason for the ECB-like figure's darkness; or inversely, one could wonder about the role of this dark protagonist in generating the clouds now dominating the background.

During the presentations at the Symposium we discussed the Stability and Growth Pact, its enforcement shortcomings, and potential solutions to these shortcomings, including the newly legislated six-pack.[3] Furthermore, we discussed—and some questioned—the need for increased financial regulation, the legality of a potential euro exit, as well as the risks entailed in some of the bank bailouts engineered by several member states' governments in the aftermath of the crisis.[4] What I would like to do here is provide an analysis of two distinct types of narratives, circulating in both popular and academic press, about the causes and therefore the solutions, to the crisis. Each type of narrative entails different understandings of the role of member states and the European Union (EU) itself in the production of the crisis. Are the member states' debt clouds to blame for the darkness of the ECB-like structure at the center of the poster? Or does the figure itself have something to do with the production of the clouds? Like all good stories, each narrative has victims and culprits, villains and protagonists, and each one suggests distinct approaches towards finding potential solutions—happy endings.

In the first part of my Article, I will present two types of narratives. In the first category, the crisis appears to be the result of member states failing to fulfill treaty obligations because of their ballooning welfare states, causing a cascade effect for the rest. In the second category, member states fail in their obligations, but are themselves the victims of structural defects in the very design of the euro zone, or at the very least structural forces due to the design of the euro.[5] I will suggest that politicians in both creditor countries and debtor countries appealed mostly to the first narrative in the early stages of the crisis, each for their own reasons. The later

2. Bill Marsh, *It's All Connected: An Overview of the Euro Crisis*, N.Y. TIMES, Oct. 22, 2011, http://www.nytimes.com/interactive/2011/10/23/sunday-review/an-overview-of-the-euro-crisis.html.

3. The six-pack is a combination of five regulations and one directive that entered into force in December 2011. Eur. Comm'n, *Six-pack? Two-pack? Fiscal Compact? A Short Guide to the New EU Fiscal Governance*, ECON. & FIN. AFF. (Mar. 14, 2012) [hereinafter *Guide to EU Fiscal Governance*], http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm. They provide a reinforcement of "the preventive and the corrective" parts of EU fiscal supervision, and they are meant to strengthen compliance with the Stability and Growth Pact, which forbids member states from maintaining a public debt of more than 60% GDP or a budget deficit of more than 3% GDP. *Id.*

4. Gerard Hertig, Swiss Fed. Inst. of Tech., Keynote Address at the Texas International Law Journal 2012 Symposium: The Euro Crisis (Feb. 9, 2012).

5. I will focus here on current structural accounts of problems with the euro, even though several academics foresaw significant structural problems, some even claiming they would lead to a likely euro breakup. *E.g.*, Hal S. Scott, *When the Euro Falls Apart*, 1 INT'L FIN. 207 (1998). Similarly, Martin Feldstein famously predicted that the euro was likely to lead to increased conflict within Europe. Martin Feldstein, *EMU and International Conflict*, FOREIGN AFF., Nov.-Dec. 1997, at 60.

stages of the crisis have made evident its structural nature but the propagation of the first type of narrative is making the resolution of the crisis a difficult political challenge.

In the second part, I will argue that the discourse employed by the European Commission (the Commission) throughout the crisis has not been characterized by a moral impugnation of lazy southerners, but instead, of their corrupt and inefficient state structures. The remedies proposed for that problem are strikingly in line with the structural conditionality of the loan agreements with the EU and the International Monetary Fund (IMF), but more importantly, they are strikingly in line with the recommendations coming out of the EU for the last decade not only on growth, but also on social cohesion. The language that the Commission has been using to describe the structural conditionality of the Greek loans shows an understanding of social cohesion almost entirely based on active labor markets combined with minimum safety nets. Thus, even though the Commission refrains from using the moral narrative, it employs a structural account of the crisis that suggests solutions almost identical to the EU and IMF recipe for Greece. This, I argue, signifies a defeat for the progressive forces that had been pushing for the creation of a "Social Europe," closer to the welfarist traditions of some European states.

I. EXPLORING THE MORAL AND STRUCTURAL NARRATIVES ON THE CAUSES OF THE CRISIS

A. The Moral Narrative: P.I.I.G.S., Ants, and Grasshoppers

> Greece needs to do its own homework to become competitive . . . . We're happy to help but we shouldn't give others the feeling that they don't have work [sic] hard themselves. Every country is responsible for itself.
>
> Wolfgang Schäuble, German Finance Minister, February 2012[6]

The first narrative is very straightforward and bears all the structural characteristics of a good fairy tale: a good character, getting entangled in some adventure because of his or her own failures or someone else's evil acts, a correction of the failure or evil act, followed by a swift resolution from which a moral teaching can be drawn for future reference. In the case of the crisis, the very name given to the group of euro zone countries that were first targeted by bond investors in 2009 hints at this narrative: P.I.I.G.S. (Portugal, Ireland, Italy, Greece, Spain).[7] In this

6. Erik Kirschbaum, *Schaeuble Warns Greek Promises No Longer Suffice*, REUTERS (Feb. 12, 2012), http://www.reuters.com/article/2012/02/12/us-germany-greece-idUSTRE81B05N20120212 (quoting Vol Olaf Gersemann and Jan Hildebrand, *Davon geht die Welt nicht unter*, WELT AM SONNTAG, (July 29, 2012), http://www.welt.de/print/wams/wirtschaft/article108407703/Davon-geht-die-Welt-nicht-unter.html).

7. *See* Nouriel Roubini, *Teaching PIIGS to Fly*, PROJECT SYNDICATE (Feb. 15, 2010), http://www.project-syndicate.org/commentary/teaching-piigs-to-fly (referring to the group of countries as "the PIIGS economies" in a discussion of possible tactics for dealing with the euro zone's financial problems); *see also* Shira Ovide, *PIIGS to the Slaughterhouse. Meet GIIPS.*, DEAL J. (July 15, 2011), http://blogs.wsj.com/deals/2011/07/15/piigs-to-the-slaughterhouse-meet-giips/ (discussing how political correctness has led many commentators to reverse the acronym so that the indebted European periphery

version of the story the little P.I.I.G.S. were either good characters committing the mistake of overburdening themselves with debt or, in a slight variation, they were the evil characters threatening the innocent euro zone and, more specifically, their northern partners with destruction because of their profligacy.

This last version of the crisis can also be compared to the ant versus the grasshopper fairy tale. The industrious ants spent their days laboring and saving for the future, while the lazy grasshoppers sang and lived the good life—that is, until hard times arrived. The desperate grasshoppers then knocked on the door of the industrious ants asking them for something to eat so as to survive the winter.[8] Just like the industrious ants of the fairy tale, northern European neighbors of the lazy European southerners had to choose whether to help the desperate grasshoppers or not, with the twist of course that in the euro zone's case the grasshoppers' deaths threatened the demise of the ants as well. The euro was founded on an explicit agreement that each country would maintain debt levels below 60% of its GDP and primary deficits lower than 3% GDP, as well as a "no-bailout" clause, which had from the beginning been inserted in order to assure the industrious north that monetary union with a lazy south did not mean mutual sharing of debt.[9] The crisis in this version then could straightforwardly be characterized as a debt crisis instigated by the profligacy of greedy little grasshoppers.

Enter the Greek grasshoppers. Since the beginning of the crisis, Greece was used as a stand-in for the debt problems facing the entire European periphery. The Greek narrative influenced the way European policymakers imagined the roots of the problem for the entire periphery and the types of solutions they devised at the European level: partial, reluctant, and aimed at remedying an imagined public-debt crisis caused by the profligacy of unsustainably generous welfare states. In the case of Greece, common characters started to pop up—welfare queens and kings who retired at unsustainably young ages[10] and public sector employees who commanded

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is referred to as GIIPS).

8. Greek economist Yanis Varoufakis has also used the ants and grasshoppers metaphor to describe how European politicians dealt with the Greek crisis. Yanis Varoufakis, *NEVER BAILED OUT: Europe's Ants and Grasshoppers Revisited*, YANIS VAROUFAKIS (Dec. 15, 2011), http://yanisvaroufakis.eu/2011/12/15/never-bailed-out-europes-ants-and-grasshoppers-revisited/.

9. *Guide to EU Fiscal Governance*, *supra* note 3; *See* Treaty of Lisbon Amending the Treaty on European Union and the Treaty Establishing the European Community art. 125, Dec. 13, 2007, 2007 O.J. (C 306) 30 [hereinafter Lisbon Treaty] ("A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project," thus establishing a "no bailout" clause.); *see also* Scott, *supra* note 5, at 209 (stating that within the European monetary union, national debt is solely the responsibility of each particular country as opposed to a mutual burden among members).

10. *See, e.g.*, Diane Francis, *Greece Is Not a Country, It's a Party*, HUFFINGTON POST (June 8, 2011), http://www.huffingtonpost.com/diane-francis/greece-is-not-a-country-i_b_871296.html (stating that Greeks retired, on average, at only 53 years of age); Walter Loeb, *Retirement in Germany May Rise to Age 69 While Greece Is at Age 58*, FORBES (June 17, 2012), http://www.forbes.com/sites/walterloeb/2012/06/17/retirement-in-germany-may-rise-to-age-69-while-greece-is-at-age-58/ (comparing retirement ages in various European countries and highlighting that Greece is among the lowest). However, these accounts are not accurate. Average age of labor force exit for Greek women was 62.4 and 60.9 for men in 2009. OECD, SOCIETY AT A GLANCE 2009: OECD SOCIAL INDICATORS 83 tbl SS6.1 (5th ed. 2009) [hereinafter SOCIETY AT A GLANCE], *available at* http://www.oecd-ilibrary.org/docserver/download/8109011e.pdf?expires=1360263478&id=id&accname=guest&checksum=A6154B8FEE2F329689ED5AC09BCB2843. Greek women retire on average slightly later than German women, and Greek men slightly earlier than

insane privileges as compared to their private sector colleagues.[11] With a slight of hand, these characters were then made out as representatives of the European welfare state in general, which, given the crisis, was beginning to look particularly unsustainable.[12]

The Greek story had a private sector piece to it as well. Private sector employees started appearing along with their inflated wages and their favorable collective agreements, which were said to have caused the crisis of competitiveness that ended up undoing the sustainability of Greek debt in the last decade.[13] Add to

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German men. *Id.* German and Greek workers both retired at ages slightly below the OECD average. *Id.* The official retirement age in 2008 was 65 for both men and women. *See* OECD, PENSIONS AT A GLANCE 2011: RETIREMENT-INCOME SYSTEMS IN OECD COUNTRIES: GREECE 1, *available at* http://www.oecd.org/greece/47272439.pdf ("The normal pension age is 65 for both men and women."). In addition, Greek workers work much longer hours than the OECD average and certainly much more than the average German. In 2008 Greeks reached an annual average of 2051 working hours, compared to the German average of 1422. *Average Annual Hours Actually Worked Per Worker*, OECD.STATEXTRACTS (Feb. 7, 2013, 7:01 PM), http://stats.oecd.org/Index.aspx?DatasetCode=ANHRS. From a fiscal perspective, however, Greece's pension expenditures were significant even before the crisis and had long been the cause of major concern. The size of pension expenditures is partly due to the fact that the Greek state was making up for meager social transfers, such as housing and unemployment benefits, through inefficient pension transfers. Manos Matsaganis, *The Welfare State and the Crisis: The Case of Greece*, 21 J. EUR. SOC. POL'Y 501, 503 (2011). The other part of the explanation is the clientelist nature of the Greek state, which resulted in a hugely fragmented pension system. It lacked truly universal coverage and provided radically distinct benefits for different groups of workers. It benefited the self-employed over the salaried, public over private sector workers, the middle-aged over the young, and men over women. *Id.*

11. *See, e.g.*, Raffaela Giordano et. al., *The Public Sector Pay Gap in a Selection of Euro Area Countries* 25 (European Cent. Bank, Working Paper No. 1406, 2011), *available at* http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1406.pdf (explaining the benefits public sector employees in Greece enjoy as compared to their counterparts in other European countries, including lifetime contracts and protections from termination); John Sfakianakis, Op-Ed., *The Cost of Protecting Greece's Public Sector*, N.Y. TIMES (Oct. 10, 2012), http://www.nytimes.com/2012/10/11/opinion/the-cost-of-protecting-greeces-public-sector.html ("Wages in the public sector were on average almost one and half times higher than in the private sector.").

12. *See* Robert J. Samuelson, *Greece and the Welfare State in Ruins*, WASH. POST (Feb. 22, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/02/21/AR2010022102914.html ("The threat to the euro bloc ultimately stems from an overcommitted welfare state.").

13. *See* Stathis Tikos, *National General Collective Agreement Signed for 2008–2009*, EIRONLINE (Sept. 08, 2008), http://www.eurofound.europa.eu/eiro/2008/05/articles/GR0805039I.htm (discussing a new collective agreement in Greece increasing minimum wage rates by 12.42% over two years); *see also* Matthew Higgins & Thomas Klitgaard, *Saving Imbalances and the Euro Area Sovereign Debt Crisis*, 17 CURRENT ISSUES IN ECON. & FIN., no. 5, 2011 at 5–6, http://www.newyorkfed.org/research/current_issues/ci17-5.pdf (explaining the various factors that led to Greece's loss of competitiveness within the euro zone). Interestingly employers' associations in Greece have noted that "competitiveness problems were not due to wage levels . . . and that the collective bargaining system was balanced and protected sound competition." ILO, REPORT ON THE HIGH LEVEL MISSION TO GREECE 30 (2011), *available at* http://www.ilo.org/wcmsp5/groups/public/---ed_norm/---normes/documents/missionreport/wcms_170433.pdf. Greece is a country with a large informal sector almost entirely outside the purview of collective agreements. *See* LENA TSIPOURI ET AL., FLEXIBILITY AND COMPETITIVENESS: LABOUR MARKET FLEXIBILITY, INNOVATION AND ORGANISATIONAL PERFORMANCE (FLEX-COM), NATIONAL REPORT: GREECE, FINAL REPORT 2, *available at* flexcom.econ.uoa.gr/files/NationalReport_Greece.doc (calculating the Greek informal sector at between 29%–36% of the overall economy and noting that "institutionalisation of flexible labour forms will not improve the competitiveness of small companies (which will continue to favour the informal sector)"). Additionally, microfirms, characterized by informal labor arrangements, comprise 91.8% of establishments in the Greek economy. *See id.* (concluding that such microfirms would continue to favor informality despite the availability of formal flexible contracts).

that the Greeks' penchant for not paying their taxes, and you have a morally corrupt people who are expecting extravagant state perks while giving nothing in return.[14] This version of the narrative was propagated once more recently, this time by the head of the IMF, Christine Lagarde, who scolded the poorest of Greek parents whose children were going hungry for not paying their taxes.[15]

The suggested solutions in this version of the narrative almost insinuated themselves from the moral and other failings of the characters. If the problem was one of unsustainable public profligacy, then the solution could be quickly pointed out: cut back on public spending and, more specifically, on those extravagances that had to do with the excesses of the welfare state and the privileges of certain categories of workers, which turned a state's labor force uncompetitive *vis-à-vis* the northern euro zone countries. Dramatic reforms in the private sector labor conditions were indeed part of the conditionality attached to the loan agreement that Greece received from its partners in the euro zone, along with the IMF in May 2010.[16] So was a very imaginative, highly desirable—but surely impossible in the timeline allowed—reordering of Greece's tax administration.[17]

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14. Greece is the typical case of a "tipping point" in tax evasion, whereby relatively high tax rates for individuals combine with low corporate rates and state corruption to produce a state of affairs where it makes sense to try to hide your income because you are not getting your euro's worth of public services. *See* Manos Matsaganis & Maria Flevotomou, *Distributional Implications of Tax Evasion in Greece* 20, 24 (Hellenic Observatory, Greece Paper No. 31, 2010) (finding that tax evasion is around 10% in the lower income strata, falls to 5–8% in the middle income strata, and sharply rises to 15% in the higher income strata). The clientelist nature of the Greek state also guarantees an asymmetric risk of punishment for tax evasion for clients as compared to non-clients. Greek politics were recently rocked by revelations that two consecutive finance ministers from 2010 to 2012 sat on a list containing thousands of names of Greek Swiss bank account holders instead of using the list to identify high value tax evaders. One of the finance ministers is being investigated for allegedly having removed names of relatives form the original list. Helena Smith, *Greece's 'Lagarde list' Sparks Calls for Catharsis over Tax Avoidance*, THE GUARDIAN (Jan. 7, 2013), www.guardian.co.uk/world/2013/jan/07/greece-christine-lagarde.

15. Larry Elliott & Decca Aitkenhead, *It's Payback Time: Don't Expect Sympathy—Lagarde to Greeks*, THE GUARDIAN (May 25, 2012), http://www.guardian.co.uk/world/2012/may/25/payback-time-lagarde-greeks.

16. *See* Directorate-General for Econ. & Fin. Aff., *The Economic Adjustment Programme for Greece*, 21–22, 79–80, Occasional Papers 61 (May 2010) [hereinafter *Economic Adjustment Programme*] (noting the revision of private sector wage bargaining as a condition to the agreement in addition to noting how public sector changes should signal corresponding changes in the private sector); Int'l Monetary Fund, *Europe and IMF Agree €110 Billion Financing Plan With Greece*, IMF SURV. MAG.: COUNTRIES & REGIONS (May 2, 2010), http://www.imf.org/external/pubs/ft/survey/so/2010/CAR050210A.htm (describing the agreement made between Greece, the IMF, and other euro zone countries). The insistence on labor market reforms on the part of the IMF and the EU is surprising given the lack of evidence in international literature about the effectiveness of labor market flexibility in spurring growth. *See* Alvaro Santos, *Labor Flexibility, Legal Reform, and Economic Development*, 50 VA. J. INT'L L. 43, 49 (2009–10) (reviewing the relevant literature and positing that "we know less than we might think" about the impact of labor market flexibility on "job creation, unemployment duration, productivity, investment in research and development, and, ultimately, on economic growth"). Greek labor markets are characterized by de facto flexibility, since so-called rigid labor provisions are only applicable to a small portion of the private sector businesses. TSIPOURI, *supra* note 13, at 2; *see also* Philomila Tsoukala, Op-Ed., *A Family Portrait of a Greek Tragedy*, N.Y. TIMES (Apr. 25, 2010), http://www.nytimes.com/2010/04/25/opinion/25tsoukala.html (arguing that since most of the private sector businesses are family-owned, they rely on family labor, and therefore "no minimum-wage or maximum-hour laws apply"). Moreover, "[u]ntil Greece can find a way to disentangle the private sector from the family and find another way to allocate resources . . . no amount of reform will make a difference." *Id.*

17. *Economic Adjustment Programme*, *supra* note 16, at 44 (detailing Greece's tax reforms); *see also* Paul Tharp, *Greek Tax Ax Cuts to Bone, Portugal Worries Deepening*, N.Y. POST (Apr. 16, 2010),

Other countries were advised to quickly cut down on their own public spending lest the markets decide that their debt burdens were unsustainable and, hence, produce a liquidity crisis for these countries too.[18] The moral of the Greek story was that European welfare states had become unsustainable, and the best that member states could do was to start the process of trimming on their own before they were forced to do so through the accumulated pressure of market speculation and exclusion from international financial markets.

B. Structural Stories: Who's the Grasshopper Now Dear Ant?

Despite this straightforward tale of crime and punishment, there were still voices pointing to the structural nature of the crisis and the need for a structural solution from every side of the political spectrum. As early as April 2010, Martin Feldstein, former Chief Economic Advisor to President Reagan, pointed out that if it were not for the euro, Greece's bonds would not have been trading almost on par with Germany's, and Greece would have been forced to restrain its public spending given a lack of access in the international financial markets.[19] In addition, Feldstein pointed out that in the context of the EU/IMF loan, without the possibility of devaluation, the austerity demanded significant contraction of the Greek economy, as well as political difficulties.[20] The true lesson to be learnt from the crisis was not simply that Greece would not have borrowed as much or would have adjusted more easily had it not been for the euro, but rather that the very design of the euro was to blame for the current situation, which was common throughout what began to be referred to as the European periphery.[21] This structural account has various versions as well.

One of the structural accounts involves Nobel Laureate Robert Mundell's theory of what constitutes an optimum currency area (OCA).[22] According to Mundell's theory, for a common currency area to work well the different regions in the area should be exposed to similar sources of economic disturbance, disturbances should have the same effects within regions, and regions should have similar

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http://www.nypost.com/p/news/business/greek_tax_ax_cuts_to_bone_sxoH3tXCghQSELYnw365sM (describing the tax reforms as extensive and harsh).

18. Toby Helm, Ian Traynor & Paul Harris, *Europe Embraces the Cult of Austerity—But at What Cost?*, THE GUARDIAN (June 12, 2010), http://www.guardian.co.uk/business/2010/jun/13/europe-embraces-cult-of-austerity.

19. Martin Feldstein, *Why Greece Will Default*, PROJECT SYNDICATE (Apr. 28, 2010), http://www.project-syndicate.org/commentary/why-greece-will-default.

20. *See id.* (noting that to get Greece back to the prescribed "debt-to-GDP ratio [of] 60% level" would mean reducing the budget deficit by 10% of its current GDP). Feldstein noted that this reduction would not only be politically difficult, but would also lead to either an "enormous cut in government spending or a dramatic rise in tax revenue, or both." *Id.* The fact that a neo-classical economist like Feldstein was clear about this dynamic from the beginning, as were the Keynesians, suggests there was consensus from a broad spectrum of economists. For a more typically Keynesian take on the euro's structural problems, see Joseph E. Stiglitz, *Can the Euro be Saved?*, PROJECT SYNDICATE (May 5, 2010), http://www.project-syndicate.org/commentary/can-the-euro-be-saved.

21. *See* Stiglitz, *supra* note 20 (noting structural problems in the euro zone such as the fixed exchange rate and Germany's trade surplus, which essentially puts the rest of the euro zone at a deficit).

22. The discussion on optimum currency areas is mostly drawn from HENDRIK VAN DEN BERG, INTERNATIONAL FINANCE AND OPEN-ECONOMY MACROECONOMICS: THEORY, HISTORY, AND POLICY 645–52 (2010).

responses to shocks.[23] If the different regions of the common currency area are subject to regional shocks, then prices and the supply of labor need to be able to adjust quickly.[24]

Why is this? In order to illustrate, Mundell uses the example of two countries, A and B, with fixed exchange rates and their central banks actively intervening in currency markets to maintain the peg.[25] If there is a shift in global demand from country A's products to country B's products and prices between these two countries do not adjust quickly and labor does not move, the result is going to be a surge in unemployment in country A, and inflationary pressures in country B.[26] If country A intervenes in the currency markets to try to maintain the fixed exchange rate by buying its own currency so as to avoid depreciation, the result is going to be a shrinking money supply and a worsening of the unemployment problem.[27] Similarly, if country B intervenes in the currency markets by selling its own currency to avoid appreciation, this is going to further exacerbate the inflationary pressures by flooding the markets with more money.[28] If prices adjust easily and labor moves easily between countries A and B, the problem could be avoided, as workers from country A will move to country B, thus easing both the unemployment problem in country A and the inflationary pressures in country B.[29] Alternatively, if countries A and B cannot so easily adjust their prices and labor supply, they could undo the currency peg.[30] In that case, country A's currency would depreciate and country B's would appreciate, thus rebalancing exports as between the two.[31] In addition to this, both countries could use active monetary policy to target their unemployment by expanding money supply, rather than intervening in the markets to maintain a currency peg.[32]

The case that the euro area is not an OCA has now been repeatedly made. Even though the entire euro area was subject to the same external shock in 2008, the responses were very different and more importantly, neither prices nor labor supply seem to have adjusted quickly between the different regions of the euro area. If only the unemployed Greeks could quickly move to Germany to relieve Greek unemployment and German inflationary pressures, all would be better. Instead, prices have remained doggedly fixed and labor stubbornly immovable.[33] Moreover, things could perhaps slightly improve if the ECB had a policy mandate broader than price stability (e.g., aimed at unemployment), even though given the dramatically

23. *Id.* at 652.
24. *Id.*
25. *Id.* at 646–47.
26. *Id.* at 646.
27. *Id.*
28. VAN DEN BERG, *supra* note 22, at 646.
29. *Id.* at 646–47.
30. *Id.* at 646.
31. *Id.*
32. *Id.*
33. *See* Press Release, Hellenic Statistical Auth., Consumer Price Index: January 2012 (Feb. 9, 2012) (on file with author) (noting that while some sectors have experienced downward trends, overall price levels remain well above the 2009 mark with 2009 equaling 100%); Eurostat, *Demography Report 2010*, at 61 Table I.6.3, Eur. Comm'n, (Mar. 2011), *available at* http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KE-ET-10-001/EN/KE-ET-10-001-EN.PDF (illustrating that Greece, represented by the symbol "EL," experienced net growth due to migration, indicating that labor is moving into Greece instead of to another country, like Germany).

different conditions prevailing in each region of the euro zone, any ECB intervention aimed at average European conditions is bound to be wrong for any region involved.[34]

So how is this an account that attributes to the euro itself some of the blame for the dire straits peripheral countries have found themselves in? The first thing to note is that this is a theory that instead of singling out individual countries for their failures to stick to the constraints of the Stability and Growth Pact tries to discern the reasons why some countries have been particularly prone to doing so. Indeed, this story very quickly reaches the conclusion that there are systemic, structural pressures at play, which have to do with the fact that the euro area consisted of several highly dissimilar countries such as the imaginary countries A and B of the Mundell example. With a hard currency peg, such as the euro, in place, and with a global shift in demand in favor of Europe's industrial north, peripheral countries had limited options in order to adjust, short of breaking out of the euro and devaluing. They could address their unemployment by shipping off their unemployed to the industrial north, or they could try to force price levels to drop by enforcing a policy of internal devaluation. Indeed, the grinding austerity imposed on Greece's economy as part of the conditionality agreement for the loans Greece received in April 2010 and again in October 2011 is explicitly aiming to achieve an internal devaluation that would help Greece regain competitiveness *vis-à-vis* Germany without the help of currency devaluation.[35]

In a distinct version of the systemic story, part of Germany's competitive advantage in the global markets and part of the peripheral countries' disadvantage comes from the fact that the euro is devalued by comparison to where the German mark would have been had the EU not included countries such as Greece, Ireland, Spain, and Portugal.[36] For these countries the euro is overvalued, thus exacerbating their comparative disadvantage *vis-à-vis* the European core.[37] So not only does the European core benefit from being in a monetary union with weaker peripheral economies, but the latter are left without policy tools to deal with the disadvantages that come from being in a monetary union with a much more competitive country. Short of leaving the euro, and given that the ECB's monetary policy is never going to be primarily aimed at dealing with the unemployment that results from the peripheral countries' automatic loss of competitiveness,[38] peripheral countries dealing with a loss in competitiveness, as was the case in Greece, have one option left, which

34. Van den Berg quotes an economist as saying that "[s]ince no country is average, you've ensured that every country has the wrong monetary policy all the time." VAN DEN BERG, *supra* note 22, at 645.

35. *See Economic Adjustment Programme*, *supra* note 16, at 42 (noting that in a monetary union, the goal of restoring Greece's external competitiveness must rely on reductions in domestic costs and prices).

36. *See, e.g.*, Kenneth C. Griffin & Anil K. Kashyap, Op-Ed., *To Save the Euro, Leave It*, N.Y. TIMES (June 26, 2012), http://www.nytimes.com/2012/06/27/opinion/to-save-the-euro-germany-must-leave-it.html (arguing that if Germany reintroduced the mark, the subsequent devaluation of the euro would allow the other euro zone countries to restructure their economies and restore competitiveness).

37. *See* Virginie Coudert, Cecile Coubarde & Valerie Mignon, *On Currency Misalignments Within the Euro Area* 17–19 (CEPII, Working Paper No. 2012-07, 2012), *available at* http://www.euroframe.org/fileadmin/user_upload/euroframe/docs/2012/EUROF12_Coudert_etal.pdf (explaining how peripheral countries experienced higher inflation than the core euro countries).

38. *See Objective of Monetary Policy*, EUR. CENT. BANK, http://www.ecb.europa.eu/mopo/intro/objective/html/index.en.html# (last visited Aug. 20, 2012) ("To maintain price stability is the primary objective of the Eurosystem and of the single monetary policy for which it is responsible.").

is to finance the deficits that result from external trade imbalances in the international markets, thus fueling further their current account deficits.[39]

Actually, in the most structural version of the competitiveness and balance of payments story there is no possible way that all of the countries in the euro zone will maintain trade surpluses with each other. It is a mathematical impossibility and a matter of simple arithmetic that if Germany seeks to become a major exporter of its goods to other euro zone countries, some of these countries will, by necessity, need to have a trade deficit with Germany.[40] Importing euro zone countries will need to cover their trade deficits by borrowing money in the international financial markets, thus contributing to the debt problem.[41] In different euro zone countries the problem manifested itself in different ways, as in each country a different sector was responsible for the trade imbalance. In Spain there was a real estate bubble financed by cheap credit coming from mostly German banks who were redistributing German surplus in the form of loans.[42] In Greece, German banks lent money to the government, which then proceeded to allocate it via contract jobs with the government or to the buying of German and French military products, and they also lent to the Greek banking sector, which financed a consumer spending spree (even though Greek household debt remained low relative to the rest of Europe).[43]

In all versions of the structural story, it was only Greece that arguably already had an important fiscal imbalance before the crisis, with a growing public debt. Every other peripheral country had suffered from the effects of a private credit bubble whose sudden burst in 2008 left European banks undercapitalized. Saving the banks after the bust is what caused the balance sheets of most European countries to

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39. *See* Higgins & Klitgaard, *supra* note 13, at 10 (discussing the limited options available to peripheral countries for financing their debt).

40. The Economist recently illustrated this principle with a soccer metaphor: "Germany, which retained 66% of the possession in last night's Euro 2012 football match, is wondering why Greece couldn't just do the same." *Fallacy Football*, FREE EXCHANGE BLOG: THE ECONOMIST (June 23, 2012, 3:22 PM), http://www.economist.com/blogs/freeexchange/2012/06/euro-competitiveness.

41. Higgins & Klitgaard, *supra* note 13, at 2.

42. *See* Andrew Moravcsik, *Europe After the Crisis: How to Sustain a Common Currency*, 91 FOREIGN AFF. 54, 59 (2012) ("German banks and investors lent their extra cash to southern Europe at historically low interest rates, ignoring the long term risk."); *see also Spain's Housing Bubble a Threat to Its Banking Sector*, THE ECON. TIMES (Apr. 30, 2012), http://articles.economictimes.indiatimes.com/2012-04-30/news/31508432_1_spanish-banks-banking-sector-banking-system (discussing Spain's record amount of borrowing from the ECB, thus increasing its banking sector's reliance on the entity).

43. *See* Roxane McMeeken, *Less Healthcare, but Greece Is Still Buying Guns: Greeks Furious at 'Intact' Arms Spending as Eurozone Leaders Insist on Cuts to Their Public Services*, THE INDEP. (Nov. 6, 2011), http://www.independent.co.uk/news/business/analysis-and-features/less-healthcare-but-greece-is-still-buying-guns-6257753.html ("During the five years up to the end of 2010, Greece purchased more of Germany's arms exports than any other country .... Over the same period, Greece was the third-largest customer for France's military exports ... ."); Jack Ewing, *In Euro Crisis, Fingers Can Point in All Directions*, N.Y. TIMES (Aug. 24, 2012), http://www.nytimes.com/2012/08/25/business/global/in-euro-crisis-plenty-of-blame-to-go-around.html?pagewanted=all ("French and German banks[] continued to lend Greece money. At the end of June 2009, just before the debt crisis exploded, Greece owed French banks 76.5 billion euros, or $96 billion, and German banks 38.6 billion euros, according to the Bank for International Settlements."); *The World Factbook: Greece*, CIA, https://www.cia.gov/library/publications/the-world-factbook/geos/gr.html (last updated Aug. 15, 2012) ("[I]ncreased availability of credit ... sustained record levels of consumer spending."); Int'l Monetary Fund, *Global Financial Stability Report*, WORLD ECON. & FIN. SURV., Apr. 2012, at 13, *available at* http://www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/text.pdf (comparing the gross household debt of various countries).

grow dangerously, so that for most of Europe it is accurate to say that this had been a crisis of private debt transforming itself into public debt via bank rescues, not a crisis of profligate public spending.[44]

C. The Role of the Different Narratives in the Solutions Devised (or Not)

I have already noted that the first narrative has some of the main elements of a good fairy tale, which says something about what I think of its credibility. It certainly has some descriptive power (euro zone countries had a legal obligation to stick to the Stability and Growth Pact;[45] Greece—among others—did not stick to the Stability and Growth Pact;[46] the rest of the euro zone is at risk of contagion if Greece goes bankrupt or exits the euro; the euro itself might even collapse if Greece exits the euro). But pretending that this descriptive power is at the same time explanatory leads to some misguided solutions.[47]

So which one of these narratives has the EU adopted through this crisis? First, let us take a look at the specific measures devised to deal with the crisis at the EU level. The only legislative measures approved at the EU level have to do with increased enforceability of the Stability and Growth Pact, namely the famous six-pack group of regulations and directives that is meant to put some teeth into the, up until now, punishment-free SGP.[48] This suggests an underlying understanding of the crisis as essentially a crisis of the sustainability of public finances, which can be corrected as soon as states take appropriate measures to correct their public expenditures. So far, EU institutions have dealt with the crisis as if there were one

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44. For the connection between banking crises and sovereign debt crises, see generally Carmen M. Reinhart & Kenneth S. Rogoff, *From Financial Crash to Debt Crisis*, 101 AM. ECON. REV. 1676 (2011).

45. Council Resolution on the Stability and Growth Pact Amsterdam (EC) No. 236/01 of 2 Aug. 1997, 1997 O.J. (C 236).

46. *See* Heinz-Dieter Wenzel, Jörg Lackenbauer & Klaus J. Brösamle, *Public Debt and the Future of the EU's Stability and Growth Pact* 2 (Bamburg Univ. Res. Group on Gov't and Growth, Working Paper No. 50, 2004), *available at* http://www.uni-bamberg.de/fileadmin/uni/fakultaeten/sowi_lehrstuehle/vwl_finanzwissenschaft/DAAD-Projekt/Publikationen/pberg50.pdf (discussing Greece's continuous breach of the Stability and Growth Pact). Greece was not unique in consistently breaching the Stability and Growth pact. In fact, repeated violations by two key players, Germany and France, and the Council's unwillingness to use the available procedural mechanisms against them led the European Commission in 2005 to conclude that the original SGP framework had been disavowed. *See* Marco Buti, Directorate-General for Econ. & Fin. Aff., *Will the New Stability and Growth Pact Succeed? An Economic and Political Perspective*, 8–11, European Economy - Economic Papers 241 (Jan. 2006) (describing the reform of the SGP).

47. For example, there are those who think that Greece's failure to stick to the SGP is the cause of the crisis, and therefore believe that if we could only make countries stick to the SGP all would be well. *See, e.g.*, Edin Mujagic, *The Euro's Greek Tragedy*, PROJECT SYNDICATE (Dec. 10, 2009), http://www.project-syndicate.org/print/the-euro-s-greek-tragedy (noting Greece's routine deviations from the SGP and encouraging fiscal discipline for the future health of the euro zone). Alternatively, others believe that Greece is the problem, and therefore believe that if we could only get Greece to either fix itself or leave the EU all would be well. *See* David Crossland, *Germans Vexed by 'Stubborn' Greeks and Their Profligate Ways*, THE NAT'L (Nov. 4, 2011), http://www.thenational.ae/news/world/europe/germans-vexed-by-stubborn-greeks-and-their-profligate-ways ("'The Greeks keep causing us problems. They should have never been let into the euro and it's time they were kicked out.'").

48. *See* Press Release, European Union, EU Economic Governance "Six-Pack" Enters into Force (Dec. 12, 2011), *available at* http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898 (outlining the "Six-Pack" plan).

bad apple in the EU causing chaos for the rest, because of the interdependency of the euro zone economies and the risk of contagion of market panic in bond markets.

However, this may be a function of the EU's limited competences. Even though euro area countries were already obliged to coordinate their economic policies and were certainly supposed to abide by the SGP, no EU institution had the competence or the firepower needed to deal with a crisis of such immense proportions. The ECB emphatically refused to play the role of lender of last resort, citing its institutional capacity and limited mandate.[49] The European Financial Stability Facility and the European Stability Mechanism had to be improvised on the spot; both were judged by commentators generally as too little, too late.[50] In fact, early on in the crisis, Germany insisted on the idea that the Lisbon Treaty's "no bailout" clause[51] meant that the EU was not allowed to provide any kind of assurance to the markets at a moment when Greece's interest rates started to go up.[52] This expansive interpretation of the clause (no bailout means no loans even if they are still yielding profits for lending countries) predominated in the European discussion and invited speculation by bond investors,[53] who then drove Greece's interest rates so high that the country became practically excluded from international financial markets and in need of a loan in order to fulfill its obligations.[54]

Thus, even if one was of the view that not only Greece's problems, but also the euro zone's problems were a function of the southern belt's lax enforcement of fiscal rectitude, some of the necessary steps to avert contagion via the markets to other euro zone countries seemed institutionally unavailable. The general story of the next two years has been one of institutional improvisation that necessarily has to come from the intergovernmental level, and which arrives usually after the fact. At the time of writing this Article, Spain, one of the big elephants in the room that nobody wanted to think about in 2010,[55] has already been affected and is in the process of negotiating a direct bank recapitalization with the ECB.[56]

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49. Note that for some, the ECB violated its institutional capacity and limited mandate through accepting junk Greek bonds as guarantees for liquidity. *E.g.*, Jim Brunsden, *ECB Agrees to Accept Greek 'Junk' Bonds as Collateral*, EUROPEANVOICE.COM (May 3, 2010), http://www.europeanvoice.com/article/2010/05/ecb-agrees-to-accept-greek-junk-bonds-as-collateral/67854.aspx; *see also* Geoffrey R. D. Underhill, *Eurocrisis: We Knew All We Needed to Know . . .*, VOX (Dec. 23, 2010), http://www.voxeu.org/article/eurozone-crisis-we-knew-all-we-needed-know ("During the financial phase of the crisis the EU led by the Bank behaved just so, violating its own rules to take on all sorts of dubious collateral from banks.").

50. Vincent Cignarella, *Too Little Too Late For EFSF or Euro-Bonds*, DJ|FX TRADER (Nov. 25, 2011), http://www.dowjones.com/products/djfxtrader/articles/TooLittleTooLateForEFSFOrEuro-Bonds.asp.

51. Lisbon Treaty, *supra* note 9, art. 125.

52. *See* Helen Pidd, *Greek Bailout Challenged in Germany's Constitutional Court*, THE GUARDIAN (July 5, 2011), http://www.guardian.co.uk/business/2011/jul/05/germany-greek-bailout-legal-challenge-constitutional-court (illustrating the controversial nature of the Greek bailout in relation to the Lisbon Treaty's "no bailout" clause).

53. *See, e.g.*, Mujagic, *supra* note 47 (recognizing that "[c]urrent European rules prohibit other European countries or the EU itself from helping Greece," but noting that Europe should consider changing the rules for the future health of the euro).

54. URI DADUSH ET AL., CARNEGIE ENDOWMENT FOR INT'L PEACE, *Why Greece Has to Restructure Its Debt*, *in* PARADIGM LOST: THE EURO IN CRISIS 25, 27 (2010) ("[W]hen markets realized Greece's chronic failure to report accurate statistics. . . . Greece's borrowing costs skyrocketed. Worries mounted that Greece would not be able to repay its loans . . . .").

55. *See* Anthony Faiola, *Debt Crisis Escalates in Europe; Fears Grow About Spain*, WASH. POST

This delay in improvising the institutional solutions needed, however, is not merely a function of the intergovernmental nature of the process. The prevalence of the ants and grasshoppers narrative in the national political scene of surplus countries is one of the main reasons why the European reactions have been so slow—even assuming that one thought all that needs to be done is to contain a contagion. When Greece was excluded from the markets in the spring of 2010, the European countries were so reluctant to undertake a "rescue" package on their own, that an EU/IMF collaboration was devised.[57] This was despite the fact that one of the main dangers for the rest of Europe was not simply bond market vigilantes, but the very real risk of a full-blown banking crisis following a Greek default.[58] In fact, a full 86% of the first loan Greece received went into debt service for 2010.[59] European banks, at the time, were undercapitalized after the 2008 crisis, despite bailout packages they received from European governments.[60] German, French, and other European banks were holding billions in Greek paper, possibly worth only a fraction of its nominal value.[61] European governments were faced with the very real risk of having to sell their voters another bank rescue plan if Greece were allowed to default on its debt, which is what would have happened if Greece had not received the EU/IMF package in April 2010.

The ants and grasshoppers tale was thus enlisted in the service of avoiding the need to rescue European banks for the second time in two years. It was outrageous,

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(Nov. 27, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/11/26/AR2010112601943.html (suggesting that investors did not want to imagine the dire situation should Spain require a bailout).

56. *IMF Chief: Strongly Supports 'Timely' Spanish Bank Recapitalization*, AUTOMATED TRADER (Sept. 28, 2012), http://www.automatedtrader.net/real-time-dow-jones/113974/imf-chief-strongly-supports-039timely039-spanish-bank-recapitalization. In December, the European Stability Mechanism (ESM) approved the Spanish bank recapitalization. John Geddie, *ESM Prints Bonds for Spanish Bank Recap*, REUTERS (Dec. 5, 2012), www.reuters.com/article/2012/12/05/esm-bonds-idUSL5E8N5AWZ20121205.

57. *See, e.g.*, Roubini, *supra* note 7 (arguing that an IMF intervention would be preferable to the provision of guarantees by Germany alone or the EU because IMF conditionality would ensure structural reforms).

58. Bond vigilantes are investors who sell public bonds en masse in reaction to policies they consider unsustainable thus bringing up the yields of public bonds. *See* Cushla Sherlock, *Bond Vigilantes a Factor in Europe but Not in the U.S.*, THE FINANCIALIST (Sept. 19, 2012), http://www.thefinancialist.com/bond-vigilantes-a-factor-in-europe-but-not-in-the-u-s-edward-yardeni/ ("Thirty years ago, economist Edward Yardeni coined the term 'bond vigilantes' to describe investors who seek to sway a country's fiscal policies by selling off its sovereign bonds."); *see also*, Steven Erlanger, *Greek Crisis Poses Unwanted Choices for Western Leaders*, N.Y. TIMES (May 20, 2012), http://www.nytimes.com/2012/05/21/world/europe/greek-crisis-poses-hard-choices-for-western-leaders.html (giving the example of the possibility of a "full-blown banking crisis in Spain").

59. *See* HELLENIC REPUBLIC MINISTRY OF FIN., BUDGET OF THE GREEK GOVERNMENT, FISCAL YEAR 2011 165 (2010) (illustrating in Table 8.7 that approximately 32.8 billion euro of the 38.1 billion euro borrowed went into debt servicing in 2010).

60. *See, e.g.*, Jay C. Shambaugh, *The Euro's Three Crises*, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2012 at 7, *available at* http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2012_spring_bpea_ papers/2012_spring_BPEA_shambaugh.pdf ("Euro area banks required a series of bailouts and guarantees and continue to struggle with undercapitalization.").

61. *See, e.g.*, Robert Samuelson, *Greece and the Welfare State in Ruin*, WASH. POST (Feb. 22, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/02/21/AR2010022102914.html ("The crisis originated in fears that Greece wouldn't be able to refinance almost 17 billion euros in bonds (about $23 billion) maturing this April and May, says the IIF's Jeffery Anderson. If lenders balked, Greece would default on its bonds. A default would inflict losses on banks and other investors.").

but true! Lazy Greeks had managed through their profligacy to create a euro-wide danger that European governments were obliged to deal with despite their reluctance. In exchange for saving these lazy, profligate southerners though, they would have to correct their ways and go through a process of purging their sins through pounds of flesh.[62]

The narrative of ants and grasshoppers continued unabated in the popular press, fueled by statements of European politicians, who were now attributing the failure of the Greek state to meet the loan agreement's fiscal targets to the same laziness and corruption that had brought Greece to its knees in the first place.[63] As many economists had warned though the punitive conditionality of the Greek loan agreement would make the fiscal targets hard to meet. The required "internal devaluation," which was applied in the form of a severe tax increase and wage reduction against the salaried, depressed demand and sent the Greek economy into a death spiral that is still ongoing today.[64] Thus, just as it is becoming clearer that the euro zone will probably only survive the test of bond vigilantes if it moves, at the very least, towards a mutual guarantee of debts through euro bonds or some other such mechanism, the narrative generated and perpetuated by European governments was making this politically impossible.

Understandably so. Think about it: You are a German citizen who has been told that the reason for the mess is southern laziness, in contrast to your own successes of the last decade that can only be attributed to your own thrift. Then you are told that if you want the euro to survive you need to become the guarantor of the debts of the very same profligate countries that caused the crisis in the first place. If you are a German worker whose wages have been kept low in the last ten years in Germany's bid to keep its global competitiveness,[65] while you hear stories of Greeks retiring at 51,[66] this adds insult to injury. Why would you accede? You are probably

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62. This is why it is the EU this time, and not the IMF, that has been insisting on strict conditionality. The IMF has in fact shown some understanding that too much austerity can cause a downward spiral in the short-term. *See* Hugo Dixon, *IMF-Euro Conditions Not What They Seem*, REUTERS (Apr. 23, 2012), http://blogs.reuters.com/hugo-dixon/2012/04/23/imf-euro-conditions-not-what-they-seem/ ("The IMF is actually in some ways calling for less rather than more short-term austerity in the euro zone. So if the Europeans submit to IMF discipline, it will ironically mean less of a hair shirt.").

63. *See* REBECCA M. NELSON, PAUL BELKIN & DEREK E. MIX, CONG. RESEARCH SERV., R41167, GREECE'S DEBT CRISIS: OVERVIEW, POLICY RESPONSES, AND IMPLICATIONS 11 (2010) ("[M]any [EU countries] are exasperated by the idea of rescuing a member state that, in their perspective, has not exercised budget discipline, has failed to modernize its economy, and allegedly has falsified past financial statistics.")

64. *See id.* at 8–9 (discussing the reforms taken by the Greek government and noting economists' concerns regarding Greece's drastic fiscal reforms); *see also Panayiotis Roumeliotis: IMF Wanted Haircut to Bonds Earlier*, EKATHIMERINI.COM (Oct. 10, 2012), http://www.ekathimerini.com/4dcgi/_w_articles_wsite1_1_10/10/2012_465549 ("The solution that was finally chosen was that of internal devaluation, which is a very difficult endeavor, triggers a drawn-out recession and has succeeded in very few cases, just as the IMF said in its last report on the country [in March 2012]. The same report stresses that the conditions for the success of an internal devaluation are absent in Greece because, among other reasons, the public debt is very high.").

65. *See* Varoufakis, *supra* note 8 (noting that German exports accelerated because German wages remained low and stagnant).

66. *See Greece's Early Retirement Rules Breed Resentment*, USA TODAY (May 17, 2010), http://www.usatoday.com/money/world/2010-05-18-europeretire18_ST_N.htm (noting that some Greeks retire as early as 50 depending on their profession). In reality, the average retirement age is approximately 61, almost the same as in Germany. SOCIETY AT A GLANCE, *supra* note 10, at 83 tbl. SS6.1.

feeling as if you have been taken hostage by the blackmailing Greeks, who top laziness with ingratitude and hit the streets every other day to protest their own salvation![67] If you are a German politician why would you even suggest it? You know that since you have convinced your voters that this is a problem of profligate Greeks, there is no way you are getting reelected if you concede to further integration with the very same people.

The tale of ants and grasshoppers has made the resolution of the crisis even more difficult from the Greek perspective as well. This takes a little more explaining precisely because the narrative naturally gives rise to the question of why any Greek would object to being saved by the generosity of her European partners. To understand why, you need to put yourself in the shoes of the average Greek salaried person. Before the accession to the euro your government had already been enforcing inflation containment measures that kept your wages stagnant.[68] After the accession to the euro you have seen the cost of living nearly double, while your salary has lagged behind.[69] You are paying your taxes, because you have no choice contrary to the thousands of Greek professionals and businesses, who regularly engage in tax evasion,[70] yet you need to pay your health care and your kids' education out of pocket, because a good doctor performs for bribes,[71] and everybody knows that basic public education in Greece has very little value.[72] You have a state that looks like Sweden on paper but is more like a developing country in reality.[73] To keep up with

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67. *See* Crossland, *supra* note 47 (noting Greek protests characterizing Angela Merkel as a Nazi and blaming Germany for the radical cutbacks in Greece, even though Germany was the largest single contributor to the Greek rescue measures).

68. *See* Sophia Lazaretou, *Greek Monetary Economics in Retrospect: The Adventures of the Drachma*, 34 ECON. NOTES 331, 359–61 (2005) (discussing Greece's monetary policy aimed at decelerating the rate of inflation as a response to the relaxation of wage controls, which increased inflation).

69. *See* Henry Samuel, *Euro Blamed for Rocketing Cost of Living*, THE TELEGRAPH (Jan. 1, 2007), http://www.telegraph.co.uk/news/worldnews/1538304/Euro-blamed-for-rocketing-cost-of-living.html (noting the public perception that adopting the euro resulted in a painful rise in cost of living in many euro zone countries).

70. *See* Matsaganis & Flevotomou, *supra* note 14, at 23 ("[E]mployers in 10% of all firms inspected in 2008 failed to pay social contributions, while 27% of all workers remained unregistered . . . . Such practices are particularly widespread in retail trade, construction, tourism, contracted-out services such as cleaning and catering and so on.").

71. Suzanne Daley, *Greek Wealth Is Everywhere but Tax Forms*, N.Y. TIMES (May 1, 2010), http://www.nytimes.com/2010/05/02/world/europe/02evasion.html ("To get more attentive care in the country's national health system, Greeks routinely pay doctors cash on the side, a practice known as 'fakelaki,' Greek for little envelope.").

72. *See Greek Woes: The Mediterranean Blues*, ECONOMIST (Jan. 14, 2012), http://www.economist.com/node/21542815 ("Since 2008, ever more young people (mostly in their 20s) have gone, often to foreign universities. . . . Greece's archaic education system and strikes have held back those who pursued their education at home. Exams have been delayed or cancelled. Some students are a year or more behind in their studies.").

73. Greece was never a European welfare state. It is a corrupt cash machine for the insiders, with the outsiders left to fund education, health, housing, and any other services that a welfare state would support on their own. It is a low-productivity economy, based on low wages, family provisioning, and public employment as a substitute for welfare for the one quarter of the workforce who can get such jobs. It bears some similarities with other southern European states, especially in the important role that the family plays in taking care of dependents (including the perennially unemployed well into their mature adulthood). Esping-Andersen, who famously created three ideal types to describe western welfare states, was obliged to add a fourth one later on, to capture the familistic feature of welfare provisioning in many southern European states. *See* GØSTA ESPING-ANDERSEN, SOCIAL FOUNDATIONS OF POSTINDUSTRIAL

your neighbors who have sons and daughters working in the better remunerated public sector, you take out loans for housing, education, as well as consumption, prompted by low interest rates and a loose banking sector lending to everyone. Your cardinal sin is that instead of doing your best to get rid of such a vicious system, you too approach your local politician, crowding to enter his pyramid of clients, in return for your family's vote in the next elections.

In October 2009, the government you have elected on a program of fighting corruption and taxing the rich to redistribute wealth downward announces that the deficit is nearly double what the previous government announced.[74] It tells you Greece needs to be saved by the EU and the IMF, where saving means that the debt level will go from the 120% thought unsustainable to nearly 160% GDP subsiding only in ten years' time under very optimistic assumptions about growth (most of which have already been proven wrong).[75] In return, the Greek government promises to enforce structural reforms, some of which, like tax reform and the fighting of public corruption, sound promising, but mostly, it promises to bring its budget deficit down to Maastricht compliant levels[76] within three to five years and sell off major public assets. The vast majority of the loan's money is directed at servicing a debt that you know is already unsustainable. The reactions on the street show that the Greek people are divided; yet no one asks you to choose.[77] You are told this is an exceptional situation needing exceptional measures, no time for electoral processes or consultations.

The government then proceeds to conduct a campaign of tax and wage aggression against the little fish. Not one member of the political class is prosecuted; not a single person is found responsible for the innumerable public procurement scandals in the press that have bloated the public budgets.[78] Instead, the same people

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ECONOMIES 90 (1999) (noting that several authors believe a Mediterranean model should be added and stating that "[t]he acid test of a distinct Mediterranean model depends . . . on the issue of familialism"). *See generally* GØSTA ESPING-ANDERSEN, THE THREE WORLDS OF WELFARE CAPITALISM (1990).

74. *See* NELSON ET AL., *supra* note 63, at 3 ("In October 2009, the new socialist government, led by Prime Minister George Papandreou, revised the estimate of the government budget deficit for 2009, nearly doubling the existing estimate of 6.7% of GDP to 12.7% of GDP.").

75. *Outlook for Greece*, ERNST & YOUNG EUROZONE FORECAST, Mar. 2012, at 2, *available at* http://www.ey.com/Publication/vwLUAssets/Eurozone_forecast_Spring2012_Greece/$FILE/Eurozone_forecast_Spring2012_Greece.pdf.

76. HELLENIC REPUBLIC MINISTRY OF FIN., HELLENIC NAT'L REFORM PROGRAMME 2011–2014 63 (2011); *see also* Mich. State Univ., *Greece: Economy*, GLOBALEDGE http://globaledge.msu.edu/Countries/Greece/economy (last visited Aug. 24, 2012) ("Specifically, the 3-year reform program includes measures to cut government spending, reduce the size of the public sector, tackle tax evasion, reform the health care and pension systems, and liberalize the labor and product markets."); INTERNATIONAL BUSINESS PUBLICATIONS, GREECE: MINERAL, MINING SECTOR INVESTMENT AND BUSINESS GUIDE 23 (2013) ("Greece has committed to reduce its deficit to under 3% of GDP (the ceiling under the EU's Maastricht Treaty) by 2014.").

77. *See* Michael Winfrey & Renee Maltezou, *Greeks March to Protest Austerity Campaign*, WASH. POST (June 18, 2011), http://www.washingtonpost.com/world/europe/greeks-march-to-protest-austerity-campaign/2011/06/18/AGXqsdaH_story.html ("An opinion poll taken before the reshuffle showed 47.5 percent of respondents wanted Parliament to reject the reform package and for Greece to hold early elections. Just over a third—34.8 percent—wanted it to be approved so that the government could secure the second bailout.").

78. A former minister of defense who was in charge of various military procurement contracts was recently arrested on money laundering counts. *Former Pasok Minister Tsochatzopoulos Arrested*, ATHENS NEWS (Apr. 11, 2012), http://www.athensnews.gr/portal/8/54837. The state has so far been unable

who have built the political system of the last thirty years, who you suspect probably have all their illegitimate assets in Switzerland, are telling you that it is you, the small salaried person who is to blame for all this because you have been enjoying way too many benefits in the last thirty years. You are a lazy grasshopper and our European partners are right to be pointing the finger at you.[79]

The placid and self-serving acquiescence of the Greek political class to a European narrative of average Greek laziness is not the Europeans' fault of course. Except that putting pressure on the Greeks first to accept the loans, instead of defaulting, and then to avoid any process of democratic consultation on such deeply divisive measures, casts a very unflattering light on the EU and the European political class from the perspective of the average Greek. If the EU was so concerned with Greek corruption, why did they entrust the same corrupt political class to enforce such a radically divisive program? Why did they at every turn suggest that the appeal to any type of democratic consultation would mean the end of the world as we know it for Greeks, deepening divisions and provoking a turn to virulent nationalism? Wait, why were Merkel and Sarkozy so outraged when Papandreou proposed to put the second bailout to a referendum?[80] Why were they celebrating the appointment of Lucas Papademos as the new Prime Minister[81]—through constitutionally contested proceedings?[82] Was he not the central banker when the corrupt Greeks were supposedly cooking their books to enter the euro?[83] Why did the EU not even flinch when in July 2011 the Greek parliament voted to

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to establish corruption charges even though there is no other explanation for the assets that the minister accumulated during his tenure. *See id.* ("According to the findings of the committee . . . Tsochatzopoulos' 'source of income' declaration did not . . . correspond with assets in his possession."); *see also* Rachel Donadio & Niki Kitsantonis, *Corruption Case Hits Hard in a Tough Time for Greece*, N.Y. TIMES (May 2, 2012), http://www.nytimes.com/2012/05/03/world/europe/akis-tsochatzopouloss-corruption-case-hits-hard-in-greece.html (discussing the desire within Greece for corruption to be curbed and offenders prosecuted).

79. Theodoros Pangalos, a politician with considerable influence during the last thirty years, and the Vice President of the Papandreou government in 2009, famously proclaimed that "[w]e [Greeks] ate the money together," provoking the immediate ire of the average Greek. *See, e.g.*, Tony Barber, *Greece Plays the Ethical Blame Game*, FIN. TIMES (June 21, 2011), http://www.ft.com/intl/cms/s/0/42d88b20-9c1f-11e0-acbc-00144feabdc0.html (stating that Greeks have "[p]articular contempt" for Pangalos and describing a banner in Syntagma that vowed to "make salami" out of him).

80. *Greece's Woes: The Markets Are Not the Euro's Only Threat. Voters May Be Too,* ECONOMIST (Nov. 5, 2011), http://www.economist.com/node/21536597.

81. *See* Larry Elliott, *The Emergence of the Frankfurt Group Has Turned Back the Democratic Clock*, THE GUARDIAN: ECON. BLOG, (Nov. 8, 2011, 10:22 AM), http://www.guardian.co.uk/business/economics-blog/2011/nov/08/euro-papandreou-berlusconi-bailout-debt ("Angela Merkel and Nicolas Sarkozy think Papademos is the sort of hard-line technocrat with whom they can do business.").

82. *See Greece's Politicians: In Their Own Time*, ECONOMIST (Nov. 10, 2011), http://www.economist.com/blogs/newsbook/2011/11/greeces-politicians (referencing a statement by Alexis Tsipras, the leader of the SYRIZA party, that "[The appointment of Lucas Papademos] is a degeneration of democracy, a manipulation of the Constitution, and a ridicule of our Parliament").

83. *See* Elliot, *supra* note 82 (noting the contention within the European Union between democratic processes and the "Frankfurt Group," which seems to make the "real decisions in Europe"); *see also* Damien Mcelroy, *Money Matters: Greece Banks on Country's Euro Architect to Save It from Economic Meltdown*, SYDNEY MORNING HERALD (Nov. 12, 2011), http://www.smh.com.au/world/money-matters-greece-banks-on-countrys-euro-architect-to-save-it-from-economic-meltdown-20111111-1nbqg.html ("[T]here was an angry reaction on the streets to the choice of Mr [*sic*] Papademos, who was one of the key players in Greece's entry into the euro zone a decade ago, a process allegedly underpinned by statistical fraud about the real state of the country's economy.").

accept a second bailout,[84] despite the fact that the vast majority polled said they were against it, and those gathered outside the Parliament to protest were violently tear gassed and clobbered by the police?[85]

A structural understanding of the crisis suggests structural solutions, such as a fiscal and political union, or euro bonds and mutual-sharing of debts at the very least. The prevalence of the morality narrative in the context of national politics is a huge obstacle to the resolution of the current crisis because it makes extremely difficult the justification and adoption of the measures that are needed in the national political scenes of the member states. At the moment of this writing, German politicians whose electorate needs to accept Germany's further integration with other member states if the euro is to survive, have continued to propagate the morality tale,[86] thus heightening the chances that further integration might be rejected, especially after Greece's voters—the *par excellence* grasshoppers—decided to give the euro another chance in the June 17 elections.[87] As the situation stands, the best chance for euro area states to move towards the closer union that they need in order for the monetary aspects to work is still for Greece to exit. Only then can the politicians of the northern member states use the danger created at the moment of exit and the symbolic power (sacrifice of the guilty) to create a banking and perhaps even a fiscal union with the rest.[88]

II. DO GRASSHOPPERS NEED SPECIAL TREATMENT?: CONSIDERING THE FUTURE OF (SOCIAL) EUROPE

In this part of my Article, I would like to concentrate on the Commission's descriptions of the Greek loans and their conditionality, because I believe they are significant for more than the immediate economic future of Greece; they are significant for the future of social policy at the EU level. Contrary to the morality narrative, the Commission employs a discourse largely sympathetic to Greek citizens. The solutions it prescribes for Greece are of a structural sort, and they stem from its view that the Greek state, as opposed to its citizens, is guilty of profligacy and inefficiency. The type of structural solution envisioned, however, is akin to the standard IMF recipes of previous debt crises. This has important implications for the

84. *See Eurozone Group Backs Second Greek Bailout*, BBC NEWS (Mar. 12, 2012), http://www.bbc.co.uk/news/business-17338100 (discussing the support from euro zone finance ministers for the second bailout).

85. Roland Gribben & Louise Armistead, *Greece Passes Crucial Bailout Vote as Country Burns*, TELEGRAPH (Feb. 13, 2012), http://www.telegraph.co.uk/finance/financialcrisis/9078221/Greece-passes-crucial-bailout-vote-as-country-burns.html.

86. *See* Crossland, *supra* note 47 (describing the popular German belief that Greece is to blame for the crisis); *see also* Kabir Chibber, *What Is Germany's Vision for Europe?*, BBC NEWS (Dec. 7, 2011), http://www.bbc.co.uk/news/business-16030374 (noting Germany's vision for structural reforms and how it is a "'morality play'" for Germany) (quoting Martin Van Vilet, senior economist at ING Bank in Amsterdam).

87. Rachel Donadio, *Supporters of Bailout Claim Victory in Greek Election*, N.Y. TIMES (June 17, 2012), http://www.nytimes.com/2012/06/18/world/europe/greek-elections.html?pagewanted=all.

88. *See* Simon Tilford, Op-Ed., *Ousting Greece Will Not Bring Catharsis*, N.Y. TIMES (June 5, 2012), http://www.nytimes.com/2012/06/06/opinion/ousting-greece-will-not-bring-catharsis.html (arguing that Greece's exit would not be a solution in itself, but it could potentially provide the needed "political space" that German authorities need in order to bring in institutional reforms).

type of social provisioning that the Commission sees as required by the nature of the EU project as a "social market" economy.[89] On this point, the Commission's discourse is largely continuous with language on structural reforms and social policy that the Commission has been developing in the context of social policy coordination. To illustrate, it is necessary to examine the structural reforms envisioned in the loan agreements as described by the Commission and their assumed relationship to the goal of achieving social cohesion. What emerges from this examination, I believe, is a solidification of the Commission's discourse on social cohesion in a direction that will not thrill social progressives, as it further collapses the goals of social cohesion with the goal of dynamic growth through markets.

The structural stories of the crisis suggest that in a monetary union where labor and prices adjust slowly or not at all, and the central bank lacks the capacity to adjust its monetary policy in response to crises, a depression of wages and prices in the less competitive regions is the only remaining way to provoke an adjustment. This is the famous "internal devaluation," which partly dictates the logic of the measures that have been adopted as part of the conditionality for Greece's loan agreements with the EU and IMF.[90] Greece, the *par excellence* sinner in the grasshopper story, has undertaken to return to Maastricht compliant budget deficit levels by 2014, and has already succeeded in reducing the budget deficit by more than six percentage points in two years, the biggest fiscal adjustment in a western nation in recent years.[91] The consequent contraction into which this austerity policy has thrown the economy—not to mention the political and social turmoil—has meant a vicious cycle in which Greece fails to meet subsequent budgetary targets, and the EU and IMF respond by demanding that more be done before any more money can be released.[92]

More specifically, what is demanded of Greece through the conditionality of these agreements can be described as nothing less than a complete reinvention of the Greek state.[93] The Commission itself has recently stated, "The reforms agreed under

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89. *Communication from the Commission, Europe 2020, A Strategy for Smart, Sustainable and Inclusive Growth,* at 10, COM (2010) 2020 final (Mar. 3, 2010) [hereinafter *Communication on Europe 2020*].

90. The Commission itself explains internal devaluation in the following way:

> Greece has to restore competitiveness through an ambitious internal devaluation, *i.e.*, a reduction in prices and production costs relative to its competitors, as well as a shift from a consumption-led to an export-led economy. Since a strong increase in productivity takes time, an upfront reduction in nominal wage and non-wage costs is necessary. This is unavoidable, but it complicates fiscal adjustment through the impact that the internal devaluation has on nominal GDP and, concomitantly, on tax bases. Moreover, when recovery takes hold, the composition of growth is expected to be less tax-rich than in previous upswings.

Directorate-General for Econ. & Fin. Aff., *The Second Economic Adjustment Programme for Greece*, 2, Occasional Papers 94 (Mar. 2012) [hereinafter *Second Economic Adjustment Programme*].

91. *Id.* at 1–2.

92. This downward spiral was predicted by many economists early on in the crisis. *See, e.g.*, Feldstein, *supra* note 19 ("There simply is no way around the arithmetic implied by the scale of deficit reduction and the accompanying economic decline: Greece's default on its debt is inevitable."); Charles Wyplosz, *And Now? A Dark Scenario*, VOX (May 3, 2010), http://www.voxeu.org/article/greek-package-eurozone-rescue-or-seeds-unravelled-monetary-union ("The drop in public spending . . . will provoke a profound recession that will deepen the deficit. This, along with the social and political impact of the crisis, will undoubtedly prevent the Greek government from delivering on its commitments.").

93. Greece has signed two loan agreements with the member states and the IMF, each of which comes with a Memorandum of Understanding that includes specific conditions for the disbursement of the

the Second Economic Adjustment Programme seek to create a more equitable society."[94] The conditionality of the agreements aims at an almost complete overhaul of the Greek public administration and an attempt to reinvent it through the provision of technical assistance by the other EU member states.[95] To those familiar with the structural conditionality of IMF loans, the Greek program will sound familiar, except for its particularly condensed timetable dictated more by the perceived necessity to bring down sovereign bond rates than by any idea related to the feasibility of the program. In fact, the timetable provided for the various reforms can be modestly characterized as thoroughly unrealistic.[96]

Any Greek citizen would welcome many of the required reforms, especially those reforms concerning the tax administration and increasing the efficiency of the state's operations.[97] However, starting in 2010, the only "reforms" that the politically battered Greek government was capable of enforcing had to do with a campaign of tax increases against the salaried middle class, which was already a captive tax audience.[98] Because Greece never had a properly functioning system of public welfare provision, but instead used the diffuse, client-based distribution of public sector jobs and pensions to deal with unemployment and poverty, the fiscal adjustment required of Greece translated into a direct blow to Greek families'

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loans. The list of reforms is long; it includes almost the entire structure of public administration, including health and social security, employment, the justice system, labor law, and taxation. The loan agreements also provide for the extensive privatization of public assets such as the electricity and water grids. *Second Economic Adjustment Programme*, *supra* note 90, at 123–72.

94. *Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank: Growth for Greece*, at 4, COM (2012) 183 final (Apr. 18, 2012) [hereinafter *Growth for Greece*], *available at* http://ec.europa.eu/economy_finance/articles/financial_operations/pdf/2012-04-18-greece-comm_en.pdf.

95. The Commission set up a special Taskforce for Greece in July 2011 for the purpose of providing technical expertise. The Commission describes the Taskforce's goals as follows:

> The Taskforce is already working closely with Greek authorities to identify needs, and mobilise expertise from other Member States and international organisations in the areas of structural fund absorption, tax administration/public financial management, including the fight against fraud, smuggling and corruption, the reform of the public administration, business environment, judicial reform and healthcare reform. Many Member States are playing their part in making leading specialists available to advise the Greek authorities.

Id. at 16. The Taskforce acquired a permanent presence in Greece beginning in February 2012. *Second Economic Adjustment Programme*, *supra* note 90, at 6.

96. *See* Wyplosz, *supra* note 92 (arguing that the plan for Greece's recovery is unreasonable and will fail).

97. Others, like the promoted labor law reform, seem like an unwarranted intervention in internal politics, especially since the cost of labor in Greek private markets was already low. *See* Matthew Boesler, *The Entire World Will Once Again Be Watching an Insanely Close Greek Parliament Vote That Could Have Huge Ramifications*, BUS. INSIDER (Nov. 2, 2012), http://www.businessinsider.com/greek-labor-reform-vote-preview-2012-11 ("The Court of Auditors, which vets Greek laws before they are submitted to parliament, said planned measures could be against constitutional provisions including the 'principles of individual dignity and equality before the law.'") (quoting Deutsche bank strategist Jim Reid). The so-called rigidity in labor regulation seems ideological rather than descriptive because the market is characterized by widespread de facto flexibility already. TSIPOURI ET AL., *supra* note 13, at 2; Tsoukala, *supra* note 16.

98. In its review of Greece's Second Economic Adjustment Programme, the Commission notes that the fiscal measures adopted in early 2012 were the first since 2010 not accompanied by a tax increase. *Second Economic Adjustment Programme*, *supra* note 90, at 2.

traditional capacity to contain poverty.[99] Pensioners have suffered deep horizontal cuts, while both public and private sector wages have also been dramatically reduced.[100] As fiscal contraction led into depression, hundreds of thousands of small Greek family businesses, the backbone of the Greek economy, have closed. Poverty has skyrocketed, and it has become increasingly difficult for Greek families with several dependent members to make ends meet. In the several community kitchens that have sprung up in the center of Athens, one can see previously middle class Greek pensioners lining up for their food so that they can save some euros to pass onto their unemployed adult children, who do not have dependable rights to housing, child-care, or health benefits.[101] There are repeated reports that the suicide rate in Greece, once amongst the lowest in Europe, has spiked in the last two years.[102] Finally, thousands of illegal immigrants still swarming to—or just trapped in—Greece have faced an increasingly hostile and racist Greek population, which has recently elected eighteen members of Parliament from the extreme right-wing party of "Golden Dawn."[103]

The situation in Greece gives pause to anyone concerned with the future of the social-Europe agenda incorporated in the Europe 2020 program post-Lisbon Treaty. How can a Europe that is aspiring to significantly reduce poverty by the year 2020 adopt measures that are throwing thousands of Greeks into poverty?[104] One way to square the circle might be to argue, for example, that for the sake of expediency the goal of assuring social cohesion or a reduction in poverty has been temporarily suspended, while the countries receiving loans from the EU and IMF deal with their emergency budget situations. This would be an opportune moment for the

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99. Regardless of the particularly corrosive and corrupt way in which Greece distributed public sector jobs, the distribution of such jobs and the state's borrowing to cover that cost is a typical response when a state lacks monetary tools to deal with rising unemployment. In the words of Van den Berg, "The problem was the single currency: a permanently fixed exchange rate limits a country's response to high unemployment to fiscal stimulus. But, as Greece found out, if government debt grows too large, further borrowing is no longer possible. In this case, the government is left with no macro-economic policy with which to increase employment." VAN DEN BERG, *supra* note 22, at 664.

100. *See* Elliott & Aitkenhead, *supra* note 15 ("Greece . . . has been told to cut wages, pensions and public spending in return for financial help from the IMF").

101. Larry Elliott, *Troubled Greece: Fears of 'First Domino' to Fall as Austerity Is Counted a Failure*, THE GUARDIAN (May 31, 2012), http://www.guardian.co.uk/world/2012/may/31/greece-austerity-failure-syriza-bailout.

102. Niki Kitsantonis, *Greece: Man Dies After Fall from Acropolis*, N.Y. TIMES (June 28, 2012), http://www.nytimes.com/2012/06/29/world/europe/greece-man-dies-after-fall-from-acropolis.html.

103. Associated Press, *Golden Dawn, Greek Far Right Party, Returns To Parliament*, HUFFINGTON POST (June 17, 2012), http://www.huffingtonpost.com/2012/06/17/golden-dawn-election-results_n_1604097.html.

104. The Europe 2020 program has set specific targets for poverty reduction for Europe overall and individual Member States. The European target is to reduce the number of people at risk of poverty by at least 20 million by the year 2020. *Europe 2020 Targets*, EUR. COMM'N, http://ec.europa.eu/europe2020/pdf/targets_en.pdf (last visited Sept. 10, 2012). The specific national goal for Greece is to reduce the population at risk of poverty by at least 450,000. *Id.* In the meantime, the continuing downward spiral of the Greek economy, produced in large part because of the application of fiscal consolidation measures, has produced a skyrocketing of unemployment to 22% (more than 50% for the youth). *Greek Unemployment Hits New Record of 22.5 Pct in April*, REUTERS (July 12, 2012), http://uk.reuters.com/article/2012/07/12/uk-greece-unemployment-idUKBRE86B0IB20120712. According to Eurostat data, 27.7% of Greeks are living with the risk of poverty and social exclusion. *More Than a Quarter of Greeks at Risk of Poverty*, EKATHIMERINI.COM (Feb. 8, 2012), http://www.ekathimerini.com/4dcgi/_w_articles_wsite1_1_08/02/2012_426805.

deployment of the morality tale too: Greece is a special case because its citizens are guilty of causing the crisis; hence the exceptional measures that we do not expect will apply to anyone else.

Notably, this is not the understanding of the reforms the Commission is promoting and I believe this is an important moment for the EU as a whole. While the Commission readily recognizes that the structural adjustment demanded of Greece by the conditions of the two loan agreements has hit the weakest Greeks worst of all, the Commission understands the very design of the program is to respond to the deep demands of any European society for social equity.[105] Its posture is one of sympathy with the Greek citizens who were already suffering from a corrupt and inefficient state, but also of complete intolerance for the Greeks' state structures. It is worth quoting the Commission at some length to get a sense of this perspective:

> The full and timely implementation of the Second Economic Adjustment Programme must be the top priority for Greece. The reform measures it contains are designed to restore the growth and job creating potential of the Greek economy and to do away with the value-destroying rules and opportunities for corruption and bureaucracy that prevent Greek citizens and businesses from engaging in productive activities. Currently, over-regulation and a poorly performing public administration create inefficiency and too many cases of rent-seeking behaviour.
>
> The removal of the most blatant obstacles to growth can significantly improve the situation of citizens and companies in a relatively short time-frame. In the medium term, more profound reforms of the Greek public administration and justice system are required to ensure faster, more efficient procedures, a substantially more effective and equitable tax collection system, less red tape and more legal certainty for investment and new business activities.
>
> The reforms agreed under the Second Economic Adjustment Programme seek to create a more equitable society—where all segments of the population bear a fair share of the burden of adjustment and will all enjoy the benefits of reform. The impact of the severe imbalances that have built up in the Greek economy has hit the less well-off particularly hard, making the need for reform even more pressing. Vested interests, both inside and outside the public administration, which have exploited their position in an opaque and bureaucratic system which lends itself to corruption, should no longer be tolerated. However, the whole population will benefit from these changes and deserve better governance.[106]

In the same communication, the Commission describes the two loan agreements as "massive financial aid" to Greece and openly compares them to the Marshall plan—despite the fact that the Marshall plan consisted of transfers and not profitable

105. *Growth for Greece*, *supra* note 94, at 20.

106. *Id.* at 4.

loans.[107] It insists that social equity has always been part of the design of the loan agreements:

> Social equity has always featured strongly in the design of the programmes. This is reflected in reforms of pensions, other social programmes, labour market, and health care and in the fight against tax evasion, where particular efforts have been made to protect the most vulnerable parts of the population.
>
> The programme is designed to ensure debt sustainability and to build a new Greek economy. The goal is to help Greece regain competitiveness in the coming years and to respond quickly to the unacceptably high levels of unemployment by cutting labour costs from the current unsustainable levels and creating a more modern, flexible labour market. Product and service markets will also be overhauled so as to increase competition and price flexibility and to help ensure that lower costs feed through into higher economic growth to the benefit of all. The programme will also transform the business environment, improving framework conditions for entrepreneurship and innovative projects, a prerequisite for the future dynamism of the Greek economy.[108]

This excerpt highlights an underlying understanding about the meaning of social equity. The reforms in "pensions, other social programmes, labour market, and health care and . . . against tax evasion" required by the loan agreements are themselves part of the program to reduce poverty because they will allegedly help the Greek economy regain its competitiveness.[109] This understanding of a poverty reduction strategy is repeated in the Commission's later proposal for a Council recommendation on Greece's 2012 national reform program:

> The economic crisis and subsequent fiscal consolidation measures have had an impact on the ability of Greece to achieve the Europe 2020 goals, especially the socially oriented ones. Nevertheless, the structural reforms, particularly those in the labour market, the liberalisation of several sectors and a number of measures to improve the business environment, will help promote competition, spur productivity, increase employment and reduce production costs, thus contributing to an increase in employment and limiting poverty and social exclusion in the medium term.[110]

Thus, the loan agreements are "financial aid" and the harsh conditionality of the loans are poverty reducing structural reforms as per the Commission.[111] It is

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107. *Id.* at 2, 19. The loans to Greece have an interest rate that is much lower than what Greece would be able to get in the markets but that is still higher than what Germany borrows the money for in the markets.

108. *Id.* at 20.

109. *Id.*

110. *Recommendation for a Council Recommendation on Greece's 2012 National Reform Programme*, para. 13, COM (2012) 307 final (May 30, 2012), *available at* http://ec.europa.eu/europe2020/pdf/nd/csr2012_greece_en.pdf.

111. Debt repayment is one of the main goals of the loan agreements, which contain various clauses tying Greece's hands and limiting its options for default. The second loan agreement contains a clause

worth noting that this is far from the notions of solidarity coming from the traditions of European welfare states. But I would argue that it fits comfortably with the type of understanding the Commission has been developing over the last several years on the question of poverty reduction based on the results of the Open Method of Coordination (OMC) on social policy, the revised Lisbon Agenda, and finally, the Europe 2020 initiative.[112]

The OMC is a so-called "soft law" mode of governance that entails mutual learning through standard setting, benchmarking and repeated iterations of feedback.[113] In its initial phases, the OMC was conceptualized as an alternative form of governance, one that could theoretically allow common standards on social policy to emerge not from a top-down legislative process, but through mutual consultation and learning between various stakeholders in the member states. It has been used in many areas of non-exclusive EU competence, where undertaking legislative action in the mode of regulations, directives, or decisions is not possible (because of the lack of competence) or desirable (because of the lack of unanimous political will required). The OMC was reformulated in 2005 in the so-called revised Lisbon agenda.[114] This revision was criticized by progressive NGOs and scholars as subordinating the social-protection aspect of the OMC to economic considerations of efficiency and sustainability.[115] Portions of the revised Lisbon agenda were finally incorporated into the Europe 2020 program. The Europe 2020 language draws from the revised Lisbon agenda and could be equally criticized for embodying this limited notion of social solidarity via structural reforms.[116]

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that provides that any surplus Greece makes will be directed towards repayment of the loans. In fact, a special account has been opened into which the loan to Greece can be deposited so that it can be directly applied towards debt repayment. Greece also undertook to pursue extensive privatizations. To that end, it has created a "special purpose vehicle," into which assets worth 50 billion, including energy, water, land, and mines, are to be irrevocably transferred by the Greek state. The proceeds from privatizations are to be exclusively directed towards debt repayment. *Vision*, HELLENIC REPUBLIC ASSET DEV. FUND, http://www.hradf.com/en/the-fund/vision (last visited July 18, 2012); Directorate-General for Econ. & Fin. Aff., *The Economic Adjustment Programme for Greece: Fourth Review—Spring 2011*, 80, Occasional Papers 82 (July 2011).

112. *See generally* Caroline de la Porte & Philippe Pochet, *Why and How (Still) Study the Open Method of Co-ordination (OMC)?*, 22 J. EUR. SOC. POL'Y 336 (2012) (engaging in a good overview of the Open Method of Coordination). Beginning in 2000, the Lisbon Agenda was an attempt to make the European economy "the most competitive knowledge-based economy in the world" and to improve EU governance. David Natali, *The Lisbon Strategy, Europe 2020 and the Crisis in Between*, OSE DELIVERABLE, May 31, 2010, at 4. Europe 2020 is a European initiative that attempts to integrate fiscal governance and the coordination of social policy at the European level. *Communication on Europe 2020*, *supra* note 90, at 5 (stating that Europe 2020 is a strategy to "turn the EU into a smart, sustainable and inclusive economy delivering high levels of employment, productivity and social cohesion").

113. Linda Basile, *Participation in the Open Method of Coordination: The Case of the European Employment Strategy* 2–4 (Jean Monnet Working Papers in Comparative and Int'l Politics, Paper No. 63, 2008), *available at* http://www.fscpo.unict.it/EuroMed/jmwp63.pdf.

114. *Id.* at 11.

115. KENNETH A. ARMSTRONG, GOVERNING SOCIAL INCLUSION: EUROPEANIZATION THROUGH POLICY COORDINATION 105–14 (2010).

116. In the 2010 Communication on Europe 2020, for example, the Commission's description of the "European Platform Against Poverty" highlights the Commission's understanding of the EU level as mainly concerned with increasing employment opportunities in national economies, eliciting public and private commitment to reducing poverty, providing funding for re-training, and providing an assessment of the "adequacy and sustainability" of pension systems while member states are urged to "fully deploy their social security and pension systems to ensure adequate income support and access to health care."

The argument here is that far from seeing the case of Greece as a moment of suspension of social concerns for the sake of fiscal considerations, the Commission repeatedly articulates the conditionality of the loan agreements as part and parcel with the project of creating a more equitable society in Greece,[117] and I would suggest, as part and parcel with the project of constructing a new, EU-based understanding of what the European social model should become. This conception is quite notable, since the conditionality of the loan agreements calls for deep structural reforms and extensive privatizations. It seems to indicate that the Commission has embraced an understanding of social cohesion that primarily rests on structural reforms and employability as the main tools for poverty reduction, while optimizing (without expanding) whatever systems of social protection are already in place.[118]

The crisis and the language the Commission is using to describe its social effects may represent yet another moment of retrenchment for those who wished to see more independence between social protection and the economic goals represented by the active labor-policy piece of the Lisbon agenda. But the reality is that the language developed thus far in the context of the OMC comfortably fits with a process of fiscal consolidation without much need for adapting the discourse to recognize the exceptional nature of the measures adopted.

The continuity and comfortable fit between the language ensuing from the OMC on social policy, and the language of structural reforms as a remedy to ailing economies is particularly striking in the context of pension reforms. Member states had already agreed to ensure that pension schemes are adequate and sustainable.[119] Notably, the OMC process on pensions formulated the goal of equity both within and between generations, so that when the Commission talks about the adequacy of pensions it is also speaking to the adequacy of pensions for future generations, which obviously includes the limiting of pension rights for current generations. Member states agreed to aim for the prolongation of working lives by extending the retirement age and equalizing it between men and women, and promoting "active ageing."[120] The pension reforms demanded of Greece, in the context of its Memoranda of Understanding (MoU) with the EU and IMF, were therefore in line with the type of "modernization" the EU itself was envisioning for all member states

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Communication on Europe 2020, *supra* note 89, at 19.

117. *See Growth for Greece*, *supra* note 94, at 2 ("A crisis of such magnitude calls for far-reaching changes in Greece so that a new, dynamic, competitive Greek economy can emerge, one that is capable of generating sustainable growth, creating jobs, supporting social cohesion and delivering on the expectations of Greek citizens.").

118. Note that in the case of the countries that could be described as "Mediterranean" in their mode of social provisioning, like Greece, the structural adjustment and fiscal consolidation measures provided for by the loan agreements are applied against the background of minimal state provisioning and directly affect the main mechanism of welfare provisioning, which is the family. *See* ESPING-ANDERSEN, SOCIAL FOUNDATIONS, *supra* note 73, at 90 (noting that "Mediterranean" countries focus on families for welfare provisioning because "it is assumed (and legally prescribed) that families are the relevant locus of social aid; and it is assumed that families normally do not 'fail'").

119. GRP. CONSULTATIF ACTUARIEL EUR., SUSTAINABILITY OF PENSIONS SYSTEMS IN EUROPE—THE DEMOGRAPHIC CHALLENGE Appendix 3 (2012), *available at* http://www.gcactuaries.org/documents/Sustainability_pension_system_%20final_020712%20270612_web.pdf.

120. *Commission Staff Working Document Ex-Ante Evaluation Accompanying Document to the Decision of the European Parliament and of the Council on the European Year for Active Ageing (2012)*, at 3, SEC (2010) 1002 final (June 9, 2010), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2010:1002:FIN:EN:PDF.

even before the crisis broke out.[121] It is characteristic that, in its 2012 White Paper on Pensions, the Commission seamlessly includes the reforms undertaken by the MoU with the reforms that the rest of the member states have committed to pursuing.[122]

Despite appearances, this specific understanding of solidarity is not simply a function of the EU's limited competences on social policy. In other words, the Commission's attitude toward the effects of the loan conditionality on the Greek safety net is not simply the result of a hands-off approach inspired by its own understanding of limited competence. It entails a positive vision of how social provisioning should be done in member states, and that is mainly through the markets, via employment, with safety nets playing a residual and minimal role, which does not burden the state unduly.[123] Formally, the crisis does not mark any changes in the legislative competence of the EU in regards to social policy, but the social policy "mainstreaming" that was envisioned in the Europe 2020 program seems to be in full swing at this moment of crisis.[124] If anything, the integration of reporting on the Europe 2020 goals—some of which have to do with social cohesion—into the European Semester—which is about fiscal coordination—has created higher visibility for the social cohesion language at the European level. I would argue that it is making the EU governance level look increasingly more like a national government concerned with every aspect of a particular crisis rather than the group of effects that fall directly into its zone of competence.

Finally, despite the continuing lack of formal exclusive competence on social policy, the substance of the measures required by the MoU is such that in reality they are dictating social policy to the finest detail for the countries subjected to them under the guise of fiscal emergency. This includes labor law, pensions, wages, and—in the particular case of Greece—every possible aspect of the safety net.

What does this collapse of the distinction between fiscal goals and social policy mean for the rest of the member states and more importantly, for the future of social policy at the EU level? Though it remains to be seen, it does not bode well for the future of social Europe.

CONCLUSION

At the moment of this writing, European politicians continue to propagate the morality tale of the crisis despite all evidence to the contrary. This means that the future of the euro zone is up for grabs as the morality tale itself creates hurdles for the adoption of the structural solutions that are needed. Assuming that the euro

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121. For an account of the process of modernization in pension policies preceding the crisis, see generally DAVID NATALI, PENSIONS IN EUROPE, EUROPEAN PENSIONS: THE EVOLUTION OF PENSION POLICY AT NATIONAL AND SUPRANATIONAL LEVEL (2008).

122. *White Paper: An Agenda for Adequate Safe and Sustainable Pensions*, at 23–40, COM (2012) 55 final (Feb. 16, 2012), *available at* http://ec.europa.eu/social/BlobServlet?docId=7341&langId=en.

123. *E.g.*, *Communication on Europe 2020*, *supra* note 89, at 17–19.

124. Mainstreaming is a governance technique commonly used in the European Union. It requires incorporating analyses of the consequences of any program on a specific area of concern. So far, the European Union had famously "mainstreamed" gender and environmental analyses in all of its actions, so that for any proposed program or legislative action there has to be an analysis of its potential consequences. Europe 2020 requires the mainstreaming of social policy in the same way. Natali, *supra* note 112, at 19.

zone survives, there are very interesting questions about the particular political direction its policies will take. More specifically, throughout the crisis, the Commission has promoted a discourse that characterizes the EU level as a government concerned with all aspects of the crisis, economic and social, despite an apparent lack of legislative capacity on the latter. The Commission's discourse on the social piece, however, evinces elements of continuity with an understanding of social protection that rests on employability and the active labor policies, which scholars have criticized as weak by comparison to many national welfare contexts. The crisis seems to consolidate the more conservative version of the OMC on social policy through various iterations of the social Europe idea in the fiscal governance documents published by the Commission. Social Europe as a concept is likely to survive if the EU itself does, but it is not certain that social progressives will be thrilled about the development of its contents.

Combating the Financial Crisis: European and German Corporate and Securities Laws and the Case for Abolishing Sovereign Debtors' Privileges

CHRISTIAN KERSTING*

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INTRODUCTION

The financial crisis is a multidimensional phenomenon. It involves private and state actors. It touches on private, public, national constitutional, European and international law. It is embedded in political visions of peace, prosperity, and solidarity that to a certain extent collide with hard economic facts and different priorities set by public opinion in different states. The complexity of the issue makes it imperative to focus on specific aspects. The first part of this Article deals primarily with the 2008 subprime crisis, the corporate law tools employed in Germany to combat it and the European context. The second part briefly looks at the ongoing sovereign debt crisis and focuses on securities law and private law measures taken by the European Union. The third part looks more closely at sovereign debtors and suggests that they be treated to a greater extent like private debtors. Other issues like institutional reforms within the European Union and especially within the euro area, i.e., the Member States of the European Union that use the euro as their currency,[1] will only be dealt with *colorandi causa*.[2]

1. *See generally What is the euro area?*, EUR. COMM'N, http://ec.europa.eu/economy_finance/euro/adoption/euro_area/index_en.htm (last visited June 25, 2012).

A. *The Financial Crisis*

Due to an increase in interest rates, many homeowners defaulted on their loans, which led to a substantial number of foreclosures followed by a decline in house-prices because supply exceeded demand. In consequence, banks found the houses to be insufficient collateral for their loans, especially if they had granted non-recourse loans, and had to write off a significant portion of their receivables. Since many of the so-called subprime loans had been securitized and sold on, it was by no means transparent which banks and insurances were affected. This led to great insecurity which culminated in the collapse of the bank Lehman Brothers on September 15, 2008.[3] The Lehman insolvency affected banks and insurances worldwide. Banks lost trust in each other and refused to lend each other money.[4] This forced states to bail-out banks and insurances which in turn proved to be a significant strain on the states' budgets, which also suffered from the effects of the economic turmoil and the costs of immense stimulus packages.[5]

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2. *See generally* Statement by the Euro Area Heads of State or Government (Dec. 9, 2011), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf; Euro Summit Statement, paras. 30–35 & annex 1 (2011), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf (reporting the informal meeting of (the euro area) members of the European Council). For the official discussion about institutional reforms, see *European Council 16–17 December 2010 Conclusions*, EUR. COUNCIL (Jan. 25, 2011), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/118578.pdf; *European Council 28–29 October 2010 Conclusions*, EUR. COUNCIL (Nov. 30, 2010), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117496.pdf. Kevin Featherstone, *The Greek Sovereign Debt Crisis and EMU*, 49 J. COMMON MKT. STUD. 193, 193 (2011); Wolfgang Philipp, *Die Karikatur einer Aktiengesellschaft* [*The Caricature of a Stock Corporation*], *in* 2011 DIE AKTIENGESELLSCHAFT [A.G.] 697; Matthias Kullas, *Kann der reformierte Stabilitäts- und Wachstumspakt den Euro retten?* [*Is it Possible to Rescue the Euro by a Reformed Stability and Growth Pact?*], CENTRUM FÜR EUROPÄISCHE POLITIK [C.E.P.] (2011), *available at* http://www.cep.eu/en/analyses-of-eu-policy/economic-stability-policy/reformed-stability-and-growth-pact/; *EU Economic Governance*, EUR. COMM'N, http://ec.europa.eu/economy_finance/economic_governance/index_en.htm (last visited Feb. 28, 2012) (official page of the EU Commission on legislative developments and proposals in the field of institutional reform in response of the financial crisis).

3. *Supra* note 2.

4. *See generally* HANS-WERNER SINN, KASINO-KAPITALISMUS [CASINO-CAPITALISM] 21–23, 67–75 (2009); JAHRESGUTACHTEN DES SACHVERSTÄNDIGENRATS 2008/2009 [GERMAN COUNCIL OF ECONOMIC EXPERTS ANNUAL REPORT 2008/2009] 1–189 (2008), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/gutachten/ga08_ges.pdf, English translation of Chapter 1 *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_one_2008.pdf; Stefan Grundmann, Christian Hofmann & Florian Möslein, *Finanzkrise und Wirtschaftsordnung* [*Financial Crisis and Economic Order*], FINANZKRISE UND WIRTSCHAFTSORDNUNG [FINANCIAL CRISIS AND ECONOMIC ORDER] 1 (Stefan Grundmann, Christian Hofmann & Florian Möslein eds., 2009); Ulrich Seibert, *Deutschland im Herbst* [*Germany in Fall*], *in* FESTSCHRIFT FÜR KLAUS J. HOPT ZUM 70. GEBURTSTAG AM 24. AUG. 2010 [COMMEMORATIVE PUBLICATION IN HONOR OF KLAUS J. HOPT] 2525, 2525–32 (Stefan Grundmann ed., 2010) (illustrating the point of view of a government official involved in the emergency legislation); THE DE LAROSIÈRE GROUP, THE HIGH LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU (Feb. 25, 2009), *available at* http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf [hereinafter THE DE LAROSIÈRE REPORT].

5. *See, e.g.*, DER SACHVERSTÄNDIGENRAT ZUR BEGUTACHTUNG DER GESAMTWIRTSCHAFTLICHEN ENTWICKLUNG, DIE ZUKUNFT NICHT AUFS SPIEL SETZEN: JAHRESGUTACHTEN 2009/10 [GERMAN COUNCIL OF ECONOMIC EXPERTS, SECURING THE FUTURE THROUGH RESPONSIBLE ECONOMIC POLICIES: ANNUAL REPORT 2009/10], paras. 19, 106 (2009), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/gutachten/ga09_ges.pdf, English translation of Chapter 1

Investors also began to distrust states with high debts, deficits, and poor economic perspective (even more so when lacking fiscal discipline). Portugal, Italy, Ireland, Greece, and Spain were considered to be especially vulnerable.[6] Since many European banks had significantly invested in the bonds of these states (and were still weakened because of the crisis[7]), any default of such a state could have triggered a new bank crisis.[8] With the states still having to recover financially from the first bail-out, a new bail-out of banks might have proved difficult (and did so for Spain in June 2012),[9] and for some, impossible. This, it was feared, could lead to an implosion of

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available at http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_one_2009.pdf (discussing rising debt and the difficulty of reversing that trajectory in countries using stimulus programs); DER SACHVERSTÄNDIGENRAT ZUR BEGUTACHTUNG DER GESAMTWIRTSCHAFTLICHEN ENTWICKLUNG, CHANCEN FÜR EINEN STABILEN AUFSCHWUNG: JAHRESGUTACHTEN 2010/11 [GERMAN COUNCIL OF ECONOMIC EXPERTS, OPPORTUNITIES FOR STABLE RECOVERY: ANNUAL REPORT 2010/11], para. 125 (2010), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/gutachten/ga10_ges.pdf (explaining how massive imbalances in public budgets resulted from efforts to dull the impact of the financial crisis).

6. *See, e.g.*, CHANCEN FÜR EINEN STABILEN AUFSCHWUNG: JAHRESGUTACHTEN 2010/11, *supra* note 5, paras. 115–17 (discussing housing market volatility and economic turmoil in Spain and Ireland); Carlo Angerer, et al., *Griechenland, Italien und Co.: Europas Sorgenstaaten kämpfen gegen den Krisensog* [*Greece, Italy and Co.: Europe's Problem States Fight Against the Crisis Maelstrom*], SPIEGEL ONLINE (July 13, 2011), http://www.spiegel.de/wirtschaft/soziales/griechenland-italien-und-co-europas-sorgenstaaten-kaempfen-gegen-den-krisensog-a-773982.html (discussing how market volatility in countries such as Ireland and Portugal is raising fears about the future of the euro); *PIIGS: Die Sorgenkinder der Eurozone* [*PIIGS: The Problem Children of the Euro Area*], FAZ.NET (Apr. 27, 2010), http://www.faz.net/aktuell/wirtschaft/europas-schuldenkrise/piigs-die-sorgenkinder-der-eurozone-1943158.html (providing a brief overview of the PIIGS' financial woes on a country-by-country basis).

7. *See* SINN, *supra* note 4, at 191–94 (describing European bank rescue attempts).

8. *Cf.* DER SACHVERSTÄNDIGENRAT ZUR BEGUTACHTUNG DER GESAMTWIRTSCHAFTLICHEN ENTWICKLUNG, VERANTWORTUNG FÜR EUROPA WAHRNEHMEN: JAHRESGUTACHTEN 2011/12 [GERMAN COUNCIL OF ECONOMIC EXPERTS, ASSUME RESPONSIBILITY FOR EUROPE: ANNUAL REPORT 2011/12] 7, 128–74 (Nov. 2011), *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/gutachten/ga11_ges.pdf, English translations of Chapters 1 & 4 *available at* http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_one_2011.pdf & http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/Sonstiges/chapter_four_2011.pdf [hereinafter JAHRESGUTACHTEN 2011/2012] (discussing actual repercussions on the banking system and the interaction between financial and sovereign debt crises); Patrick Bolton & Olivier Jeanne, *Sovereign Default Risk and Bank Fragility in Financially Integrated Economies* 8–9 (Nat'l Bureau of Econ. Research, Working Paper No. 16899, 2011), *available at* http://www.nber.org/papers/w16899 ("If the crisis were allowed to spill over to a large fraction of euro area government debt, it could then engulf the whole euro area banking system, including the banks of countries, such as Germany or France, where government debt itself was not perceived to be a problem."); John H. Cochrane & Anil Kashyap, *Europe's Greek Stress Test*, THE WALL STREET JOURNAL ONLINE (June 17, 2011), http://online.wsj.com/article/SB10001424052702304186404576389542793496526.html (explaining that if Greece were allowed to default, "the European financial system would be in shambles, because . . . the banks are holding the debt"). *See also Finanzmarkt-Regulierung: Ackermann warnt vor einer Staatspleite Griechenlands* [*Financial Market Regulation: Ackermann warns against Greek Sovereign Default*], FAZ.NET (Mar. 18, 2010), http://www.faz.net/aktuell/wirtschaft/europas-schuldenkrise/finanzmarkt-regulierung-ackermann-warnt-vor-einer-staatspleite-griechenlands-1232763.html (referring to the comments made by Joseph Ackermann, then CEO of Deutsche Bank, on the danger of Greek financial instability to European banks).

9. *See, e.g.*, Euro Area Summit Statement (June 29, 2012), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf (proposing that bail-out funds for Spain will first come from the EFSF, then from the ESM); Christian Teevs, *Spanien: Die wichtigsten Fragen zur Rettung der Banken* [*Spain: The Most Important Questions About the Bank Rescue*], SPIEGEL ONLINE (June 25, 2012), http://www.spiegel.de/wirtschaft/soziales/spanien-die-wichtigsten-fragen-zur-rettung-der-banken-a-840807.html (describing the problematic nature of Spain receiving funds from the EFSF).

the whole financial and banking system.[10] Therefore, tremendous efforts, some of very questionable legality,[11] were undertaken in order to reduce the risks for the banking system and to prevent the default of a euro area state.[12]

B. Regulatory Framework

The regulatory framework in Europe is rather complicated. The twenty-seven Member States of the European Union have twenty-seven different corporate, securities, banking and private laws and each Member State has supervisory agencies of its own.[13] E.U. law, however, provides for a significant degree of harmonization. Harmonization directives, which according to Article 288, paragraph 3 of the Treaty on the Functioning of the European Union (TFEU)[14] are "binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods," have been enacted, *inter alia*, in the fields of corporate, securities and banking law.[15] Thus, whereas the Member States in principle retain their legislative powers in the fields mentioned, their results have to be identical. There is also the possibility of enacting European regulations which according to Article 288, paragraph 2 of the TFEU have general application and are binding in their entirety and directly applicable in all Member States. The European Union has made use of this possibility and set up different supervisory agencies for the financial sector that coordinate the work of the national agencies and can, in urgent cases, act in their stead.[16] This allows for a more coherent approach[17] which, given the nature of the capital markets, is indispensable,[18] especially in the field of securities law. A prohibition on short selling in Frankfurt is

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10. *Cf. supra* note 8.

11. *See infra* Part II.B (especially notes 119, 123, 126).

12. *Cf. supra* note 8. Bolton & Jeanne, *supra* note 8, at 9–12.

13. Donato Masciandaro, et al., *Will They Sing the Same Tune? Measuring Convergence in the New European System of Financial Supervisors* 4 (Int'l Monetary Fund, Working Paper No. 09/142, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1442244##.

14. Consolidated Version of the Treaty on the Functioning of the European Union, 2008 O.J. (C 115) 47, art. 288, para. 3 [hereinafter TFEU], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0047:0199:EN:PDF.

15. *See, e.g.*, STEFAN GRUNDMANN, EUROPÄISCHES GESELLSCHAFTSRECHT [EUROPEAN CORPORATE LAW], paras. 106–24 (2d ed. 2011); Christiaan Timmermans, *Harmonization in the Future of Company Law, in* CAPITAL MARKETS AND COMPANY LAW 623 (Klaus Hopt & Eddy Wymeersch eds., 2003) (discussing developments in harmonization directives in corporate law); *see also* discussion *infra* pp. 17–18, 26–32, 34–41.

16. *See, e.g.*, Regulation 1095/2010, of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Securities and Markets Authority), Amending Decision No 716/2009/EC and Repealing Commission Decision 2009/77/EC, art. 9, paras. 1–5, art. 18, para. 4, 2010 O.J. (L 331) 84 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2010R1095:20110721:EN:PDF [hereinafter Regulation 1095/2010] (providing the establishment of a European Supervisory Authority and its powers and tasks as an example) (all EU legislation is available at http://eur-lex.europa.eu/en/index.htm); *see also infra* Part III.B.1 (describing the establishment of the ESRB and three European Supervisory Authorities: EBA, ESMA, EIOPA).

17. *Id.* 11th recital.

18. *Cf.* THE DE LAROSIÈRE REPORT, *supra* note 4, paras. 101, 104 (emphasizing the importance of a single financial market for effectiveness).

of no use if it is not matched by a similar prohibition in London, Paris, and other stock markets.[19]

I. SUBPRIME CRISIS 2008

In 2008, many banks had to write off a significant portion of receivables. Following the collapse of Lehmann brothers on September 15, 2008, banks were more and more unwilling to lend each other money, especially since the banks' exposure to the subprime risk was in no way transparent.[20] The pressure on banks grew steadily and after bank runs had already occurred in Great Britain in 2007 (bank run on Northern Rock, September 14, 2007)[21] the risk of further bank runs seemed to be imminent even in Germany.[22] It is reported that cash withdrawals increased so significantly that €500[23] notes were becoming scarce.[24] The Member States prevented a collapse of the financial system by employing different strategies. The first part of this Article will take a closer look at the strategies employed in Germany and put them into their European law context.

A. *Guarantee of Savings*

In order to prevent a bank run perceived as imminent in Germany, Chancellor Merkel[25] and Minister of Finance Steinbrück[26] guaranteed in a joint television statement all German savings—a guarantee worth between 1,000 and 3,000 billion euros.[27] Even though the government would hardly have been able to make good on such a guarantee,[28] it had the desired psychological effect. No bank run occurred. Thus the legal validity of this guarantee has not been tested. The government

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19. *See id.* para. 162 (discussing the lack of coordination e.g., on short selling).

20. *Supra* pp. 2–3, especially note 4.

21. *See* SINN, *supra* note 4, at 61–65.

22. *See id.* at 16, 76 (describing the bank run on the rather healthy Constantia Bank in Austria on October 17, 2008, which lead immediately to its takeover).

23. €500 € ≈ $625 (exchange rate of June 28, 2012).

24. Seibert, *supra* note 4, at 2531.

25. "Wir sagen den Sparerinnen und Sparern, dass ihre Einlagen sicher sind. Auch dafür steht die Bundesregierung ein." ["We are telling the savers that their deposits are safe. The federal government answers for that." (author's translation)]. *Merkel und Steinbrück im Wortlaut: "Die Spareinlagen sind sicher" [Merkel and Steinbrück Verbatim: "The Deposits are Safe"]*, SPIEGEL ONLINE (Oct. 5, 2008), http://www.spiegel.de/wirtschaft/0,1518,582305,00.html.

26. "Ich möchte gerne unterstreichen, dass wir in der Tat in der gemeinsamen Verantwortung, die wir in der Bundesregierung fühlen, dafür Sorge tragen wollen, dass die Sparerinnen und Sparer in Deutschland nicht befürchten müssen, einen Euro ihrer Einlagen zu verlieren." ["I would like to underscore that—on the basis of the joint responsibility felt within the federal government—we indeed want to make sure that the savers in Germany do not have to worry about losing a single Euro of their savings." (author's translation)]. *Id.*

27. *See* Seibert, *supra* note 4, at 2530 (speaking of €3,000 billion, €3,000 billion ≈ $3,750 billion (exchange rate of June 28, 2012)); David Roth, *Die Garantieerklärung der Bundesregierung: Juristisch unverbindlich—politisch bindend [The Guarantee of Savings by the Federal Government: Not Legally But Politically Binding]*, 62 NEUE JURISTISCHE WOCHENSCHRIFT [N.J.W.] 566, 567 (2009) (speaking of €1,000 billion, €1,000 billion ≈ $1,250 billion (exchange rate of June 28, 2012)).

28. *See* Seibert, *supra* note 4, at 2530–31 ("nicht einen halben Tag" ["not for half a day" (author's translation)]).

insisted that it was a political statement without any binding legal effect.[29] Yet, the wording was very close to a binding guarantee.[30] The European Commission also seems to have considered such guarantees as having a certain legal effect. It treated them as falling under the state aid provisions of Article 107 of the TFEU, and—given the exceptional circumstances—indicated its approval of them.[31] The guarantee was reiterated by Chancellor Merkel in November 2011,[32] and again in March 2013.

B. Corporate Law

However, psychological measures were not sufficient. The banks needed to be recapitalized urgently; every delay increased the insecurity in the market and caused stock prices to fall. Falling stock prices in turn increased the need for write-offs in the balance sheet and exacerbated the crisis in a downward spiral. Thus, recapitalization had to be effected within hours or days.[33]

Against this background, emergency legislation was passed in order to enable the quick recapitalization of companies overnight. Within a week, a special public entity, the Financial Market Stabilization Fund, was created by law with the purpose of stabilizing the financial market by providing undertakings of the financial sector

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29. *See* Press Conference, Ulrich Wilhelm (German government spokesperson), Themen waren unter anderem der Anschlag der PKK auf einen Grenzposten des türkischen Militärs und die internationale Finanzkrise. [Topics Including the Attack by the PKK on a Border Post of the Turkish Military and the International Financial Crisis] (Oct. 6, 2008), *available at* http://archiv.bundesregierung.de/Content/DE/Archiv16/Pressekonferenzen/2008/10/2008-10-06-regpk.html (referring to the guarantee as a "politischen Erklärung" ["policy statement"]); *see also* Roth, *supra* note 27 ("Die Bundesregierung hat ihrer Erklärung kein entsprechendes Gesetz folgen lassen. Auch im Verordnungswege ist keine Staatsgarantie normiert worden. Eine formal-gesetzliche Anspruchsgrundlage existiert daher nicht." ["The federal government did not let a corresponding law follow its statement. Also no legally binding guarantee was provided for by ordinance. Therefore, a formal legal basis for a claim does not exist."]). *But see* Franz Jürgen Säcker, *Gesellschaftsrechtliche Grenzen spekulativer Finanztermingeschäfte* [*Corporate Law Limits to Speculative Financial Futures*], 61 N.J.W. 3313, 3316–17 (2008) (understanding the statements as creating a legally binding private law guarantee).

30. *Cf.* Säcker, *supra* note 29, at 3317 (arguing that the government cannot rely on the statement in question being a mere political statement as this would be an abuse of law in the light of the solemn public guarantee declaration)

31. *See* Commission Communication, The Application of State Aid Rules to Measures Taken in Relation to Financial Institutions in the Context of the Current Global Financial Crisis, 2008 O.J. (C 270) 8, para. 19 (EU) ("In the present exceptional circumstances, it may be necessary to reassure depositors with financial institutions that they will not suffer losses, so as to limit the possibility of bank runs and undue negative spillover effects on healthy banks. In principle, therefore, in the context of a systemic crisis, general guarantees protecting retail deposits (and debt held by retail clients) can be a legitimate component of the public policy response."). *Cf.* Christoph Arhold, *Globale Finanzkrise und europäisches Beihilfenrecht* [*Global Financial Crisis and European State Aid Law*], 19 EUROPÄISCHE ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [EU. Z.W.] 713 (2008) ("Gem. Art. 87 I EG sind staatliche Beihilfen grundsätzlich verboten." ["According to Article 87 Paragraph 1 EC State aid is prohibited in principle."]).

32. *Europäische Schuldenkrise: Merkel bekräftigt Staatsgarantie für Spareinlagen* [*European Sovereign Debt Crisis: Merkel Reaffirms State Guarantees of Savings*], WELT ONLINE (Nov. 11, 2011), http://www.welt.de/wirtschaft/article13711047/Merkel-bekraeftigt-Staatsgarantie-fuer-Spareinlagen.html.

33. *See* Seibert, *supra* note 4, at 2538–39. ("Es erschien am Wochenende des 11./12. Oktober 2009 denkbar, dass eine Rekapitalisierung eines Unternehmens im worst case in kürzester Frist, u.U. auch über Nacht vollzogen werden müsste." ["On the weekend of October 11–12, 2009, it appeared possible that recapitalization had to be completed immediately."]).

with equity capital.[34] It had a budget of 400 billion euros for the provision of guarantees[35] and 70 billion euros for the provision of equity.[36] Shortly afterwards the European Commission approved state aid for the financial sector according to Article 107, paragraph 3 of the TFEU.[37]

Yet, the provision of a budget for state aid was not sufficient. It was also necessary to create a corporate law way of quickly providing the undertakings of the financial sector with the money. While providing guarantees was relatively easy, the quick provision of equity capital proved to be more problematic: Unless the company's board can call on sufficient authorized capital, under normal corporate law procedures "[a]ny increase in capital must be decided upon by the general meeting."[38] Such a decision of the general meeting cannot be obtained within the short time frame. First, a meeting needs to be called at least thirty days in advance of the meeting.[39] Second, in Germany, predatory shareholders often seek an annulment of the decisions of the general meeting, hoping that the company will try to pay them off.[40] An application for annulment can very significantly delay the implementation

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34. Finanzmarktstabilisierungsfondsgesetz [FMStFG] [Act on the Establishment of a Financial Market Stabilization Fund], Oct. 17, 2008, BGBL. I at 1982, last amended by Zweites Finanzmarktstabilisierungsgesetz [2. FMStG] [Second Financial Market Stabilization Act], Feb. 24, 2012, BGBL. I at 206, art. 1 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/fmstfg/gesamt.pdf (all German federal legislation is *available at* http://www.gesetze-im-internet.de/index.html), English translations *available at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/fmstfg_en.html (providing a translation for information purposes only).

35. FMStFG § 6, para. 1, sentence 1. €400 billion ≈ $500 billion (exchange rate of June 28, 2012).

36. FMStFG § 9, para. 1. €70 billion €≈ $88 billion (exchange rate of June 29, 2012).

37. Commission Decision Staatliche Beihilferegelung Nr. N 512/2008—Rettungspaket für Kreditinstitute in Deutschland [State Aid Scheme No N 512/2008—Rescue Package for Credit Institutions in Germany] (Oct. 27, 2008), K(2008) 6422 (EC); Commission Decision Staatliche Beihilferegelung Nr. N 625/2008—Rettungspaket für Finanzinstitute in Deutschland [State Aid No. N 625/2008—Rescue Package for Financial Institutions in Germany] (Dec. 12, 2008), K(2008) 8629 (EC); *see* Commission Decision Staatliche Beihilfe N 330/2009—Verlängerung des deutschen Rettungspakets für Finanzinstitute [State Aid N 330/2009—Prolongation of the German Rescue Package for Credit Institutions in Germany] (June 22, 2009), K(2009) 4995 (EC); *see also* Commission Communication, *supra* note 31, para. 19 ("In the present exceptional circumstances, it may be necessary to reassure depositors with financial institutions that they will not suffer losses, so as to limit the possibility of bank runs and undue negative spillover effects on healthy banks.").

38. Second Council Directive 77/91, of 13 December 1976 On Coordination of Safeguards Which, for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 58 of the Treaty, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, with a View to Making Such Safeguards Equivalent, art. 25, para. 1, 1977 O.J. (L 26) 1, 17 (EC), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1977L0091:20091022:EN:PDF [hereinafter Second Council Directive]; Aktiengesetz [AktG] [Stock Corporation Act], September 6, 1965, BGBL. I at 1089, as amended, §§ 182, 192, 202 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/aktg/gesamt.pdf. Recently, the Second Council Directive has been recast in Directive 2012/30, of the European Parliament and of the Council of 25 October 2012 On Coordination of Safeguards Which, for the Protection of the Interests of Members and Others, Are Required by Member States of Companies Within the Meaning of the Second Paragraph of Article 54 of the Treaty on the Functioning of the European Union, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of Their Capital, with a View to Making Such Safeguards Equivalent, 2012 O.J. (L 315) 74 (EU), *available at* eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:315:0074:0097:EN:PDF [hereinafter Directive 2012/30] (the relevant Article is now art. 29, para. 1).

39. AktG § 123(1).

40. *See* Michael Brück, et al., *Das Finanzmarktstabilisierungsgesetz: Hilfe für die Banken—Systemwechsel im Aktien- und Insolvenzrecht?* [*The Financial Market Stabilization Act: Aid for the Banks—Change of System in Stock Corporation and Insolvency Law?*], 2008 BETRIEBS-BERATER [B.B.]

of the decision of the general meeting.[41] Thus, the Financial Market Stabilization Acceleration Act ("Acceleration Act")[42] was passed, which provided for derogations from normal company law in order to expedite the recapitalization.[43] Some of its provisions will now be looked at in greater detail.

1. Recapitalization Without Decision of the General Meeting

A key provision of the Acceleration Act introduces authorized capital that is not authorized by the general meeting of the stock corporation but *ex lege*, i.e., by law. Section 3 of the Acceleration Act empowered the management board, which needed to obtain the consent of the supervisory board, to increase the company's capital by 50%. It also provided that the increase in capital had to be registered immediately and that the commercial register was not to verify the legality of the procedure. With the registration, no annulment of the capital increase was possible. In case of an illegal increase, shareholders' rights were limited to the right to claim damages. The provision expired on December 31, 2010.[44]

At first sight this seems to be an effective way of increasing the companies' capital. Yet, in practice, this provision proved to be moot. The reason for this is its questionable compatibility with E.U. law. It is in direct contravention of the wording of the first sentence of Article 25, paragraph 1 of the Second Company Law Directive (now Article 29 of Directive 2012/30, which is a recast of the Second

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2526, 2531 (discussing the risk of legal challenges by opportunistic shareholders); Laurenz Wieneke & Torsten Fett, *Das neue Finanzmarktstabilisierungsgesetz unter besonderer Berücksichtigung der aktienrechtlichen Sonderregelungen* [*The New Financial Market Stabilization Act and Its Special Corporate Law Provisions*], 12 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT [N.Z.G.] 8, 13 (2009) (stating that certain shareholders have a reputation for exercising their options during a crisis situation); Kurt Kiethe, *Abkauf von Anfechtungsrechten der Aktionäre* [*Paying Off Shareholders Seeking an Annulment*], 7 N.Z.G. 489, 489 (2004) (discussing the phenomenon since the 1980s of greedy shareholders exercising avoidance in hopes that the company will buy them out). *See generally* Theodor Baums, Astrid Keinath & Daniel Gajek, *Fortschritte bei Klagen gegen Hauptversammlungsbeschlüsse? Eine Empirische Studie* [*Progress with Annulment Proceedings Against General Meeting Resolutions? An Empirical Study*], 2007 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT [Z.I.P.] 1629, 1630–31, 1642–47.

41. *See* Baums, et al., *supra* note 40, at 1648–49 (explaining the steps and effects of an approval procedure after an application for annulment and providing empirical data for the duration of such a procedure).

42. Gesetz zur Beschleunigung und Vereinfachung des Erwerbs von Anteilen an sowie Risikopositionen von Unternehmen des Finanzsektors durch den Fonds "Finanzmarktstabilisierungsfonds —FMS" [Financial Market Stabilization Fund—FMS] (Finanzmarktstabilisierungsbeschleunigungsgesetz) [FMStBG] [Financial Market Stabilization Acceleration Act], Oct. 17, 2008, BGBL. I at 1986, as amended (Ger.), *available at* http://www.gesetze-im-internet.de/fmstbg/index.html, *translated in* Act on the Acceleration and Simplification of the Acquisition of Shares and Risk Positions of Financial-Sector Enterprises by the Fund "Financial-Market Stabilisation Fund—FMS," *available at* http://www.bundesfinanzministerium.de/Content/DE/Publikationen/Aktuelle_Gesetze/Gesetze_Verordnungen/Finanzmarktstabilisierungsbeschleunigungsgesetz_engl_anl.pdf?__blob=publicationFile&v=2 (last visited Jan. 27, 2013) (providing a translation for information purposes only).

43. Brück, et al., *supra* note 40, at 2526–27, 2531.

44. Originally, it was due to expire December 31, 2009. This was changed to December 31, 2010. *See* Gesetz zur Fortentwicklung der Finanzmarktstabilisierung [FMStFOG] [Act for Developing Financial Market Stabilization] July 17, 2009, BGBl. I at 1980, art. 3, no. 1; Mayer Brown, *The Second Financial Market Stabilization Act* (Feb. 10, 2012), *available at* http://www.mayerbrown.com/files/Publication/41857be0-ac41-4f21-98a9-0c7f00e47838/Presentation/PublicationAttachment/68d0bafc-d735-4ad0-aea5-16aba80b56b1/12213.PDF ("Stabilization measures were limited in time; they could only be applied for until December 31, 2010.").

Company Law Directive), also known as the Capital Directive, which expressly required that "any increase in capital must be decided upon by the general meeting."[45] There is also a body of case law of the European Court of Justice which calls for a rigorous application of Article 25 of the directive (now Article 29 of Directive 2012/30): the general meeting is to decide on any increase in capital, even in a financial crisis of the company,[46] and even under exceptional circumstances.[47] According to the judicature this only changes when insolvency proceedings start[48]—a scenario that had to be avoided at all costs in the situation at hand. Many scholars therefore argued that this provision was in violation of European law,[49] and some considered it unconstitutional.[50] The criticism rendered it effectively moot; no one dared to use it.[51]

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45. Second Council Directive, *supra* note 38, art. 25, para. 1 (now Directive 2012/30, *supra* note 38, art. 29, para. 1).

46. *See* Joined Cases C-19/90 & C-20/90, Karella v. Greek Minister for Industry, Energy and Technology, 1991 E.C.R. I-2710, 2717–18, paras. 25–28 (stating that, even during times of serious financial turmoil, Member States cannot ignore the Second Council Directive's requirements to include shareholders in decision-making processes, such as increases in capital). *See generally* Case C-441/93, Pafitis v. Trapeza Kentrikis Ellados A.E., 1996 E.C.R. I-1363, 1371–72, paras. 18–24 (applying the Directive and this judicature to banks).

47. *See Karella*, *supra* note 46, at I-2719, para. 31 (asserting that the Second Council Directive precludes Member States from utilizing other community laws that provide for exceptional situations); Case C-381/89, Syndesmos Melon tis Eleftheras Evangelikis Ekklisias v. Greek State, 1992 E.C.R. I-2134, 2145–46, para. 37 (applying the Directive and the corresponding judicature even if the company is considered particularly important to the national economy); *Pafitis*, *supra* note 46, at I-1375, para. 40 (confirming Case C-381/89).

48. *See Karella*, *supra* note 46, at I-2718–19, para. 30 (applying the Directive as long as the company's shareholders and normal bodies have not been divested of their powers).

49. *See* FLORIAN BECKER & SEBASTIAN MOCK, FMSTG [COMMENTARY ON THE FINANCIAL MARKET STABILIZATION ACT] § 3 FMS-BeschleunigungsG, paras. 10–24 (2009) (explaining how the provision collides with Article 25 of Directive 77/91); Peter Veranneman & Mathias Gärtner, *in* FINANZMARKTSTABILISIERUNGSGESETZ [COMMENTARY ON THE FINANCIAL MARKET STABILIZATION ACT] § 3 BeschlG, paras. 8–10 (Matthias Jaletzke & Peter Veranneman eds., 2009) (explaining how the Article 25 is not capable of being compatible with the EU law); Klaus Hopt, et al., *Kontrollerlangung über systemrelevante Banken nach den Finanzmarktstabilisierungsgesetzen (FMStG/FMStErgG) [Gaining Control over Systemically Relevant Banks]*, 63 WERTPAPIERMITTEILUNGEN [W.M.] 821, 826 (2009); Oliver Seiler & Jonas Wittgens, *Sonderaktienrecht für den Finanzsektor [Special Corporate Law Provisions for the Financial Sector]*, 2008 Z.I.P. 2245, 2249 (arguing that the E.U. structure is not compatible with such a domestic provision); Hildegard Ziemons, *Rekapitalisierung nach dem Finanzmarktstabilisierungsgesetz—Die aktienrechtlichen Regelungen im Überblick [Recapitalization According to the Financial Market Stabilization Act—The Stock Corporation Law at a Glance]*, 61 DER BETRIEB [D.B.] 2635, 2637–38 (2008) (discussing how Section 3 of the German Acceleration Act was in violation of Article 25 of the Capital Directive); Hans-Jürgen Hellwig, *Das Rettungspaket verstößt gegen Europarecht [The Rescue Package Violates European Law]*, FAZ.NET (Nov. 4, 2008), http://www.faz.net/aktuell/wirtschaft/recht-steuern/finanzmarktkrise-das-rettungspaket-verstoesst-gegen-europarecht-1725389.html (noting the clash between the Acceleration Act and Article 25 of the Directive); Gerald Spindler, *Finanzkrise und Gesetzgeber [Financial Crisis and Legislator]*, 2008 DEUTSCHES STEUERRECHT [D. ST. R.] 2268, 2273–74 (discussing the patent contradiction when comparing the Acceleration Act with the Directive).

50. *See* Frank Roitzsch & Gerhard Wächter, *Gesellschaftsrechtliche Probleme des Finanzmarkt stabilisierungsgesetzes [Corporate Law Problems of the Financial Market Stabilization Act]*, 19 DEUTSCHE ZEITSCHRIFT FÜR WIRTSCHAFTS- UND INSOLVENZRECHT [D.Z.W.I.R.] 1, 2 (2008) (stating that it is questionable if Section 3 of the Acceleration Act is compatible with Article 14 of the German Constitution); Ziemons, *supra* note 49, at 2637–38; *Bundesverfassungsgericht [BVerfG] [Federal Constitutional Court]*, 2009 Z.I.P. 753 (deciding not to hear the case since the petitioner had not seized the competent courts beforehand); *see also* Lutz Haertlein, *Aktionärsrechtsschutz gegen Rekapitalisierungsmaßnahmen auf Grund des Finanzmarktstabilisierungsgesetzes [Protection of Shareholders Against Measures of Recapitalization According to the Financial Market Stabilization Act]*, 12

To some extent this was surprising: First, even under the ECJ's strict judicature it can well be argued that the derogation from the Directive is compatible with European law.[52] Second, the ECJ's judicature itself is questioned by a well-founded view that understands the Directive as only dealing with conflicts within the company, i.e., between shareholders or shareholders and the board, and denies the judicature's premise that the Directive also applies to conflicts between the company and its shareholders on one side, and measures undertaken by the state on the other side.[53] Third, based on that view one could have proceeded with the capital increase and left the question of compatibility with European law to be decided later by the ECJ.[54] Possible claims for damages by shareholders[55] would not have been a

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N.Z.G. 576 (2009) (explaining subsidiary principle, i.e., that one cannot be heard by the Constitutional Court until one has exhausted every other possible legal course of action); Sebastian Mock, *Finanzmarkstabilisierungsgesetz, gesetzlich genehmigtes Kapital, Rechtsschutz, Commerzbank* [*Financial Market Stabilization Act, Legally Authorized Capital and Legal Expenses*], 2009 ENTSCHEIDUNGEN ZUM WIRTSCHAFTSRECHT [E. WI. R.] 383 (stating that Section 3 is problematic because of Article 14 of the German Constitution (Guarantee of Property) and because it violates several regulations of the Capital Directive).

51. *See* Seibert, *supra* note 4, at 2540–41 (stating that no one dared to use Section 3 because it had been "talked to death"); *see also* Mock, *supra* note 50, at 384 (discussing serious doubts about the constitutionality of Section 3 and its conformity with European Law).

52. *See* Lutz Krämer & Alexander Kiefner, *Aktienrechtliche Sonderregelungen im Finanzmarkt stabilisierungsgesetz* [*Special Corporate Law Provisions in the Financial Market Stabilization Act*], 2008 A.G. R507, R508 (stating that ensuring the functioning of financial markets is a very important principle in European Law); Ulrich Noack, *Das Aktienrecht der Krise—das Aktienrecht in der Krise?* [*Corporate Law for the Crisis—Crisis of Corporate Law?*], 2009 A.G. 227, 230–31 [hereinafter Noack, *Das Aktienrecht der Krise*] (positing that Section 3 Acceleration Act is compatible with Article 25 as its solution is preferable to an expropriation of investors which would be the only other alternative in case of a bank that is "too big to fail"); Ulrich Noack, *Krisen-Aktienrecht für Unternehmen des Finanzsektors* [*Crisis Corporate Law for Financial Undertakings*], 2008 STATUS RECHT 356 (mentioning that Section 3 does not violate the Capital Directive as it concerns an exception in case of a systemic crisis); Seibert, *supra* note 4, at 2539–40 (stating Article 2, Section 3 of the Financial Market Stabilization Act is "obviously" not in accordance with the wording Section 25 of the Capital Directive, but that under the circumstances an exception seems to be justified); Wieneke & Fett, *supra* note 40, at 11–13 (arguing that that an application of Section 3 Acceleration Act would be justified in very exceptional cases); Christian Gehling, *Genehmigtes Kapital per Gesetz ist europakonform* [*Statutorily Authorized Capital Is in Conformity with European Law*], BÖRSEN-ZEITUNG, Dec. 3, 2008, at 2 (arguing that in case of a crisis with European impact, national law creating the necessary instruments to deal with the crisis holds precedent over European Law protecting investor's rights). For information about how the German government relied on the Commission's approval of state aid, *see* Press Release, Gemeinsame Pressemitteilung des Bundesministeriums für Wirtschaft und Technologie und des Bundesministeriums der Finanzen [Joined Press Release of the Federal Ministry of Trade, Industry, and Technology and of the Federal Ministry of Finance], Freie Fahrt für den Stabilisierungsfonds - EU-Kommission genehmigt den deutschen Bankenschirm [EU Commission Approves German Bank Package] (Oct. 28, 2008), *available at* http://www.bmwi.de/BMWi/Navigation/Presse/pressemitteilungen,did=276582.html ("[The government emphasized that] the Financial Market Stabilization Act has been confirmed by the European Commission as EU-compliant aid scheme."). *But see* BECKER & MOCK, *supra* note 49, § 3 FMS-BeschleunigungsG, para. 15 (rightly criticizing this argument of the German federal government); Seiler & Wittgens, *supra* note 49, at 2249 (arguing that the compatibility of Section 3 of the Acceleration Act with Article 25 of the Capital Directive is doubtful and that exemptions (like in Article 19, paragraphs 2, 3, Article 40, paragraph 2, Article 41, paragraph 2, Article 43, paragraph 2 of the Capital Directive) do not apply).

53. Wolfgang Schön, *Die Europäische Kapitalrichtlinie—eine Sanierungsbremse?* [*The European Capital Directive—An Obstacle to Restructuring?*], 174 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT [Z.H.R.] 155 (2010).

54. *See* Noack, *Das Aktienrecht der Krise*, *supra* note 52, at 231 (arguing that necessity knows no law).

55. *See generally* BECKER & MOCK, *supra* note 49, § 3 FMS-BeschleunigungsG, paras. 16–24.

deterrence. Given the fact that the banks needed to be rescued, the shareholders' damages would have been nominal at best.

In the end, the useful provision was not used. Attempts at obtaining an exception from the provisions of the Directive failed during the crisis.[56] The introduction of an exception was considered for the future, although, until now, nothing happened.[57] The Second Financial Market Stabilization Fund Act of February 2012, which was designed to deal with the effects of the sovereign debt crisis on banks, eliminated these provisions.[58]

2. Expedited General Meeting

Section 7 of the Acceleration Act created the possibility of an expedited general meeting in order to increase the company's capital. In its original version the deadline for convening a meeting was reduced from thirty days to one day, and the company was free to choose the venue.[59] Considering other applicable deadlines,[60] this gave the company the possibility of calling a general meeting in a soccer stadium within six days.[61] Again, the increase in capital has to be registered immediately and the commercial register is not to verify the legality of the procedure. With the registration, no annulment of the capital increase is possible; shareholders can only sue for damages.

This provision was also met with concerns regarding its compatibility with European law.[62] It was argued that Article 5, paragraph 1 of the Shareholder's Rights Directive required that the general meeting be called at least twenty-one days in advance.[63] It was, however, rightly pointed out that the deadline for implementing the Directive had not expired and that Member States were therefore still free to

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56. *See* Seibert, *supra* note 4, at 2542–45 (stating that as other states like the Netherlands and France did not use a solution similar to Section 3 of the Acceleration Act and had not asked the Commission for an exception, attempts at obtaining an exception were not possible).

57. *Id.* at 2544–45 n.102 ("[C]onsideration may be given to whether derogation from Article 25 (1) of Directive 77/91 covering resolutions for banks should be introduced.").

58. *See* 2. FMStG art. 3, no. 3 ("§§ 3 and 4 [of the Acceleration Act] are repealed.").

59. *See* Seibert, *supra* note 4, at 2545 (discussing the freedom of a company to choose a venue for its stockholder meeting); *see also* Alert Memo, Cleary Gottlieb Steen & Hamilton LLP, Proposed Amendments to the German Financial Market Stabilization Program (Feb. 26, 2009), http://www.cgsh.com/files/News/2a811304-5318-428b-8f82dbe7db4ace6f/Presentation/NewsAttachment/1e4fc906-88b9-449a-8a34-dc4cdc88393f/Alert%20MemoProposed%20Amendments%20to%20the%20German%20Financial%20Market%20Stabilization%20Program.pdf ("If a shareholders' meeting is convened, the Draft Bill provides that the applicable notice period may be reduced to one day.").

60. *Cf., e.g.*, Wertpapiererwerbs- und Übernahmegesetz [WpÜG] [Securities Acquisition and Takeover Act], Dec. 20, 2001, BGBL. I at 3822, as amended, § 16, para. 4 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/wp_g/gesamt.pdf, *translated at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wpueg_en.html?nn=2821360 (providing a translation for information purposes only).

61. Seibert, *supra* note 4, at 2545.

62. *See* Spindler, *supra* note 49, at 2274 (stating that whether a legal definition that robs the shareholder of virtually any corporate law legal protection is compatible is questionable); Hellwig, *supra* note 49 (discussing the possibility that this new rule is contrary to Community Law).

63. Directive 2007/36, of the European Parliament and of the Council of 11 July 2007 On the Exercise of Certain Rights of Shareholders in Listed Companies, 2007 O.J. (L 184) 17 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:184:0017:0024:EN:PDF.

legislate differently.[64] Consequently, the law was amended as of the day on which the directive had to be transposed into national law: From August 3, 2009 the deadline is now twenty-one days.[65] Yet, some scholars argued that under E.U. law the obligation to transpose a directive into national law also contains a stand still obligation prohibiting, even before the deadline for transposition has passed, any changes in the law that are in contravention of the directive.[66] In light of the unusual circumstances and the urgent necessity to deal with the financial crisis, this argument is, however, unconvincing[67] and has been rejected by a Munich District Court.[68]

3. Eminent Domain Solution

Since the actors were reluctant to use the statutorily authorized capital option of Section 3 of the Acceleration Act any capital increase had to be decided upon by the general meeting. Even though the process was facilitated by the Acceleration Act,[69] a decision by the general meeting nevertheless required a three-fourths majority.[70] This requirement was difficult to meet, because shareholders were in a hold out position. Knowing that the state had to rescue the bank in order to avoid disastrous consequences for the entire financial system they were able to ask a high price for their consent.

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64. Seibert, *supra* note 4, at 2545.

65. Directive 2007/36, *supra* note 63, arts. 5[1], 15.

66. *See* Seiler & Wittgens, *supra* note 49, at 2252 (arguing that the Directive was infringed, although it had to be transposed later because the stand-still rule forbade the Member States to enact law in contravention to the Directive even before the date of transposition); Ziemons, *supra* note 49, at 2639 (stating that the provision does not collide with the Directive before the date of transposition but that Germany infringes the principle of loyal cooperation of E.U. law by enacting a law in contravention of the Directive to come); *see also* BECKER & MOCK, *supra* note 49, § 7 FMS-BeschleunigungsG, para. 8 (stating that the provision collides with Article 25 of Directive 77/91 and infringes the stand-still rule). *See* Case C-194/10 P, Abt v. Hypo Real Estate Holding AG. (determining that preliminary ruling on the matter was inadmissible because the European law question would not have been relevant for the national case).

67. *See* Seibert, *supra* note 4, at 2545 (stating that it is obvious that such an analysis does not fit in the special situation of systemic crisis). Also, even though the ECJ stated a stand still obligation prohibiting the Member States to take any measures liable to seriously compromise the result prescribed by a directive during the period of transposition, this does not cover transitional measures. Case C-129/96, Inter-Environment Wallonie ASBL v. Wallonne, 1997 E.C.R. I-7411, para. 45, 49 ("Member States are not obliged to adopt those measures before the end of the period prescribed for transposition, [however,] . . . during that period they must refrain from taking any measures liable seriously to compromise the result prescribed," and "the incompatibility of the transitional national measures with the directive, or the non-transposition of certain of its provisions, would not necessarily compromise the result prescribed"). In the present context it is not conceivable that the transitional measure of allowing for expedited general meetings could have a serious actual effect on the results of the directive after transposition.

68. *See* Landgericht München I [LG München I] [District Court Munich I] Feb. 23, 2012, 2012 A.G. 423, 426 (Ger.) (stating that the German legislator had taken due account to the date of transposition and that the directive had anyway no effect in cases, in which the deadline of twenty-one days was observed); *see also* Press Release, Tobias Pichlmaier, Spokesperson, District Court Munich I, Anfechtungsklagen gegen HRE-Kapitalerhöhung abgewiesen, Pressemitteilung 03/12 [Action to Set Aside HRE Capital Increase Dismissed, Press Release 02/12] (Mar. 1, 2012), *available at* http://www.justiz.bayern.de/gericht/lg/m1/presse/archiv/2012/03407/ (rejecting an action against a capital increase excluding subscription rights).

69. *See* FMStBG § 7 (describing the authority during a general meeting to initiate a capital increase).

70. AktG §§ 182, 193, 202. An amendment to § 7 of the FMStBG lowered this requirement to a majority of the votes cast. *See infra* note 78 and accompanying text.

This was the case with the Hypo Real Estate bank which was severely affected by the subprime crisis and was in dire need of financial support by the state.[71] Substantial state guarantees led in the beginning of 2009 to demands that the bank should be taken over by the state so that the state would not only bear the risk, but also profit from a successful rescue operation.[72] Using already authorized capital, the state, acting through the Financial Market Stabilization Fund, acquired in March 2009 8.7% of the bank[73] and then made a public bid for all outstanding shares in April.[74] This bid was only partially successful; the fund acquired only 47.3%.[75] Shareholder Christopher Flowers refused to sell his 21.7% of the shares and declared that he preferred to remain a shareholder.[76] With his shareholding he was likely to command over 25% of the votes in a general meeting and thus be in a position to veto any capital increase.

This prompted the legislator to act: As of April 9, 2009, the majority necessary to decide on a capital measure was lowered to a simple majority of the votes cast,[77] the majority necessary for a decision to exclude the shareholders' preemptive rights

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71. Untersuchungsausschuss des Deutschen Bundestages, Beschlussempfehlung und Bericht [Report of the Second Parliamentary Investigative Committee], BTDrucks 16/14000 (Sept. 18, 2009), *available at* http://dipbt.bundestag.de/dip21/btd/16/140/1614000.pdf. *See generally* Michaela Schiessl, *Arroganz am Abgrund* [*Arrogance at the Abyss*], DER SPIEGEL GESCHICHTE, July 28, 2009, at 138–39, *available at* http://www.spiegel.de/spiegel/spiegelgeschichte/d-66214363.html (discussing the history of the HRE); Press Release, Hypo Real Estate Group, Liquiditätslinien und Finanzmarktstabilisierungsfonds [Liquidity and Financial Market Stabilization Fund] (Oct. 29, 2008), http://www.hyporealestate.com/pdf/PI-Faszi_FinStab_Deutsch_Endfassung.pdf; Markus Dettmer, et al., *Zocken im Morgengrauen* [*Gambling at Dawn*], DER SPIEGEL, Aug. 17, 2009, at 58–63, *available at* http://www.spiegel.de/spiegel/print/d-66436856.html; *Dax-Konzern Hypo Real Estate kämpft ums Überleben* [*Dax-corporation Hypo Real Estate Struggles for Survival*], SPIEGEL ONLINE (Sept. 28, 2008), http://www.spiegel.de/wirtschaft/0,1518,581011,00.html; *Dax-Konzern Hypo Real Estate kurz vor dem Kollaps* [*Dax-corporation Hypo Real Estate on the Brink of Collapse*], WELT ONLINE (Sept. 28, 2008), http://www.welt.de/wirtschaft/article2505773/Dax-Konzern-Hypo-Real-Estate-vor-Kollaps.html; Thomas Fromm, *Ein Fass ohne Boden* [*A Bottomless Pit*], SÜDDEUTSCHE.DE (Jan. 21, 2009), http://www.sueddeutsche.de/geld/hypo-real-estate-hilfe-ein-fass-ohne-boden-1.468936 (announcing the history of and response to Hypo Real Estate Bank's crisis).

72. *See* Interview by Patrick Gensing with Hans-Werner Sinn, President of Leibniz Institute for Economic Research at the University of Munich, at the Tagesschau (Feb. 2, 2009) (Ger.), *available at* http://www.tagesschau.de/wirtschaft/sinn110.html (discussing calls for nationalization of the Hypo Real Estate Bank); *SoFFin-Chef dringt auf Hypo-Real-Verstaatlichung* [*Chief Executive of the Sonderfonds Finanzmarktstabilisierung (SoFFin) Demands Hypo-Real Socialization*], BÖRSENNEWS.DE (Mar. 15, 2009), http://www.boersennews.de/nachrichten/artikel/soffin-chef-dringt-auf-hypo-real-verstaatlichung-rettungsgespraeche/100164578 (referring to an interview with Hannes Rehm, Chief Executive of the Sonderfonds Finanzmarktstabilisierung (SoFFin), discussing nationalization of banks).

73. Press Release, Hypo Real Estate Group, Bund steigt ins Kapital der Hypo Real Estate Group ein [Federal Government Takes a Holding in the Hypo Real Estate Group's Capital] (Mar. 28, 2009), http://www.hyporealestate.com/pdf/032809_Soffin_Absichtserklaerung_Deutsch_Endfassung.pdf; *Bund beteiligt sich an Hypo Real Estate* [Federal Government acquires Hypo Real Estates Shares], SPIEGEL ONLINE (Mar. 28, 2009), http://www.spiegel.de/wirtschaft/0,1518,616087,00.html.

74. Öffentliches Übernahmeangebot (Barangebot) der Bundesrepublik Deutschland, [Public Takeover Bid (Cash-offer) by the Federal Republic of Germany] (Apr. 16, 2009), http://w3.cantos.com/09/soffin-904-d71oz/documents/HRE_deutsch_clean.pdf (entailing the state's public bid for all outstanding shares of Hypo Real Estate in April 2009).

75. Press Release, Hypo Real Estate Group, Hypo Real Estate Shareholders Approve Capital Increase, with a Large Majority (June 2, 2009), *available at* http://www.hyporealestate.com/uploads/media/02062009_PI-HV_2009_Englisch_Endfassung.pdf.

76. *Krisenbank: BaFin genehmigt HRE-Übernahme* [*BaFin Approves HRE-Acquisition*], SPIEGEL ONLINE (Apr. 17, 2009), http://www.spiegel.de/wirtschaft/0,1518,619498,00.html.

77. FMStBG § 7, para. 2, as amended by FMStErgG art. 2, no. 4 (Ger.).

was lowered to the minimum permitted by European law.[78] The new section 12, paragraph 4 of the Financial Market Stabilization Acceleration Act enabled a majority shareholder to squeeze out minority shareholders more easily by lowering the threshold from the requirement of a 95% shareholding to 90%. Also on April 9, 2009 the Rescue Take Over Act[79] entered into force and provided the government with a default option. If all other measures fail, the shareholders of a financial sector company can be expropriated. The law was directly aimed at the Hypo Real Estate situation[80] and consequently contains a sunset clause, which—with the act itself still being law—prohibits the initiation of expropriation procedures after June 30, 2009.[81]

The corporate law measures were sufficient, though. In a special general meeting a substantial increase in capital was decided with the new shares being exclusively allocated to the Financial Market Stabilization Fund,[82] which, having passed the 90% shareholding threshold, then squeezed out the remaining shareholders.[83]

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78. *See* FMStBG § 7, para. 3 (stating that the majority necessary for a decision to exclude shareholder's preemptive rights is two-thirds of the votes of a simple majority if half of the share capital is represented); *see also* Second Council Directive, *supra* note 38, art. 40 (now Directive 2012/30, *supra* note 38, art. 44) (stating that an exclusion of preemptive rights requires a majority of two-thirds with a simple majority being sufficient, if 50% of the subscribed capital is represented). An exclusion of the shareholders' preemptive rights was necessary in order to prevent existing HRE shareholders from participating in the capital increase. *See* Thomas Böckenförde, *Die getarnte Enteignung* [*Expropriation in Disguise*], 62 N.J.W. 2484, 2486 (2009) (stating that the thresholds of stock market and capital market instruments were lowered to the minimum requirements under European Law. Exclusion of the shareholder's preemptive rights and capital decrease do not require a three-quarter majority of the capital represented any more, a two-third majority or a simple majority if half of the capital is represented suffices.); *see also* Finanzausschuss Wortprotokoll 120. Sitzung [120th Meeting of the Finance Committee] (citing Jochen Sanio speaking simply of a takeover of the HRE by capital increase).

79. *Gesetz zur Rettung von Unternehmen zur Stabilisierung des Finanzmarktes (Rettungsüber nahmegesetz—RettungsG)* [*Act on the Rescue of Enterprises to Stabilize the Financial Market—Rescue Takeover Act*] (Apr. 7, 2009), BGBL. I at 725, as amended (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/rettungsg/gesamt.pdf, *translated at* http://www.bundesfinanzministerium.de/Content/DE/Publikationen/Aktuelle_Gesetze/Gesetze_Verordnungen/Rettungsuebernahmegesetz_engl_anl.pdf?__blob=publicationFile&v=2 (providing a translation for information purposes only).

80. Finanzausschuss (7. Ausschuss) des Deutschen Bundestages [Financial Committee of the German Parliament], BTDrucks 16/12343, at 3 (2009), *available at* http://dipbt.bundestag.de/dip21/btd/16/123/1612343.pdf; Noack, *Das Aktienrecht der Krise*, *supra* note 52, at 228; *Finanzkrise: Steinbrück wirbt für Rettungsübernahmegesetz* [*Financial Crisis: Steinbrück Promotes Act on the Rescue of Enterprises to Stabilize the Financial Market*], DER TAGESSPIEGEL ONLINE (Mar. 6, 2009), http://www.tagesspiegel.de/politik/deutschland/finanzkrise-steinbrueck-wirbt-fuer-rettungsuebernahmegesetz/1467454.html; *Steinbrück warnt vor weiteren Schockwellen auf dem Finanzmarkt* [*Steinbrück Warns Against More Shock Waves on the Financial Market*], SPIEGEL ONLINE (Mar. 6, 2009), http://www.spiegel.de/politik/deutschland/0,1518,611681,00.html; *Nur eine Lex Hypo Real Estate?* [*Just a Lex Hypo Real Estate?*], HANDELSBLATT ONLINE (Feb. 18, 2009), http://www.handelsblatt.com/politik/deutschland/kabinett-verabschiedet-rettungsuebernahmegesetz-nur-eine-lex-hypo-real-estate/3114492.html.

81. *See* Michael J. J. Brück, et al., *Das 1. Finanzmarktstabilisierungsergänzungsgesetz: Lex Hypo Real Estate oder doch mehr?* [*The First Financial Market Stabilization Supplementary Act: Lex Hypo Real Estate or More?*], 2009 B.B. 1306, 1313 (containing a clause that prohibits the initiation of expropriation procedures after June 30, 2009).

82. *See* Press Release, Hypo Real Estate Group, *supra* note 75 ("The German Financial Market Stabilization Fund . . . was admitted as the sole underwriter of the new shares to be issued within the scope of the capital increase.").

83. *Cf., e.g.*, *"Squeeze out" gebilligt: Frühere HRE-Aktionäre scheitern mit Klage [Squeeze Out*

4. Silent Partnership

Section 15 of the Acceleration Act facilitates the provision of capital to a company through a silent partnership. Under normal company law, a silent partnership concluded with a company constitutes an "inter-company agreement."[84] Such an inter-company agreement requires the consent of the general meeting with a three-fourths majority[85] and triggers the special provisions of the German law on groups of companies, which provide certain safeguards, especially for minority shareholders and creditors.[86] Section 15, paragraph 1 of the Acceleration Act now explicitly states that "an arrangement regarding the provision of an asset contribution by the Fund as silent partner in a financial-sector enterprise shall not represent an inter-company agreement." In the next sentence the most important consequence is spelled out explicitly: "In particular, it [i.e., the arrangement] shall not require the consent of the general meeting or entry in the commercial register." Thus, capital can be provided quickly without the otherwise necessary three-fourths majority in the general meeting and without registration.

Later amendments provided for the possibility of converting the silent partner's (i.e., the Fund's) stake into shares without the shareholders' right of preemption.[87] The exclusion of the shareholders' right of preemption triggers, however, the European law requirement of a decision by the general meeting.[88] Yet, the conditions under which the shareholders' right of preemption can be excluded are reduced to the minimum conditions imposed by European law.[89] While the consent of the general meeting is still needed, the majority necessary for a decision is lowered to a majority of two-thirds with a simple majority being sufficient, if 50% of the subscribed capital is represented.[90]

Approved: Former HRE-Shareholders' Suit Fails], FAZ.NET (Jan. 20, 2011), http://www.faz.net/aktuell/wirtschaft/squeeze-out-gebilligt-fruehere-hre-aktionaere-scheitern-mit-klage-1572256.html. Several HRE shareholders challenged the constitutionality of section 7, paragraph 3 of FMStBG, alleging an infringement of their property rights (Article 14 of the federal Constitution (Grundgesetz für die Bundesrepublik Deutschland)). Yet, their case was dismissed by a Munich court, Landgericht München I [LG München I] [District Court Munich I], 2012 A.G. 423, 424–25 (Ger.) (stating that section 7, paragraph 3 of the FMStBG did not amount to an expropriation).

84. Any silent partnership triggers the silent partner's participation in profit and thus constitutes an inter-company agreement. AktG § 292, para. 1, no. 2; HANDELSGESETZBUCH [HGB] [COMMERCIAL CODE], May 10, 1897, REICHSGESETZBLATT [RGBL] 219, as amended, § 231, para. 2 (Ger.); Volker Emmerich, *in* AKTIEN- UND GMBH-KONZERNRECHT [LAW OF GROUPS OF COMPANIES], § 292 AktG, para. 29 (Volker Emmerich & Mathias Habersack eds., 6th ed. 2010) (Ger.).

85. *See* AktG, § 292, 293, para. 1 (stating that an inter-company agreement requires the consent of the general meeting with a three-fourths majority).

86. *See generally* GERHARD WIRTH, ET AL., CORPORATE LAW IN GERMANY 207–18 (2d ed. 2010) (commenting on the German law on groups of companies); Ulrich Immenga, *Company Systems and Affiliation, in* XIII INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, PART 2, ch. 7, especially at 7-25 to -29 (Alfred Conrad & Detlev Vagts eds., 1985) (discussing the German law on groups of companies).

87. FMStBG, § 15, para. 2.

88. Second Council Directive, *supra* note 38, art. 29, para. 4 (now Directive 2012/30, *supra* note 38, art. 33, para. 4).

89. *Id.* art. 40.

90. *Id.*; FMStBG, § 15, para. 2.

5. Good Governance Requirements

Section 7, paragraph 3, number 1 of the Acceleration Act empowers the Federal Government to enact an ordinance requiring the Fund to demand consideration for the state aid and to impose good governance requirements on the company accepting the help. Thus, section 5 of this ordinance[91] requires the Fund to impose requirements that ensure a sustainable and prudential business policy. Companies accepting help must, e.g., provide loans to small and medium sized enterprises at reasonable market rates, evaluate their remuneration system, abolish incentives that lead to excessive risk taking, limit board remuneration to not more than €500,000 per year, and refrain from paying voluntary bonuses or dividends.[92] Also, the Fund should require board members to sign an undertaking promising to adhere to the requirements.[93] Finally, the Fund is required to impose conditions designed to avoid a distortion of competition.[94] These good governance requirements proved to be a strong incentive for the companies accepting help to pay back the state aid as soon as possible.[95]

C. Securities Law

During the subprime crisis of 2008 there was not much legislative activity in the securities law area. The German Federal Financial Supervisory Authority,[96] however, issued a series of general decrees prohibiting the short selling of certain financial instruments:[97] Market actors were increasingly contracting for the sale of

91. Finanzmarktstabilisierungsfonds-Verordnung [FMStFV] [Financial Markets Stabilization Fund Ordinance], Oct. 20, 2008, Elektronischer Bundesanzeiger [eBAnz.] AT 123 2008 V1, § 5 (Ger.).

92. FMStFV, § 5, para. 2. *But see* Marius E. Mann, *Das Finanzmarktstabilisierungsgesetz: Eine kritische Analyse* [*The Financial Market Stabilization Act: A Critical Analysis*], 18 D.Z.W.I.R. 496, 500 (2008) (Ger.) ("eine recht willkürliche und starre Vorgabe" ["a random and rigid limit"]); Wolfgang Ewer & Alexander Behnsen, *Der Finanzmarktstabilisierungsfonds—Herzschrittmacher bei drohendem Kollaps der Finanzmärkte* [*The Financial Market Stabilization Fund—Pacemaker to Prevent the Collapse of Financial Markets*], 61 N.J.W. 3457, 3460 (2008); Roitzsch & Wächter, *supra* note 50, at 6.

93. FMStFV, § 5, para. 7; Roitzsch & Wächter, *supra* note 50, at 7; Manfred Obermüller, *in* INSOLVENZRECHTS-HANDBUCH [HANDBOOK FOR INSOLVENCY LAW] § 103, para. 123 (Peter Gottwald ed., 4th ed. 2010); Klaus Cannivé, *Der Staat als Aktionär—Zu Möglichkeiten und Grenzen der gesellschaftsrechtlichen Steuerung im gemischt-wirtschaftlichen Unternehmen* [*The State as Shareholder—Possibilities and Limitations of Corporate Control in Mixed Enterprises*], 12 N.Z.G. 445, 447–48 (2009).

94. FMStFV, *supra* note 91, § 5, para. 5; Matthias Horbach, et al., *in* FINANZMARKT STABILISIERUNGSGESETZ [COMMENTARY ON THE FINANCIAL MARKET STABILIZATION ACT], *supra* note 49, § 10 FMStFG, paras. 87–89.

95. *Cf.* Presentation for Press Conference, Martin Blessing & Eric Strutz, CEO & CFO of Commerzbank: Fit für eine profitable Zukunft [Commerzbank: Fit for a Profitable Future] (Apr. 6, 2011), at 6 (naming a higher financial and strategic flexibility as an advantage of paying back the silent partnership contributions of the Fund), *available at* https://www.commerzbank.de/media/aktionaere/vortrag/2011/110604_Kapitalerhoehung_de_2.pdf. *See also* Harald Freiberger, *Merkels Pudel ist von der Leine* [*Merkel's Poodle Is Off the Leash*], SÜDDEUTSCHE ZEITUNG (Apr. 7, 2011), at 17 (citing Martin Blessing, CEO of Commerzbank: "Mein Verständnis ist, dass, wenn wir im Juni die Rückzahlung geleistet haben, die Gehaltsdeckelung aufgehoben ist." ["I understand that the salary limit will end after the payback."]).

96. Bundesanstalt für Finanzdienstleistungsaufsicht [BaFin] [Federal Financial Supervisory Authority], BaFin - Startseite, http://www.bafin.de (last visited June 26, 2012).

97. Allgemeinverfügung der BaFin vom 19. Sept. 2008 (ausgelaufen mit Ablauf 31.01.2010) [General Decree of BaFin on Short Selling, Sept. 19, 2008, expired Jan. 31, 2010] (Ger.), unofficial English

shares they did not own. In order to fulfill their contracts they had to buy the shares themselves after the conclusion of their own contract which is profitable for them if prices for the shares fall between the conclusion of their contract for sale and them buying the shares themselves. Effectively, they were betting on falling stock prices. In order to prevent a further downward spiral, to avoid excessive volatility, and to support similar prohibitions in the United States and the United Kingdom, short selling of certain bank and insurance shares was prohibited.[98] The legality of this prohibition was questioned since the regulator lacked specific authority to prohibit short selling and acted on its general authority to "counteract undesirable developments which may [. . .] result in serious disadvantages for the financial market."[99] The decrees were revoked because they were superseded by section 30h of the German Securities Trading Act[100] which generally banned naked short selling in shares and in debt securities issued by public bodies of E.U. Member States whose currency is the euro. This ensured that the short seller has to own or to have made legally binding arrangements for procuring the shares sold short on the day of the sale. This obligation counteracted the pressure put on the share price by the short sale. Additionally, section 30j of the German Securities Trading Act prohibited uncovered credit default swaps and section 30i of the German Securities Trading Act introduced a notification and disclosure requirement for net short positions. Similar provisions have been discussed and in the meantime enacted[101] at the E.U. level. As of the date of their entry into force (November 1, 2012), the German provisions became inapplicable and were therefore repealed by the German legislator.[102]

D. *Accounting Law*

Accounting issues can only be briefly touched upon. During the crisis the International Accounting Standards Board (IASB) changed its International Accounting Standard (IAS) 39 and enabled reporting entities to reclassify financial

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translation *available at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Verfuegung/vf_080919_leerverk_en.html?nn=282139; *see* Allgemeinverfügung der BaFin vom 21. Sept. 2008 (ausgelaufen mit 31.01.2010) [General Decree of BaFin on Short Selling, Sept. 21, 2008, expired Jan. 31, 2010] (Ger.) (further supplementing the aforementioned decree and extended by a series of general decrees until January 31, 2010), English translation *available at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Verfuegung/vf_080921_leerverk_en.html?nn=282139 (providing a translation for information purposes only). For an overview of all decrees, see Verena Ludewig, *in* AKTIENRECHT UND KAPITALMARKTRECHT [CORPORATE LAW AND CAPITAL MARKET LAW] at WpHG vor § 30h bis 30j, paras. 2–6 (Thomas Heidel ed., 3d ed. 2011).

98. SINN, *supra* note 4, at 305–06.

99. Wertpapierhandelsgesetz [WpHG] [Securities Trading Act], Sept. 9, 1998, BGBL. I at 2708, as amended, § 4, para. 1 (Ger.), *available at* http://www.gesetze-im-internet.de/wphg/, English translation *available at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html?nn=2821360 (providing a translation for information purposes only).

100. Allgemeinverfügung der Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) zum Widerruf der Allgemeinverfügungen zum Verbot ungedeckter Leerverkäufe in bestimmten Aktien und Schuldtiteln sowie ungedeckter CDS vom 26. Juli 2010 [General Decree of July 26, 2010 by the Federal Financial Supervisory Authority (BaFin) Revoking the General Decrees Banning Naked Short Selling Transactions in Shares and Debt Securities as well as Naked Credit Default Swaps] (Ger.), English translation *available at* http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Verfuegung/vf_100726_leerverkauf_widerruf_en.html?nn=2821396 (providing a translation for information purposes only).

101. *See infra* notes 168–171 and accompanying text.

102. *See infra* note 172 and accompanying text.

assets.[103] The European Commission had pressed hard for this change[104] and, by endorsement,[105] quickly incorporated it into E.U. law. Reclassification of financial assets, e.g., from the category "at fair value through profit or loss" to "held to maturity," enables the reporting entity to switch from a fair value valuation of assets to a valuation based on historic costs, which means that in a volatile market falling prices do not necessarily force the reporting entity to depreciate its assets and recognize a loss.[106] Thus, the possibility of reclassification was introduced in order to stop a pro-cyclical downward spiral[107] with market participants recognizing losses because of the losses of other market participants, which in turn have to recognize further losses. This measure was all the more necessary since the asset valuation at fair value had led—in good times—to significant unrealized profits and inflated values which in bad times made the fall significantly deeper.[108] Losses due to fair value valuation of assets had to be stopped because banks were in danger of failing to meet regulatory capital requirements, which would have subjected them to

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103. INT'L ACCOUNTING STANDARDS BD., RECLASSIFICATION OF FINANCIAL ASSETS: AMENDMENTS TO IAS 39 AND IFRS 7 at 4–6 (Oct. 2008) (U.K.), *available at* http://www.ifrs.org/News/Press-Releases/Documents/AmdmentsIAS39andIFRS7.pdf.

104. *See, e.g.*, Hartmut Bieg, et al., *Die Saarbrücker Initiative gegen den Fair Value* [*Saarbrücken Initiative Against Fair Value*], 61 D.B. 2549, 2551 (2008) (discussing the European Commission's adoption of the new concept of fair-value); Thomas Schildbach, *Was bringt die Lockerung der IFRS für Finanzinstrumente?* [*What Is the Advantage of Relaxed IFRS for Financial Instruments?*], 2008 D. ST. R. 2381, 2383 (discussing reclassification reform during the financial crisis).

105. Commission Regulation 1004/2008, of 15 October 2008 Amending Regulation (EC) No. 1725/2003 Adopting Certain International Accounting Standards in Accordance with Regulation (EC) No. 1606/2002 of the European Parliament and of the Council as Regards International Accounting Standard (IAS) 39 and International Financial Reporting Standard (IFRS) 7, 2008 O.J. (L 275) 37 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:275:0037:0041:EN:PDF; *see* Regulation 1606/2002, of the European Parliament and of the Council of 19 July 2002 On the Application of International Accounting Standards, 2002 O.J. (L 243) 1 (EC), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2002R1606:20080410:EN:PDF (governing the adoption of IAS).

106. Renate Hecker & Christian Klein-Wiele, *Echte und vermeintliche Wirkungen der Nacht- und Nebel-Aktion des IASB* [*Real and Imaginary Effects of the IASB's Cloak-and-Dagger Operation*], 2011 DIE WIRTSCHAFSPRÜFUNG [W. PG.] 151; *see* Burkhard Eckes & Wolfgang Weigel, *Zusätzliche Möglichkeiten der Umkategorisierung von finanziellen Vermögenswerten* [Additional Options of Reclassification of Financial Assets], 4 ZEITSCHRIFT FÜR INTERNATIONALE RECHNUNGSLEGUNG [I.R.Z.] 373 (2009) (Ger.) (stating that the reclassification of financial assets can lead to a switch of the valuation method from fair-value to one based on historic costs); Karl Petersen & Christian Zwirner, *Auswirkungen der aktuellen Änderungen in IAS 39* [*Effects of the Recent Changes in IAS 39*], 4 I.R.Z. 65, 68 (2009) (stating that the switch of the valuation method enables single companies to avoid depreciations that otherwise would have lead to a depletion of their capital); Schildbach, *supra* note 104, at 2384–85 (discussing how new classification methods will have different indirect consequences).

107. *See* SINN, *supra* note 4, at 87–89, 160–65 (discussing the fair value principle and fair value method); Petersen & Zwirner, *supra* note 106, at 67 (stating that the fair value method is considered to have an escalating, procyclic effect); *see also* European Central Bank, *The Impact of Fair Value Accounting on the European Banking Sector—a Financial Stability Perspective,* MONTHLY BULLETIN (Feb. 2004), at 69, 77–78, *available at* http://www.ecb.int/pub/pdf/mobu/mb200402en.pdf ("[Fair Value Accounting] might increase the pro-cyclicality of lending behavior and result in more pronounced economic cycles."); THE DE LAROSIÈRE REPORT, *supra* note 4, paras. 73–79 (discussing the mark-to-market principle and the changes in IAS 39, and making further suggestions).

108. *See* Bieg, et al., *supra* note 104, at 2551 ("In the current financial crisis the IASB has changed its fair-value concept. The EU Commission adopted the changes in unseen speed, after it has obviously exerted considerable influence on the IASB. ").

regulatory measures and sanctions including their closure.[109] In order to avoid this, banks would have had to sell assets which would have put even more pressure on prices.[110] This would have exacerbated the crisis and contributed to an even greater lack of trust in banks. Generally, a return to the more prudential approach to accounting, which focuses on historic costs and prohibits the recognition of unrealized profits, should be seriously considered.[111] Investor information on fair values can easily be provided in the notes to the accounts.

Another accounting change relates to the determination of the fair value. The IASB issued a document providing guidance on how "to measure the fair value of financial instruments when markets are no longer active."[112] The guidance allows for management to rely on "a valuation technique based primarily on management's internal assumptions about future cash flows and appropriately risk-adjusted discount rates."[113] This enabled the reporting entities to escape a fair value valuation based on unrealistic market prices that do not reflect the fair value.[114]

II. SOVEREIGN DEBT CRISIS

The second part of this Article will examine the sovereign debt crisis. The sovereign debt crisis is closely linked to the subprime crisis. Certain measures undertaken by the European Union and the Member States cannot be viewed as relating to a specific crisis. They were developed in the wake of the subprime crisis and finalized during the sovereign debt crisis so that experiences from both crises influenced these measures. Also, the effects of the subprime crisis contributed to some extent to the sovereign debt crises.

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109. *See* Hecker & Klein-Wiele, *supra* note 106, at 151, 158, 160–64 (describing issues with the fair value valuation and providing empirical evidence); Markus Frühauf, *Bilanzregeln für den Notstand* [Emergency Accounting Rules], BÖRSEN-ZEITUNG, Oct. 15, 2008, at 8 (discussing how the guidelines without changes would have caused the banks to fail to meet their regulatory capital requirements thus forcing closure); Petersen & Zwirner, *supra* note 106, at 69–70 (noting that their empirical study comes to the conclusion that due to this accounting change banks avoided a reduction in their equity capital of approximately 3.4 billion euros). For regulatory measures and sanctions against banks, see Gesetz über das Kreditwesen [Kreditwesengesetz - KWG] [German Banking Act], Sept. 9, 1998, BGBL. I at 2776, as amended, §§ 45–48 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/kredwg/gesamt.pdf.

110. *See* Hecker & Klein-Wiele, *supra* note 106, at 158 (recognizing that banks would have had to reduce their risk in order to bring it in line with their reduced capital and to achieve this goal they would have had to sell assets in risk of further depreciation).

111. *See* Bieg, et al., *supra* note 104, at 2551 (discussing accounting in the context of the financial crisis); Schildbach, *supra* note 104, at 2385 (arguing for a return to the more prudential approach). *But see* Hecker & Klein-Wiele, *supra* note 106, at 151–53 (arguing for the benefits of a fair value approach and highlighting the disadvantages of other approaches).

112. Int'l Accounting Standards Bd., *Using Judgment to Measure the Fair Value of Financial Instruments When Markets are No Longer Active, IASB Staff Summary* (Oct. 2008), *available at* http://www.ifrs.org/Current-Projects/IASB-Projects/Fair-Value-Measurement/EAP/Documents/IASB_Staff_Summary_October_2008.pdf [hereinafter *IASB Staff Summary October 2008*]; *see* THE DE LAROSIÈRE REPORT, *supra* note 4, para. 76 (pointing at the problem where assets can no longer be marked-to-market because there is no active market for the assets concerned).

113. *IASB Staff Summary October 2008*, *supra* note 112, para. 14.

114. Schildbach, *supra* note 104, at 2383–84; *see IASB Staff Summary October 2008*, *supra* note 112, paras. 14–16 (describing how management measures fair value).

A. Background

For numerous reasons several Member States of the European Union whose currency is the euro experienced financial difficulties. The euro enabled states with a traditional lack of budgetary discipline to borrow cheaply,[115] which was not conducive to more fiscal discipline. The effects of the subprime crisis also contributed to the financial difficulties, especially since market participants had become less trusting. Portugal, Italy, Ireland, Greece, and Spain, referred to as the PIIGS, came under pressure. Investors demanded high risk premiums which made refinancing more and more difficult for these states. Portugal, Italy, Ireland, Greece, and Spain were running the risk of not being able to refinance their old debt by issuing new bonds which would have led to a "credit event" enabling investors to call on their insurances (CDS—credit default swaps).[116] At the time, this was perceived as a disastrous scenario.[117] It was feared that the banking sector, and with it the whole financial system, could collapse if banks that had heavily invested in these states' bonds became insolvent.[118] Rating agencies correctly began to downgrade the states affected, which led to a downward spiral of higher borrowing costs, higher prices for CDS, and further downgrading.[119] For the states affected there was no quick way out because as members of the euro printing money was no option[120] and insofar as their

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115. Hamish McRae, *How Europe Can Shore Up Its Rescue of the Single Currency*, THE INDEPENDENT (Nov. 18, 2011), http://www.independent.co.uk/news/business/comment/hamish-mcrae/hamish-mcrae-how-europe-can-shore-up-its-rescue-of-the-single-currency-6263977.html. *See generally* Sarah Marsh, *ECBs Trichet: Low Inflation for 10 Years—Paper*, REUTERS (Oct. 30, 2011), http://in.reuters.com/article/2011/10/30/idINIndia-60196720111030 (discussing low inflation in the euro area).

116. *See* Patrick Bernau, *Die Macht der Griechen* [*Greek Leverage*], FRANKFURTER ALLGEMEINE SONNTAGSZEITUNG, Feb. 26, 2012, at 45 (describing how Greece and the rest of the euro area tried to circumvent a credit event). *See generally* Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution,* 2011 COLUM. BUS. L. REV. 118 (examining CDS); David M. Lindley & Edward Flanders, *Know your Exposure,* 29 INT'L FIN. L. REV. 31 (2010) (reviewing the situation in Greece and CDS).

117. On March 9, 2012, the EMEA Credit Derivatives Determination Committee resolved that a restructuring event occurred in respect of the Hellenic Republic. The markets, however, showed little reaction. Int'l Swaps and Derivatives Ass'n [ISDA], *The Hellenic Republic—Credit Event* (Mar. 9, 2012), http://www.isda.org/companies/HellenicRepublicCDS/HellenicRepublicCDS.html; Daniel Bases, *ISDA Declared Greek Credit Event, CDS Payments Triggered*, REUTERS, (Mar. 9, 2012), http://www.reuters.com/article/2012/03/09/us-greece-cds-isda-trigger-idUSBRE82817B20120309; *see also* Damian Kahya, *Why Has the Greek Default Failed to Spark Panic*, BBC NEWS (Mar. 13, 2012), http://www.bbc.co.uk/news/business-17341381 (describing the occurrence of the Greek credit event and its negative impact). It is unclear whether this shows that the previous fears of a disastrous scenario were unfounded. It is just as possible that the states and the banks were able to provide for the credit event and thus avoid a disastrous scenario.

118. *See* Daniel Pimlott, *Trichet Signals Hostility to Greek Credit Event*, FIN. TIMES (June 13, 2011), http://www.ft.com/cms/s/0/ad4dad7e-95d4-11e0-ba20-00144feab49a.html#axzz1pB21LeAl (citing the former head of the European Central Bank, Jean-Claude Trichet, in a speech at the London School of Economics on June 12, 2011: "Avoid whatever would trigger a credit event, avoid whatever would trigger a selective default or a default. . . . This is our message to governments.").

119. *See Credit Ratings: How Fitch, Moody's and S&P Rate Each Country*, THE GUARDIAN DATA BLOG (Apr. 30, 2010), http://www.guardian.co.uk/news/datablog/2010/apr/30/credit-ratings-country-fitch-moodys-standard#data (showing credit ratings of Fitch, Moody's, and Standard & Poor's of February 2011, with, e.g., Greece rated as Ca by Moody's, CCC by Fitch, and SD by Standard & Poor's).

120. Euros are only issued subject to the approval of the European Central Bank (ECB). TFEU, *supra* note 14, arts. 3, 128.

debt was denominated in euros, leaving the euro and reintroducing a national currency would not necessarily help either.[121]

B. *Political, Primary, and Constitutional Law Issues*

The E.U. governments were therefore faced with a difficult situation. The insolvency of a member of the euro area was considered too dangerous for the financial system and the monetary union as a whole. Thus, a credit event, i.e., a state defaulting and its creditors calling on their CDS, had to be avoided at all costs. The sovereign debt crisis is therefore chiefly dealt with by financial aid, which has been institutionalized in the transitional European Financial Stability Facility (EFSF)[122] and the permanent European Stability Mechanism (ESM).[123] The interventions by the European Central Bank (ECB) are another key factor.[124] The legality of these measures is, however, highly questionable.[125]

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121. *See* Wolfgang Ernst, *Privatrechtliche Folgen eines Ausscheidens einzelner Staaten aus der Euro-Währung [Consequences Under Private Law of Single States Leaving the Euro-Currency]*, 2012 Z.I.P. 49 (arguing that while there is the legal possibility of leaving the euro by leaving the European Union or by amending the E.U. treaties, this would in a practical sense take too long for being effective); Christoph Herrmann, *Griechische Tragödie—der währungsverfassungsrechtliche Rahmen für die Rettung, den Austritt oder den Ausschluss von überschuldeten Staaten aus der Eurozone [Greek Tragedy—The Monetary and Constitutional Frame for the Rescue of Indebted States and Their Withdrawal or Exclusion from the Euro-Zone]*, 21 EU. Z.W. 413, 416–18 (2010) (discussing the grave potential consequences of abandoning the euro area); Econ. Intelligence Unit [EIU], *State of the Union: Can the Euro Zone Survive Its Debt Crisis,* EIU Special Report, at 18–22 (Mar. 2011), *available at* http://pages.eiu.com/rs/eiu2/images/EuroDebtPaperMarch2011.pdf ("If a peripheral country decided to leave, not only would its debt still be denominated in euros, which would worsen the debt-service problem, but the merest hint that the option was being considered would trigger a run on the country's banking system, as local depositors rushed to transfer their euro-denominated savings to banks in other countries.").

122. *See* Council Regulation 407/2010, of 11 May 2010 Establishing a European Financial Stabilisation Mechanism, 2010 O.J. (L 118) 1 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:01:EN:HTML [hereinafter Regulation 407/2010] ("[T]his Regulation establishes the conditions and procedures under which Union financial assistance may be granted to a Member State which is experiencing, or is seriously threatened with, a severe economic or financial disturbance."); *see also* Klaus Regling, *Aufgaben und Herausforderungen der EFSF [Tasks and Challenges for the EFSF]*, 2011 EUROPÄISCHES WIRTSCHAFTS- UND STEUERRECHT [E.W.S.] 261 (explaining how the ESM is going to take over certain functions that previously belonged to the EFSF after Article 136 TFEU was amended); *About EFSF*, EFSF, http://www.efsf.europa.eu/ about/index.htm (last visited Apr. 10, 2012) ("The EFSF's mandate is to safeguard financial stability in Europe by providing financial assistance to euro area Member States . . . .").

123. *See* Treaty Establishing the European Stability Mechanism, Feb. 2, 2012, T/ESM 2012, *available at* http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf (art. 3: "The purpose of the ESM shall be to mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems . . . ."); *see also* European Council Decision No. 2011/199 of 25 March 2011, 2011 O.J. (L 91) 1, 2, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:091:0001:0002:EN:PDF (creating the legal basis for the T/ESM 2012 within the E.U. legal framework); Eur. Cent. Bank [ECB], *The European Stability Mechanism,* ECB MONTHLY BULLETIN (Jul. 2011), at 71–72, *available at* http://www.ecb.int/pub/pdf/other/art2_mb201107en_pp71-84en.pdf (describing the establishment and function of the ESM); Hanno Kube, *Rechtsfragen der völkervertraglichen Euro-Rettung [Legal Issues Regarding the Euro-Rescue by International Treaties]*, 66 W.M. 245, 245–49 (2012) (discussing legal issues regarding the ESM).

124. *See* ECB, ECB MONTHLY BULLETIN (June 2010), at 24–26, 41, *available at* http://www.ecb.int/pub/pdf/mobu/mb201006en.pdf (discussing the Securities Markets Programme as a tool used by ECB to aid malfunctioning segments of the debt securities market; "[f]ollowing the announcement of [ECB] policy measures, tensions in financial markets declined significantly, but did not completely dissipate"); ECB, ECB MONTHLY BULLETIN (Mar. 2012), at 37–42, *available at* http://www.ecb.int/pub/pdf/mobu/

The ECB is independent[126] and prohibited from financing a state's debt.[127] Even if the purchase of bonds of Member States by the ECB on the secondary market[128] arguably constitutes no "direct purchase" as prohibited in Article 123, paragraph 1 of the TFEU, it nevertheless at least violates the spirit of this provision.[129] The idea of increasing the International Monetary Fund's (IMF) capital by the Member States in order to enable it to grant additional assistance to the Member States in financial difficulty was dropped in favor of a global increase of IMF resources, not least because of concerns regarding a circumvention of Article 125 of the TFEU (and the resistance of the German Bundesbank).[130] Also, Article 125, paragraph 1 of the TFEU contains a strict no-bail-out clause:

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mb201203en.pdf (discussing several ECB measures and their impact); *see also* Peter Sester, *Die Rolle der EZB in der europäischen Staatsschuldenkrise* [*The Role of the ECB in the European Sovereign Debt Crisis*], 2012 E.W.S. 80, 80 (describing the Securities Markets Programme as ECB's direct reaction to the sovereign debt crisis of Greece, Portugal, Ireland, and other countries).

125. *See generally* Phoebus Athanassiou, *Of Past Measures and Future Plans for Europe's Exit from the Sovereign Debt Crisis*, 36 EUR. L. REV. 558 (2011); Kube, *supra* note 123 (discussing especially the ESM); Sester, *supra* note 124 (discussing the legality of EFSF, ESM, and especially the ECB measures); Wolfgang Philipp, *ESM: Was geht hier vor? Das Aktienrecht bringt es an den Tag* [*ESM: What is Going On? Stock Corporation Law Makes It Clear*], 2012 A.G. 587, 590 (referring to the ESM Treaty as violating the German budgetary law).

126. TFEU, *supra* note 14, arts. 130, 282, para. 3, sentence 3, 4.

127. *See id.* art. 123, para. 1 ("Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.").

128. *See* Decision of the European Central Bank 2010/05, Establishing a Securities Markets Programme, 2010 O.J. (L 124) 8 (EU) ("Under the terms of this Decision, Eurosystem central banks may purchase the following: (a) on the secondary market, eligible marketable debt instruments issued by the central governments or public entities of the Member States whose currency is the euro; and (b) on the primary and secondary markets, eligible marketable debt instruments issued by private entities incorporated in the euro area.").

129. *See* Council Regulation 3603/93, of 13 December 1993 Specifying Definitions for the Application of the Prohibitions Referred to in Articles 104 and 104b (1) of the Treaty, 7th Recital, 1993 O.J. (L 332) 1 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:1993:332:0001:0003:EN:PDF (demanding not to circumvent the objective of now-Article 123 of the TFEU by secondary market purchases); Athanassiou, *supra* note 125, at 566–68 (accepting the ECB's purchases on the secondary market as legal and in line with the ECB's role, despite the tensions); Oliver Berg & Kai Carstensen, *Baldige Rückkehr zur alten Rolle erforderlich!* [*Return to Original Role Urgent!*], 92 WIRTSCHAFTSDIENST 79–81 (2012) (seeing the ECB's Securities Markets Programme as a violation of at least the intention of Article 123 of the TFEU and the spirit of the Treaties of Maastricht); Sester, *supra* note 124, at 80 (questioning the legality of the ECB's Securities Markets Programme in the case of a haircut); *see also* Sven Afhüppe, et al., *Interview Jens Weidmann: "Die Regierungen müssen den Euro retten—nicht die Notenbanken"* [*Interview with Jens Weidmann, President of the German Bundesbank: "The Governments Have to Save the Euro—Not the Central Banks"*], HANDELSBLATT ONLINE (Feb. 15, 2012), http://www.handelsblatt.com/politik/konjunktur/geldpolitik/interview-jens-weidmann-die-regierungen-muessen-den-euro-retten-nicht-die-notenbanken/6213846.html (showing general skepticism towards the measures taken and especially seeing a violation of the prohibited financing of state's debts); *Spiegel Interview with Bundesbank President Jens Weidmann, Bundesbank President on ECB Bond Purchases: "Too Close to State Financing Via the Money Press,"* DER SPIEGEL (Aug. 27, 2012), English translation *available at* http://www.spiegel.de/international/europe/spiegel-interview-with-bundesbank-president-jens-weidmann-a-852285.html (expressing critical views of sovereign bonds purchased by the European Central Bank).

130. *Cf. Euro-Krise: Bundesbank-Präsident droht mit Nein für IWF-Kredit* [*Euro Crisis: President of

> The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.[131]

This clause restricts financial assistance both from the European Union and its Member States,[132] thus putting the legality of some measures taken during the sovereign debt crisis in question.[133] There are attempts to justify the financial aid given to Greece and other ailing Member States,[134] and the introduction of Article

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the Bundesbank Threatens with No for IMF Credit], ZEIT ONLINE (Dec. 14, 2012), http://www.zeit.de/wirtschaft/2011-12/bundesbank-kredit-iwf (reporting the Bundesbank President's concern for illegality of increasing the IMF funds only for helping euro Member States and possible circumvention of ban on funding E.U. States).

131. TFEU, *supra* note 14, art. 125, para. 1.

132. Especially in Germany, it is a point of hot debate whether Article 125 of the TFEU includes a complete ban on any financial assistance. For a perspective promoting a ban on any assistance, see Bernhard Kempen, *in* EUV/AEUV [TEU/TFEU], art. 125 AEUV, para. 4 (Rudolf Streinz ed., 2d ed. 2012) (Ger.) (discussing the ban of financial assistance under Article 125); Kurt Faßbender, *Der europäische "Stabilisierungsmechanismus" im Lichte von Unionsrecht und deutschem Verfassungsrecht* [*The European Stabilisation Mechanism in Light of European and German Constitutional Law*], 29 NEUE ZEITSCHRIFT FÜR VERWALTUNGSRECHT [N. VW. Z.] 799, 800 (2010) (arguing that the no-bail-out clause bans any financial assistance); Walter Frenz & Christian Ehlenz, *Der Euro ist gefährdet: Hilfsmöglichkeiten bei drohendem Staatsbankrott?* [*The Euro in Danger: Possibilities to Help in Case of Imminent Sovereign Default?*], 2010 E.W.S. 65, 67 (discussing the ban on financial assistance); Martin Seidel, *Die "No-Bail-Out"-Klausel des Art. 125 AEUV als Beistandsverbot* [*The No-Bail-Out-Clause of Art. 125 of TFEU as Prohibition of Assistance*], 22 EU. Z.W. 529 (2011) (arguing that the financial assistance ban is not a "disclaimer" but a strict prohibition). *But see* Rüdiger Bandilla, *in* DAS RECHT DER EUROPÄISCHEN UNION [EUROPEAN UNION LAW], art. 125 AEUV, paras. 10–13 (Eberhard Grabitz, et al. eds.) (last updated Oct. 2011) (arguing that Article 125 contains no absolute prohibition of financial assistance to Member States and recognizing that there may be situations in which E.U. financial assistance for Member States may be appropriate); Athanassiou, *supra* note 125, at 561–65 ("On a literal interpretation of the no-bailout clause, the mere financing by the Union of a Member State's liabilities, through bilateral loans (or credit lines), lies outside its ambit."); Herrmann, *supra* note 121, at 415–16 (arguing that Article 125 contains no ban on voluntary mutual assistance between Member States); Sester, *supra* note 124, at 86 n.49 (arguing that Article 125 cannot be interpreted as a prohibition of financial assistance for Member States themselves).

133. *See* Philipp, *supra* note 2, at 698 (discussing the ESM and the financial crisis); Sester, *supra* note 124, at 86 (describing tensions between the ESM and the no-bail-out clause); *see also* Ulrich Häde, *Haushaltsdisziplin und Solidarität im Zeichen der Finanzkrise* [*Budgetary Discipline and Solidarity in the Financial Crisis*], 20 EU. Z.W. 399, 401 (2009) (discussing some primary E.U. law mechanisms for financial assistance and their legal limits in regard of bail-outs).

134. *See, e.g.*, Athanassiou, *supra* note 125, at 562–65 (discussing the legal basis for bail-outs); Bandilla, *supra* note 132, art. 125 TFEU, paras. 20–32 (arguing there may be situations in which E.U. financial assistance for Member States may be appropriate). *Cf.* Regulation 407/2010, *supra* note 122, 1st Recital (basing the financial support on Article 122, paragraph 2 of the TFEU). *See also* Press Release, Council of the European Union, Extraordinary Council meeting Economic and Financial Affairs, 9596/10 (Presse 108) (May 9–10, 2010), at 6–7 (EU), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf (basing the financial support on Article 122, paragraph 2 of the TFEU); Häde, *supra* note 133, at 401–03 (discussing some, albeit limited possibilities to justify financial assistance in the financial crisis).

136, paragraph 3 to the TFEU[135] will at least secure the legality (in E.U. law) of the institutionalized (bail-out)[136] instrument ESM for the future, as of January 1, 2013.[137] Yet, regardless of how convincing or unconvincing these attempts at legal justification are, they certainly did not manage to convince the German public as to the legitimacy of the bail-out.[138] With Germany having to bear the brunt of the bail-out, the German government was put into a very difficult position.

Germany's condition for agreeing to enter the euro was a strict commitment to price stability,[139] independence of the ECB,[140] a no-bail-out clause,[141] and fiscal discipline.[142] Despite these safeguards, the Germans, who are still traumatized by two drastic currency changes in the twentieth century[143] and were therefore very reluctant to give up their Deutsche Mark,[144] were now told that Germany would have to help bail-out Member States that had lacked in fiscal discipline. The German public was asked to accept that the very Treaty provisions that had been promised to them in exchange for giving up their Deutsche Mark were violated. A situation occurred that every politician in Germany had sworn would never occur.

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135. European Council Decision 2011/199, 2011 O.J. (L 91) 1 (EU).

136. *See* Philipp, *supra* note 2, at 697 (explaining the role of the then planned ESM); Sester, *supra* note 124, at 88 (explaining that the ESM instrument is there to apply a bail-out regime).

137. *See* Kube, *supra* note 123, at 246 (discussing bail-out mechanisms); Matthias Ruffert, *Die europäische Schuldenkrise vor dem Bundesverfassungsgericht* [*European Sovereign Debt Crisis Before the Federal Constitutional Court*], 46 EUROPARECHT [EU. R.] 842, 852 (2011) (stating that the future TFEU Article 136 Paragraph 3 legalizes the breach of TFEU Article 125 (1) and therefore ESM should not infringe any principle of E.U. law); Sester, *supra* note 124, at 88 (arguing that Article 136 of TFEU gives a legal basis to the bail-out regime, thus ensuring conformity with E.U. law, although the ESM is not part of primary E.U. law).

138. *See, e.g.*, *ZDF-Politbarometer Juni 2011* [ZDF Politbarometer June 2011], NA PRESSEPORTAL (July 15, 2011), http://www.presseportal.de/pm/7840/2079550/zdf-politbarometer-juli-2011-mehr-menschen-denn-je-fuerchten-um-die-stabilitaet-des-euro-deutliche?search=umfrage (referring to a survey in June 2011, showing a majority of the German population disapprove of further financial aid for Greece ("Mehrheit gegen weitere Finanzhilfen für Griechenland")).

139. TFEU, *supra* note 14, art. 127, para. 1, sentence 1 & art. 282, para. 2, sentence 2.

140. *Id.* art. 130, 282, para. 3, sentences 3, 4.

141. *Id.* art. 125.

142. *Id.* art. 126; BVerfG October 12, 1993, 89 BVerfGE 155, 204–05 (Ger.); *see, e.g.*, Kenneth Dyson, *Germany and the Euro, in* EUROPEAN STATES AND THE EURO 173, 176–79 (Kenneth Dyson ed., 2002) (describing how the German theory of ordo-liberalism shaped the construction of the euro especially with regard to stability mechanisms); Featherstone, *supra* note 2, at 202 ("The insistence on there being no 'bail-out' of states with excessive deficits was fundamental to the German negotiators at Maastricht and had been accepted quite readily by its partners as a fait accompli.").

143. *See* Horst Kratzmann, *Der Staatsbankrott* [*Sovereign Default*], 37 JURISTENZEITUNG [J.Z.] 319, 320–21 (1982) (describing the currency changes after the hyperinflation of 1923 and World War II); *See, e.g.*, Dyson, *supra* note 142, at 176–79, 185–87 (describing the importance of the Deutsche Mark for German identity before the euro); *see also Umfrage: Jeder Dritte Deutsche will die D-Mark zurück* [*Survey: One Third of Germans Want the D-Mark Back*], SPIEGEL ONLINE (May 2, 2008), http://www.spiegel.de/wirtschaft/umfrage-jeder-dritte-deutsche-will-die-d-mark-zurueck-a-550989.html (stating that for many people, the Deutsche Mark is a symbol of the economic boom of the postwar period and the stable currency par excellence).

144. *See, e.g.*, Dyson, *supra* note 142, at 176–79, 185–87 (describing the importance of the Deutsche Mark for German identity before the euro); *see also Umfrage: Jeder Dritte Deutsche will die D-Mark zurück* [*Survey: One Third of Germans Want the D-Mark Back*], SPIEGEL ONLINE (May 2, 2008), http://www.spiegel.de/wirtschaft/umfrage-jeder-dritte-deutsche-will-die-d-mark-zurueck-a-550989.html (stating that for many people, the Deutsche Mark is a symbol of the economic boom of the postwar period and the stable currency par excellence).

This put the German government in a very difficult position, especially since earlier decisions by the German Constitutional Court underlined the importance of the Treaty provisions ensuring monetary stability, including the no-bail-out clause. These decisions made clear that the budgetary autonomy of the German Parliament did not allow Germany to enter into an unlimited and uncontrollable liability for other states and even indicated both the possibility and the obligation to leave the euro if the stability of the currency was to fail or parliament could lose its budgetary autonomy.[145] This could be understood as prohibiting any assistance to the states in difficulty and as possibly forcing Germany to leave the euro or the European Union if the Treaty provisions were not respected. On the other hand, the European Union and the euro have always been seen in Germany as a guarantee for peace and prosperity.[146] The government was therefore determined to save the euro against public opinion and try at the same time to assure the German public that the euro was stable and that the law was abided by. The public was told that the financial aid given did not constitute a bail-out since Greece had to pay market interest rates,[147] which was, of course, nonsense. Greece would not have had any credit on the market. The German Supreme Court accepted the financial aid as constitutional and did not consider the further complaint that the aid was given in breach of the Treaty.[148] The German discussion now revolves less around the legality of financial aid, but rather around the German Parliament's budget competence.[149] Members of

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145. *See* BVerfG Oct. 12, 1993, 89 BVerfGE 155, 204–05 (Ger.) (discussing how the development of the Monetary Union is foreseeable and can therefore be subject to parliamentary responsibility); BVerfG Sept. 7, 2011, 64 N.J.W. 2946 (2011), para. 129 (Ger.) (referring to this decision in the context of the crisis).

146. *See, e.g.*, Angela Merkel, German Chancellor, *Regierungserklärung* [*Government Statement*] (May 11, 2006), http://archiv.bundesregierung.de/Content/DE/Archiv16/Regierungserklaerung/2006/05/2006-05-11-regierungserklaerung-von-bundeskanzlerin-angela-merkel.html?nn=273396 (praising the peace and economic gain fostered by the European Union); Angela Merkel, German Chancellor, *Rede zur Bilanz der deutschen EU-Ratspräsidentschaft vor dem Europäischen Parlament* [*Address to the European Parliament Concerning the EU Presidency*], *in* BULLETIN DER BUNDESREGIERUNG Nr. 71-3 [FEDERAL GOVERNMENT BULLETIN No. 71-3] (June 29, 2007), *available at* http://www.bundesregierung.de/Content/DE/Bulletin/2001_2007/2007/06/Anlagen/71-3-bk.pdf?__blob=publicationFile&v=1 (praising European unity over the past fifty years, and particularly the rise of peace and freedom, democracy, and the rule of law).

147. *See* Statement by the Heads of State and Government of the Euro Area 1 (Mar. 25, 2010), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf (stating that interest rates will not contain any subsidy element); Press Release, Council of the European Union, Extraordinary Council Meeting Economic and Financial Affairs 6, *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf (referring to the rules of IMF); Bandilla, *supra* note 132, art. 125 AEUV, para. 26 (stating that the interest rates are oriented towards market conditions); *see also infra* note 299 and accompanying text.

148. BVerfG Sept. 7, 2011, 64 N.J.W. 2946 (2008) (Ger.); Press Release, Bundesverfassungsgericht Pressestelle [Federal Constitutional Court Press Office], Verfassungsbeschwerden gegen Maßnahmen zur Griechenland-Hilfe und zum Euro-Rettungsschirm erfolglos—Keine Verletzung der Haushaltsautonomie des Bundestages [Constitutional Complaints Lodged Against Aid Measures for Greece and Against the Euro Rescue Package Unsuccessful—No Violation of the Bundestag's Budget Autonomy] (Sept. 7, 2011), *available at* http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg11-055.html, *translated at* http://www.bundesverfassungsgericht.de/en/press/bvg11-055en.html.

149. *See, e.g.*, Christian Calliess, *Der Kampf um den Euro* [*The Euro Battle*], 31 N. VW. Z. 1, 4–7 (2012) (discussing the constitutional issues surrounding the Parlimentary budget decisions and the EFSF/ESM); Philipp, *supra* note 2, at 700–01 (stating that the German commitment to the ESM will bind the Parliament for years and infringe budgetary autonomy); Ruffert, *supra* note 137, at 847–54 (discussion the budgetary right of the Parliament according to the judgment as reserved domain (even against European Integration), but with little judicial control); *see also* Europa Braucht Mehr Demokratie [Europe Needs More Democracy], http://www.verfassungsbeschwerde.eu/home.html (homepage of an

the German Parliament were reluctant to hand over full control of financial aid packages (and thus of the tremendous budgetary risks involved) to the government.[150] In this, they were supported by the German Constitutional Court, which—while declaring the first aid package constitutional[151]—nevertheless stated that creating a mechanism that can lead to incalculable burdens on the budget without a mandatory approval by the parliament would thus infringe the parliament's budgetary rights, the principle of democracy laid down in the German federal constitution, and therefore the individual right to vote.[152] The Court also found a legal provision to be unconstitutional that placed the authority to approve government aid packages with a very small committee.[153] Furthermore, the Court considered the degree of involvement of the German Parliament in the European Council negotiations of the ESM and of other initiatives in 2011 as insufficient and unconstitutional.[154]

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initiative including former German Federal Minister of Justice Herta Däubler-Gmelin lodging a constitutional complaint against ESM); Press Release, Pringle Issues Legal Proceedings Against the Gov on ESM Treaty (Apr. 17, 2012), *available at* http://www.thomaspringle.ie/?p=693 (announcing legal proceedings initiated by Irish Member of Parliament Thomas Pringle).

150. *See, e.g.*, *Bundestag pocht auf Mitsprache* [*German Parliament Demands Participation*], FAZ.NET (Oct. 19, 2011), http://m.faz.net/aktuell/politik/europaeische-union/euro-beschluesse-bundestag-pocht-auf-mitsprache-11498742.html (detailing the German Parliament's demand that it have a say); *CSU und CDU pochen auf EFSF-Mitsprache* [*Conservative Party Members of the German Parliament Demand Say on EFSF*], FTD.DE (Oct. 18, 2011), http://www.ftd.de/politik/deutschland/:schuldenkrise-csu-und-cdu-pochen-auf-efsf-mitsprache/60117597.html (describing the CSU's and CDU's argument for involvement); *CDU-Politiker fordern Mitsprache bei Euro-Rettungsfonds* [*Politicians of the Conservative Party Demand Say on EFSF*], HANDELSBLATT ONLINE (Aug. 26, 2011), http://www.handelsblatt.com/politik/deutschland/euro-krise-cdu-politiker-fordern-mitsprache-bei-euro-rettungsfonds/4541698.html (discussing the CDU's insistence that it have a say in decisions); *Hebelung des EFSF: SPD und Grüne fordern neue Euro-Abstimmung* [*EFSF Leveraging: Social-Democrats and Greens Demand New Vote on Euro*], SPIEGEL ONLINE (Oct. 19, 2011), http://www.spiegel.de/politik/ deutschland/hebelung-des-efsf-spd-und-gruene-fordern-neue-euro-abstimmung-a-792734.html (detailing the argument for the Bundestag to vote again).

151. BVerfG Sept. 7, 2011, 64 N.J.W. 2946, para. 119 (2011) (Ger.).

152. *Id.* paras. 121–29 (especially paras. 125 and 127); BVerfG Feb. 28, 2012, 66 W.M. 494, paras. 109–12 (2012) (Ger.).

153. BVerfG Feb. 28, 2012, 66 W.M. 494, paras. 132–53 (2012) (Ger.); *see also* Press Release, Bundesverfassungsgericht Pressestelle [Federal Constitutional Court Press Office], Antrag im Organstreit "Beteiligungsrechte des Bundestages/EFSF" überwiegend erfolgreich [Application in Organstreit Proceedings Regarding the Bundestag's Right of Participation/EFSF Successful for the Most Part] (Feb. 28, 2012), *available at* http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg12-014.html, *translated at* http://www.bundesverfassungsgericht.de/en/press/bvg12-014en.html (summarizing the judgment of the Federal Constitutional Court, which was, for the most part, against the transfer of power to the special committee); Press Release, Bundesverfassungsgericht Pressestelle [Federal Constitutional Court Press Office], Einstweilige Anordnung in Sachen "Euro-Rettungsschirm": Vorläufig keine Übertragung der Beteiligungsrechte des Bundestages auf sogenanntes 9-er Sondergremium [Temporary Injunction Regarding the Euro Rescue Package: For the Time Being, No Transfer of the Bundestag's Rights of Participation to a So-Called Nine-Member Special Panel] (Oct. 28, 2011), *available at* http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg11-068.html, *translated at* http://www. bundesverfassungsgericht.de/en/press/bvg11-068en.html (noting the temporary measure against the provisions later found to be unconstitutional in the same case).

154. *See* BVerfG June 19, 2012, paras. 94–171 (especially paras. 133–53) (Ger.), *available at* http://www.bundesverfassungsgericht.de/entscheidungen/es20120619_2bve000411.html (stating that the involvement bypassed constitutionally drawn boundaries); *see also* Press Release, Bundesverfassungsgericht Pressestelle [Federal Constitutional Court Press Office], Anträge im Organstreit "ESM/Euro-Plus-Pakt" erfolgreich [Applications in Case "ESM/Euro-Plus Pact" Successful] (June 19, 2012), *available at* http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg12-042 (listing the insufficiencies of the German Parliament's involvement).

Moreover, before the ratification of the ESM Treaty, the Court issued a verdict stating that it had to be ensured under international law that Germany's overall liability was limited to the agreed 190 billion euros.[155]

C. *Regulatory Measures*

As mentioned above, the sovereign debt crisis is chiefly dealt with by financial aid and interventions by the ECB. There have, however, also been measures in the corporate and securities law field on which this Article primarily focuses.

1. New Regulatory Oversight System

In the wake of the subprime crisis the construction of the regulatory oversight over the capital markets in Europe has been reviewed[156] and, following the *de Larosière Report*,[157] a new European system of financial supervisors (ESFS) was created.[158] It consists of three European Supervisory Authorities, i.e., the European Banking Authority (EBA),[159] the European Securities and Markets Authority (ESMA),[160] and the European Insurance and Occupational Pensions Authority (EIOPA),[161] and the European Systemic Risk Board (ESRB).[162] The supervisory

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155. BVerfG Sept. 12, 2012, para. 253 (Ger.), *available at* http://www.bundesverfassungsgericht.de/entscheidungen/rs20120912_2bvr139012.html; Press Release, Bundesverfassungsgericht Pressestelle [Federal Constitutional Court Press Office], Anträge auf Erlass einer einstweiligen Anordnung zur Verhinderung der Ratifikation von ESM-Vertrag und Fiskalpakt überwiegend erfolglos [Applications for the issue of temporary injunctions to prevent the ratification of the ESM Treaty and the Fiscal Compact unsuccessful for the most part] (Sept. 12, 2012), *available at* http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg12-067.html, *translated at* http://www.bverfg.de/pressemitteilungen/bvg12-067en.html.

156. *See* Eddy Wymeersch, *The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors,* 8 EUR. BUS. ORG. L. REV. [E.B.O.R.] 237, 262 (2007) (analyzing the European supervisory system before the reforms).

157. THE DE LAROSIÈRE REPORT, *supra* note 4, at 46–47.

158. *See Financial Supervision*, EUR. COMM'N, http://ec.europa.eu/internal_market/finances/committees/index_en.htm (last visited June 20, 2012) (discussing the creation of the ESFS); *see also* Elaine Fahey, *Does the Emperor Have Financial Crisis Clothes? Reflections on the Legal Basis of the European Banking Authority*, 74 THE MODERN L. REV. 581, 581 (2011) ("[T]he European Union responded to the crisis principally with an institutional or 'supervisory architecture' package: a European System of Financial Supervision, comprising several institutions known as European Supervisory Authorities (ESAs)."); Eilis Ferran, *Understanding the New Institutional Architecture of EU Financial Market Supervision* (Univ. of Cambridge Faculty of Law, Research Paper No. 29, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1701147## (outlining the structure of the ESFS). *But see* Eddy Wymeersch, *Das neue europäische Finanzmarktregulierungs- und Aufsichtssystem* [*The New European System of Financial Market Regulation and Supervision*], 40 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT [Z.G.R.] 443, 453 (2011) (contending that the ESFS has insufficient regulatory competence).

159. *See generally* Regulation 1093/2010, of the European Parliament and of the Council of 24 November 2010 Establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, 2010 O.J. (L 331) 12 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0012:0047:EN:PDF [hereinafter Regulation 1093/2010]; EUROPEAN BANKING AUTHORITY, http://www.eba.europa.eu/Home.aspx (last visited June 27, 2012). *See also* Fahey, *supra* note 158 (discussing the role of the European Banking Authority).

160. *See generally* Regulation 1095/2010, *supra* note 16.

161. *See generally* Regulation 1094/2010, of the European Parliament and of the Council of

agencies are now able to suggest and implement technical standards,[163] oversee the transposition and application of European law in the Member States,[164] coordinate the work of the different national regulators (including settlements of disagreements),[165] and directly intervene in case of urgency.[166] A single supervisory mechanism for banks and a common system for deposit protection are now envisaged as well.[167]

2. Regulation of Short Selling and Credit Default Swaps

In 2010, the European Commission proposed a regulation on short selling and certain aspects of credit default swaps[168] in order to "set an end to the current

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24 November 2010 Establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC, 2010 O.J. (L 331) 48 (EU), *available at* http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0048:0083:EN:PDF [hereinafter Regulation 1094/2010]; EIOPA, https://eiopa.europa.eu/home/index.html (last visited June 27, 2012).

162. *See generally* Regulation 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 O.J. (L 331) 1 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:331:0001:0011:EN:PDF; EUROPEAN SYSTEMIC RISK BOARD, http://www.esrb.europa.eu/home/html/index.en.html (last visited June 27, 2012).

163. Regulation 1093/2010, *supra* note 159, arts. 10, 15; Regulation 1095/2010, *supra* note 16, arts. 10, 15; Regulation 1094/2010, *supra* note 161, arts. 10, 15; *see also* Wymeersch, *supra* note 158, at 463–66 (explaining how the new agencies can advise the legislator and implement technical rules); Ferran, *supra* note 158, at 41–48 (discussing procedures of European Supervisory Authorities).

164. *See* Regulation 1093/2010, *supra* note 159, arts. 17, 19, para. 3; Regulation 1095/2010, *supra* note 16, arts. 17, 19, para. 3; Regulation 1094/2010, *supra* note 161, arts. 17, 19, para. 3; *see also* Wymeersch, *supra* note 158, at 466–67 (explaining the ways of how a Member State's implementation of EU Law is analyzed and supervised); Ferran, *supra* note 158, at 48–51 (discussing ESA enforcement of E.U. law).

165. *E.g.*, Regulation 1093/2010, *supra* note 159, art. 16, art. 18, para. 1, art. 19, arts. 25–30, (especially art. 31); Regulation 1095/2010, *supra* note 16, art. 16, art. 18, para. 1, art. 19, arts. 25–30, (especially art. 31); Regulation 1094/2010, *supra* note 161, art. 16, art. 18, para. 1, art. 19, arts. 25–30, (especially art. 31); Wymeersch, *supra* note 158, at 468–69; Ferran, *supra* note 158, at 51, 53–55.

166. Regulation 1093/2010, *supra* note 159, art. 18, paras. 3–4; Regulation 1095/2010, *supra* note 16, art. 18, paras. 3–4; Regulation 1094/2010, *supra* note 161, art. 18, paras. 3–4; Wymeersch, *supra* note 158, at 467–68; Ferran, *supra* note 158, at 51–53.

167. *Commission Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, COM (2012) 511 final (Sept. 9, 2012); *Commission Proposal for a Regulation of the European Parliament and of the Council, Amending Regulation (EU) No 1093/2010 Establishing a European Supervisory Authority (European Banking Authority) as Regards Its Interaction with Council Regulation (EU) No.../... Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions*, COM (2012) 512 final (Sept. 9, 2012); *Communication from the Commission to the European Parliament and the Council, A Roadmap Towards a Banking Union*, COM (2012) 510 final (Sept. 12, 2012), *available at* http://ec.europa.eu/internal_market/finances/committees/index_en.htm; *see also Commission Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010*, COM (2012) 280 final (June 6, 2012) (proposing a framework that would "equip authorities with common and effective tools and powers to tackle bank crises pre-emptively, safeguard financial stability and minimise taxpayer exposure to losses in insolvency").

168. *Commission Proposal for a Regulation of the European Parliament and of the Council on Short*

fragmented situation in which some Member States have taken divergent measures."[169] The Council of the European Union adopted the regulation in February 2012 with one amendment by the European Parliament and subject to approval by the Permanent Representatives Committee.[170] The adopted regulation has been in force since March 2012.[171] Following the adoption of the regulation, Germany lifted the national ban on short selling and certain aspects of credit default swaps, as it had been superseded by the regulation.[172]

The regulation—applicable in all Member States as of November 1, 2012[173]—restricts uncovered ("naked") short sales in shares or in sovereign debt of the European Union or its Member States.[174] The regulation allows uncovered short sales in sovereign debt only if:

> one of the following conditions is fulfilled: (a) the natural or legal person has borrowed the sovereign debt or has made alternative provisions resulting in a similar legal effect; (b) the natural or legal person has entered into an agreement to borrow the sovereign debt or has another absolutely enforceable claim under contract or property law to be transferred ownership of a corresponding number of securities of the same class so that settlement can be effected when it is due; (c) the natural or legal person has an arrangement with a third party under which that third party has confirmed that the sovereign debt has been located or otherwise has a reasonable expectation that settlement can be effected when it is due.[175]

In sum, the seller must be in a legal position that ensures that he can fulfill his obligation towards the buyer when it is due. Similar conditions apply to the uncovered short sale of shares.[176] These restrictions counteract the pressure that short sales exercise on prices and reduce volatility.[177]

Selling and Certain Aspects of Credit Default Swaps, COM (2010) 482 final (Sept. 15, 2010), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:0482:FIN:EN:PDF [hereinafter *Proposal on Short Selling*].

169. *Id.* at 4th recital.

170. The decision was taken with one abstention (the United Kingdom) at a meeting of the Economic and Financial Affairs Council. Press Release, Council of the European Union, Regulation Adopted on Short Selling and Credit Default Swaps (Feb. 21, 2012).

171. Regulation 236/2012, of the European Parliament and of the Council of 14 March 2012 On Short Selling and Certain Aspects of Credit Default Swaps, 2012 O.J. (L 86) 1 (EU), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:086:0001:0024:EN:PDF [hereinafter Regulation 236/2012].

172. Gesetzes zur Ausführung der Verordnung (EU) Nr. 236/2012 des Europäischen Parlaments und des Rates vom 14. März 2012 über Leerverkäufe und bestimmte Aspekte von Credit Default Swaps [EU-Leerverkaufs-Ausführungsgesetz] [Implementation of Regulation 236/2012 Act], Nov. 6, 2012, BGBL. I at 2286, art. 1; *see* Gesetzesentwurf der Bundesregierung [Federal Government Bill], BTDrucks 17/9665, at 1, 2,7 (May 16, 2012) (Ger.), *available at* http://dipbt.bundestag.de/dip21/btd/17/096/1709665.pdf.

173. Regulation 236/2012, *supra* note 171, art. 48.

174. *Id.* arts. 12–13.

175. *Id.* art. 13, para 1.

176. *See id.* art. 12 (outlining restrictions on short sales in shares).

177. *See id.* 18th recital (explaining the need to "place proportionate restrictions on uncovered short selling"); *Proposal on Short Selling, supra* note 168, at 8 (discussing the need for requiring short sellers to have sufficient capital at the time of settlement); *Commission Staff Working Document, Summary of the Impact Assessment,* at 4, SEC (2010) 1056 (Sept. 15, 2010) (EU), *available at* http://ec.europa.eu/internal_market/securities/docs/short_selling/resume_impact_assesment_en.pdf (naming as an objective of the

The regulation not only restricts, but also generally prohibits uncovered credit default swaps in sovereign debt.[178] This prohibition ensures that market participants cannot hedge against a risk that they are not exposed to.[179] They cannot insure themselves against the default of an issuer unless such a default constitutes a risk for them, e.g., because they actually hold bonds of that issuer. This makes sense because being allowed to hedge against a risk that one is not exposed to would create perverse incentives. Since holders of uncovered credit default swaps do not bear the risk they have insured against, they might be tempted to behave in a way that leads to the realization of the risk.

Finally, the regulation provides for notification to competent authorities and public disclosure of net short positions in shares, sovereign debt, and credit default swaps.[180] This promotes market transparency and enables the competent authorities to counteract any dangerous developments.[181]

3. Regulation of Ratings and Rating Agencies

In 2009, a regulation on credit rating agencies was adopted,[182] which addressed the rating agencies' failure to detect the systemic dangers that finally led to the subprime crisis. The regulation provides for the registration of rating agencies,[183] agency independence and the avoidance of conflicts of interest,[184] demands disclosure of models, methodologies, and key assumptions on which ratings are based,[185] and obliges the agencies to publish an annual transparency report.[186]

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proposal to "reduce the risks of negative price spirals arising from short positions").

178. *See* Regulation 236/2012, *supra* note 171, arts. 4, 14 (defining an uncovered position in a credit default swap: "For the purposes of this Regulation, a natural or legal person shall be considered to have an uncovered position in a sovereign credit default swap where the sovereign credit default swap does not serve to hedge against: (a) the risk of default of the issuer where the natural or legal person has a long position in the sovereign debt of that issuer to which the sovereign credit default swap relates; or (b) the risk of a decline of the value of the sovereign debt where the natural or legal person holds assets or is subject to liabilities, including but not limited to financial contracts, a portfolio of assets or financial obligations the value of which is correlated to the value of the sovereign debt").

179. Internal Market Commissioner Michel Barnier declared that such CDSs should only be used to hedge against the risk of payment default, not for pure speculation. Mark Schrörs, *Europa untersagt Wetten auf Staatsanleihen* [*Europe Bans Bets on Government Bonds*], FTD.DE, (Oct. 19, 2011), http://www.ftd.de/finanzen/maerkte/anleihen-devisen/:schuldenkrise-europa-untersagt-wetten-auf-staatspleiten/60117794.html.

180. *See* Regulation 236/2012, *supra* note 171, arts. 5–9 (mandating procedures for net short positions in shares, sovereign debt, and credit fault swaps).

181. *See* Tobias Schmidt, *EU dämmt Spekulationen mit Leerverkäufen ein* [*EU Counteracts Speculations with Naked Short Selling*], WELT ONLINE (Nov. 15, 2011), http://www.welt.de/finanzen/article13718529/EU-daemmt-Spekulationen-mit-Leerverkaeufen-ein.html (discussing how the new regulation will allow regulators to prevent shorts from devastating the market).

182. Regulation 1060/2009, of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, 2009 O.J. (L 302) 1 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2009R1060:20110721:EN:PDF.

183. *Id.* arts. 4, 14–20.

184. *Id.* art. 6, Annex I (A, B).

185. *Id.* art. 8.

186. *Id.* art. 12.

A new proposal for an amendment of this regulation goes even further: The proposal aims at reducing "mechanistic reliance" on external credit ratings and therefore requires certain financial institutions to assess credit risks independently.[187] The European regulatory oversight bodies are required to avoid referring to "credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger mechanistic reliance on credit ratings by competent authorities or financial market participants."[188] Thus, the European legislator is trying to take away some of the power that it had previously granted the credit agencies by referring to their ratings.[189] Financial market participants are thus encouraged to at least question external ratings and to rely more on their own, independent risk assessment.

With regard to sovereign ratings, the proposal requires a more frequent rating (every six months instead of every twelve months)[190] and the publication of a full research report when a rating is issued or amended.[191] Attempts to prohibit the publication of sovereign ratings under certain circumstances[192] were not successful.[193]

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187. *See Commission Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies*, art. 1, para. 6, COM (2011) 747 final (Nov. 15, 2011), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0747:FIN:EN:PDF [hereinafter *Proposal on Credit Rating Agencies*] (inserting new Article 5a); Anja Ingenrieht, *EU legt Rating Agenturen in Ketten* [*EU Puts Rating Agencies in Chains*], RHEINISCHE POST, Nov. 16, 2011 (discussing the E.U. Commission's proposal to oblige banks and insurers to independently analyze risks posed by securities in order to reduce dependency on credit agency ratings).

188. *Proposal on Credit Rating Agencies*, *supra* note 187, art. 1, para. 6.

189. For example, under the Basel II accord, the banks may calculate the capital requirements for credit risks by external credit assessments. *See* BASEL COMM. ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENTS AND CAPITAL STANDARDS, para. 50, (2006) (Switz.), *available at* http://www.bis.org/publ/bcbs128.pdf [hereinafter Basel II] (permitting banks to assess credit by "measur[ing] credit risk in a standardised manner, supported by external credit assessments"). In two commission proposals, the Commission proposed a provision that would require credit institutions and investment firms with material credit risk exposure to use internal models rather than external credit ratings ("overreliance on credit ratings"). *Commission Proposal for a Directive of the European Parliament and of the Council on the Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions*, §§ 1.2.1, 2.2.1, 2.3.3, art. 76, para. 2, art. 77 (b), COM (2011) 453 final (July 20, 2011) [hereinafter *Proposal on Credit Institutions*]; *Commission Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*, art. 395, COM (2011) 452 final (July 20, 2011). *See infra* text accompanying note 334 (discussing the proposed amendment to eliminate mechanistic reliance of credit rating agencies); *see also infra* notes 206–207 (on the Basel III accord).

190. *Proposal on Credit Rating Agencies*, *supra* note 187, art. 1, para. 10(b).

191. *See id.* Annex I, para. 6 (inserting a new Section D, Part III, point 1).

192. *See, e.g.*, *Kampf gegen Spekulanten: Europäische Union plant Verbot von Länder-Ratings* [*Combating Speculators: European Union Plans to Ban Country Ratings*], SPIEGEL ONLINE (Oct. 20, 2011), http://www.spiegel.de/wirtschaft/unternehmen/kampf-gegen-spekulanten-europaeische-union-plant-verbot-von-laender-ratings-a-792864.html (explaining the desire of the E.U. Internal Market Commissioner, Michel Barnier, to reserve the right to temporarily prohibit publication of sovereign solvency); *Urteile über Schuldenstaaten: EU will Ratingagenturen knebeln* [Judging Debtor States: EU Wants to Gag Rating Agencies], SÜDDEUTSCHE.DE (Oct. 20, 2011), http://www.sueddeutsche.de/geld/urteile-ueber-schuldenstaaten-eu-will-ratingagenturen-knebeln-1.1169028 (discussing EU Internal Market Commissioner Michel Barnier's attempts to place restrictions on sovereign solvency estimates); *EU will Ratings für Krisenstaaten verbieten* [*EU Plans to Ban Ratings of Sovereigns*], HANDELSBLATT, (Oct. 21–22, 2011) at 14 (describing the proposed ban on ratings of sovereigns in order to prevent destabilizing the market by publishing negative ratings during financial crises).

193. *See* Thomas Schmoll, *Europa zittert vor der Kernschmelze* [*Europe Fears Meltdown*], FTD.DE, (Nov. 16, 2011) http://www.ftd.de/politik/konjunktur/:schuldenkrise-europa-zittert-vor-der-kernschmelze/60129838.html (describing the failed attempt of the European Union to reduce the power of credit

The proposal, however, does contain a provision to the effect that the agency "shall publish these ratings or outlooks only after the close of business of trading venues established in the Union and at least one hour before their opening."[194] Also, a provision on the civil liability of credit rating agencies towards investors is proposed.[195]

4. Higher Capital Requirements for Banks

Regulations for the banking sector limit a bank's exposure to risk. A bank handing out a loan has to refinance itself by taking out a loan itself, unless it can use its own funds to grant the loan to its debtor. Refinancing, however, implies that a bank may collapse if its debtors default and it is therefore unable to repay its own debts. Regulatory provisions therefore provide that a bank has to maintain a certain ratio of outstanding loans and its own funds.[196] E.U. law demands that Member States require "credit institutions to provide own funds which are at all times more than or equal to the sum of the following capital requirements: (a) for credit risk and dilution risk[197] . . . 8% of the total of their risk-weighted exposure amounts . . . ."[198] A ratio of 8%, as an example, means that with own funds of 100€, the bank can hand out loans of 1250€.[199] In other words each loan granted by the bank has to be financed by at least 8% equity (i.e., own funds) and a maximum of 92% debt.

Each exposure to credit risk, i.e., the risk of not being repaid, is risk adjusted. High-risk loans are valued at up to 150%, whereas low risk loans are valued at 0%.[200] Thus, a high-risk loan of 100€ has a risk-weighted exposure amount of 150€.[201] The bank needs to finance this loan with at least 12€ equity.[202] On the contrary, a low-risk loan of 100€ has a risk-weighted exposure amount of 0€.[203] This loan can be fully

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ratings).

194. *Proposal on Credit Rating Agencies*, *supra* note 187, Annex I, para. 6.

195. *See id.* art. 1, para. 20 (inserting new Article 35a).

196. Directive 2006/48, of the European Parliament and of the Council of 14 June 2006 Relating to the Taking Up and Pursuit of the Business of Credit Institutions, arts. 55–57, 2006 O.J. (L 177) 1, 26 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20111209:EN:PDF [hereinafter Directive 2006/48].

197. *See id.* art. 4, para. 24 (defining dilution risk as "the risk that an amount receivable is reduced through cash or non-cash credits to the obligor").

198. *Id.* art. 75, cl. (a); *see also* Directive 2006/49/EC, of the European Parliament and of the Council of 14 June 2006 on the Capital Adequacy of Investment Firms and Credit Institutions (Recast), arts. 18–20, 2006 O.J. (L 177) 201 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0049:20110104:EN:PDF [hereinafter Directive 2006/49] (specifying the size and manner of institutions which fit within the 8% risk exposure capital requirement). The aforementioned directives implement the Basel II accord in the European Union. *See* Directive 2006/48, *supra* note 196, 37th recital (referring to the 2004 Basel Committee on Banking Supervision); Directive 2006/49, *supra* note 200, 11th recital (referring to Directive 2006/48); *Capital Requirements Directive, Legislation in Force*, EUR. COMM'N, http://ec.europa.eu/internal_market/bank/regcapital/legislation_in_force_en.htm (giving further information on the adoption of the aforementioned directives) (last visited Nov. 26, 2012).

199. 100€ / 8% = 1250€.

200. Directive 2006/48, *supra* note 196, Annex VI, pt. 1, cl.(1.1)(2).

201. 100€ * 150% = 150€.

202. 150€ * 8% = 12€.

203. 100€ * 0% = 0€.

financed through debt. No equity is needed in this case. Such a loan does not limit the bank's remaining ability to hand out further loans. Against this background, banks adjust their interest rates according to the risk-weighted exposure amount—the higher the exposure amount, the higher the interest rate will be. The reasons for this are twofold: First, a high exposure amount limits the bank's ability to grant other loans and the bank wants to be compensated for this; second, financing a loan through equity is more costly than refinancing through debt because equity holders usually demand a higher return on investment than creditors.[204]

Whereas exposures to central governments or central banks are usually assigned a risk weight between 0% and 150%,[205] E.U. Member States, their central banks, and the ECB are assigned a risk weight of 0%.[206] With regard to these sovereign debtors, there is no regulatory need for the banks to provide for the possible default of their debtor. Lending to these debtors is therefore cheaper, which in turn means lower borrowing costs for them. This constitutes a privilege for sovereign debt because banks are given an incentive to invest in sovereign debt.

The sovereign debt crisis has not prompted a fundamental rethinking of this approach. Under Article 109, paragraph 4 of the proposed new regulation on prudential requirements for credit institutions and investment firms, which will replace the above-mentioned regulations and implement the Basel III accord, "[e]xposures to Member States' central governments and central banks denominated and funded in the domestic currency of that central government and central bank shall be assigned a risk weight of 0%."[207] However, the participants of a European summit issued a statement regarding the capitalization of banks according to which "there is broad agreement on requiring a significantly higher capital ratio of 9% of

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204. *See, e.g.*, Christian Kersting, *Zinsanpassung nach Basel II [Interest-Rate Adjustment According to Basel II]*, 2007 Z.I.P. 56, 56 (explaining why equity requirements lead to additional costs for banks).

205. *See* Directive 2006/48, *supra* note 196, Annex VI, pt. 1, cl.(1.1)(2) (providing a table for assessing the risk of exposure to central governments and central banks).

206. *See id.* Annex VI, pt. 1, cl.(1.1)(3), (1.2)(4) (stating that exposures to the European Central Bank, Member States' central governments, and Member State central banks shall be assigned a 0% risk weight); Directive 2006/49, *supra* note 198, art. 13 (referring to Directive 2006/48); Verordnung über die angemessene Eigenmittelausstattung von Instituten, Institutsgruppen und Finanzholding-Gruppen [Ordinance on the Capital Adequacy of Institutions, Groups of Institutions, and Financial Holding Groups] [Solvabilitätsverordnung - SolvV] [Solvency Ordinance], Dec. 14, 2006, BGBL. I at 2926, as amended, § 26, nos. 2, 3 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/solvv/gesamt.pdf (transposing Directive 2006/48 and Directive 2006/49).

207. *Commission Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms: Part I*, art. 109, paras. 3, 4, COM (2011) 452 final (July 20, 2011), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0452(01):FIN:EN:PDF; *see* Nina Schindler, *Umsetzung von Basel III in Europa: Höhere Kapitalausstattung der Banken und verbesserte Qualität des Kapitals [Higher Capital Requirements for Banks and Increased Quality of Capital]*, 66 W.M. 192 (2012) (discussing the E.U. implementation of the Basel III requirements for bank capital adequacy); Christoph Schmitt, *Umsetzung von Basel III in europäisches Recht—Implikationen für die Mittelstandsfinanzierung [Implementing Basel III in European Law: Implications for SME Financing]*, 2011 B.B. 2347, 2348 (noting that the CRD IV gives government bonds for European countries a risk-weight of 0%); Hermann Schulte-Mattler & Thorsten Manns, *CRD-IV-Regulierungspaket zur Stärkung der Widerstandsfähigkeit des Bankensektors [CRD-IV-Packet to increase the Resilience of the Banking Sector]*, 65 W.M. 2069 (2011) (discussing the E.U. implementation of the Basel III requirements for bank capital adequacy); *New proposals on capital requirements (CRD IV Package)*, EUR. COMM'N, http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm (last visited June 24, 2012) (giving further information on the proposal and its discussion); *Proposal on Credit Institutions*, *supra* note 189, arts. 125–30 (setting forth capital buffer requirements, which are the only changes related to Basel III not dealt with directly by the Commission's proposal for Regulation).

the highest quality capital and after accounting for market valuation of sovereign debt exposures, both as of September 30, 2011, to create a temporary buffer, which is justified by the exceptional circumstances."[208] This has been taken up by the European Banking Authority, which issued a recommendation to this effect to the national regulators.[209] The German legislature empowered the German Financial Supervisory Authority to follow the recommendation.[210] A more correct assessment of, and provision for, the risk of E.U. sovereign debtors defaulting is certainly appropriate in the current circumstances. Unfortunately, this is only a temporary measure that only suspends, but does not eliminate the E.U. sovereign debt privilege of a 0% risk weight.[211]

D. *Revival of the Financial Market Stabilization Fund Act*

Temporarily higher regulatory capital requirements for banks may, again, trigger the need for state aid for banks, if the banks fail to meet the stricter requirements. Germany has therefore revived its Financial Market Stabilization Fund Act.[212] The Second Financial Market Stabilization Fund Act enables the Fund to assume guarantees of up to 400 billion euros for debt instruments issued by, and liabilities accrued by, financial-sector enterprises until December 31, 2012.[213]

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208. Euro Summit Statement, Annex 2, para. 4 (Oct. 26, 2011), *available at* http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf.

209. European Banking Authority, (*EBA Recommendation on the Creation and Supervisory Oversight of Temporary Capital Buffers to Restore Market Confidence*) 3, EBA/REC/2011/1 (Dec. 8, 2011), *available at* http://stress-test.eba.europa.eu/capitalexercise/EBA%20BS%202011%20173%20Recommendation%20FINAL.pdf.; *see* Press Release, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) [Federal Financial Supervisory Authority], The EBA Publishes Details on Capital Shortfall of Banks (Oct. 27, 2011), *available at* http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2011/meldung_111027_eba_rekapitalisierungsbedarf.html?nn=2821494 (discussing the EBA's response to the capital shortfall); Press Release, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) [Federal Financial Supervisory Authority], Results for Germany of the E.U. Wide Survey on Bank Recapitalisation (Dec. 8, 2011), *available at* http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Meldung/2011/meldung_111208_eba-rekapitalisierungsumfrage_en.html?nn=2821494 [hereinafter Results for Germany Survey] (reporting that six of the nine surveyed German banks reported a shortfall).

210. *See* KWG § 10, para. 1b, as amended by 2; FMStFG art. 2, no. 1 (empowering the German Financial Supervisory Authority to impose special capital adequacy requirements).

211. *See infra* Sections III.A.4, III.B.3.d. for an overall picture and assessment of sovereign debt privileges; *see also* Press Release, European Banking Authority, The EBA Details the EU Measures to Restore Confidence in the Banking Sector (Oct. 26, 2011), *available at* http://eba.europa.eu/News--Communications/Year/2011/The-EBA-details-the-EU-measures-to-restore-confide.aspx (follow link Question & Answers for more detailed information); Results for Germany Survey, *supra* note 209 (discussing how recapitalization is a factor of bank financial security).

212. Gesetzesentwurf der Fraktionen der CDU/CSU und FDP des Deutschen Bundestages [Bill by the Government Coalition in the German Parliament], Entwurf eines Zweiten Gesetzes zur Umsetzung eines Maßnahmenpakets zur Stabilisierung des Finanzmarktes (Zweites Finanzmarktstabilisierungsgesetz —2. FMStG) [Draft of a Second Financial Market Stabilization Act], BTDrucks 17/8343, at 1–3 (Ger.); *see also* Tim Oliver Brandi & Karsten Müller-Eising, *Neuauflage des Finanzmarktstabilisierungsgesetzes* [New Edition of the Financial Market Stabilization Act], 2012 B.B. 466 (Ger.) (discussing Germany's reactivation of the Financial Market Stabilization Fund (FMS) by reintroducing the Financial Market Stabilization Act). For details on the original FMStFG see discussion *supra* Part I.B. Corporate Law; for details on the original FMStBG see discussion *supra* Sections I.B.1–3.

213. FMStFG § 6(1), as amended by 2; FMStG art. 1, no. 7; *see* Drittes Gesetz zur Umsetzung eines Maßnahmenpakets zur Stabilisierung des Finanzmarktes [Drittes Finanzmarktstabilisierungsgesetz] [3. FMStG] [Third Financial Market Stabilization Act], Dec. 20, 2012, BGBL. I at 2777, art. 1, no. 6

Additionally, the German Federal Ministry of Finance is empowered to take out loans of up to 70 billion euros for the Fund in order to enable it to buy shares, participate in a recapitalization or assume risks.[214] This also opens the way for the application of the Financial Market Stabilization Acceleration Act, which facilitates and expedites the implementation of necessary corporate law measures (convocation of general meetings, capital increases, silent partnerships).[215]

III. THE CASE FOR ABOLISHING SOVEREIGN DEBTORS' PRIVILEGES

The sovereign debt crisis shows that investments in sovereign debt are not risk-free and that sovereign debtors do have incentives for opportunistic behavior. Thus, investors in sovereign debt are possibly in as much, if not more, need for protection as investors in shares or private debt. Nevertheless, sovereign debtors, especially E.U. sovereign debtors, enjoy a number of privileges which give them easier access to the capital markets by exempting them from provisions that protect investors and promote market integrity. This raises the question as to the justification for these privileges which will now be addressed in the third part of this Article. In the first subsection, some privileges are examined in greater detail. The second subsection argues that there is no justification for these privileges and, as a lesson from the crisis, they should be abolished.

A. Privileges Granted to Sovereign Debtors

The following paragraphs examine the privileges granted to sovereign debtors. By looking first at the provisions dealing with public offers of securities, then at the continuous obligations of issuers of listed securities, and afterwards at provisions addressed to market participants in general, we will see that in all these aspects sovereign debtors and their agents enjoy privileges. Finally, a look at the regulation of banks will show that sovereign debt itself is privileged.

1. Prospectus Requirement

The Prospectus Directive requires a prospectus for every public offer of securities in the European Union.[216] The prospectus

> shall contain all information which, according to the particular nature of the issuer and of the securities offered to the public or admitted to trading on a regulated market, is necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profit and losses,

(extending the period to Dec. 31, 2014). €400 billion ≈ $500 billion (exchange rate of June 28, 2012).

214. FMStFG § 9, as amended by 2; FMStG art. 1, no. 14. €70 billion ≈ $87 billion (exchange rate of June 28, 2012).

215. *See supra* Section I.B. for details.

216. Directive 2003/71, of the European Parliament and of the Council of 4 November 2003 on the Prospectus to Be Published When Securities Are Offered to the Public or Admitted to Trading and Amending Directive 2001/34/EC, art. 3, 2003 O.J. (L 345) 64 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2003L0071:20110104:EN:PDF [hereinafter Directive 2003/71].

> and prospects of the issuer and of any guarantor, and of the rights attaching to such securities.[217]

Whereas non-E.U. sovereign debtors are subject to these requirements and have to publish a prospectus,[218] E.U. sovereign debtors are exempted from the obligation to publish a prospectus.[219] Member states may also decide to exempt E.U. sovereign debtors from the listing requirements[220] prescribed by Directive 2001/34.[221]

Consequently, the German Securities Prospectus Act[222] does not apply to E.U. sovereign debtors.[223] Given this exemption, there is also no listing requirement for such securities under German law; they are automatically admitted to trading on every German stock exchange.[224] In the United Kingdom, the prohibition of dealing in transferable securities without approved prospectus[225] does not apply to non-equity transferable securities issued by the ECB or by the government, a local or regional authority, or the central bank of a European Economic Area (EEA)[226] Member State.[227] Spanish law exempts the ECB, E.U. Member States, and their central banks from the obligation to publish a prospectus,[228] as does the according implementation

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217. *Id.* art. 5, para. 1.

218. Commission Regulation 809/2004, of 29 April 2004 Implementing Directive 2003/71/EC of the European Parliament and of the Council as Regards Information Contained in Prospectuses as well as the Format, Incorporation by Reference and Publication of such Prospectuses and Dissemination of Advertisements, 20th recital, 2004 O.J. (L 149) 1 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004R0809:20120922:EN:PDF; *see also* Christiane Schmitz, *in* WPPG [COMMENTARY ON THE SECURITIES PROSPECTUS ACT], art. 19 EU-ProspV, Anh. XVI EU-ProspV, art. 20 EU-ProspV, Anh. XVII EU-ProspV (Timo Holzborn ed., 2008) (commenting on the details about the registration documents for securities required by Directive 2003/71); Wertpapierprospektgesetz [WpPG] [Securities Prospectus Act], June 22, 2005, BGBL. I at 1698, as amended, § 7 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/wppg/gesamt.pdf (pointing to Regulation 809/2004 regarding requirements of the prospectus).

219. *See* Directive 2003/71, *supra* note 216, art 1, para. 2, cl.(b) ("This Directive shall not apply to: . . . (b) non-equity securities issued by a Member State or by one of a Member State's regional or local authorities, by public international bodies of which one or more Member States are members, by the European Central Bank or by the central banks of the Member States."); *id.* 11th recital.

220. For the official listing requirements, see Directive 2001/34, of the European Parliament and of the Council of 28 May 2001 on the Admission of Securities to Official Stock Exchange Listing and on Information to Be Published on those Securities, arts. 60–63, 2001 O.J. (L 184) 1 (EC), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2001L0034:20070120:EN:PDF [hereinafter Directive 2001/34].

221. *Id.* art. 2, para. 2, cl.(b).

222. WpPG.

223. *See id.* § 1, para. 2, nos. 2–3 ("This Act shall not apply to: 2. non-equity securities issued by an EEA signatory state or a regional or local authority in such a state, by international organisations under public law of which at least one EEA signatory state is a member, by the European Central Bank or the central banks of the members of the European Economic Area; 3. securities unconditionally and irrevocably guaranteed by an EEA signatory state or by one of an EEA signatory state's regional or local authorities.").

224. *See* Börsengesetz [BörsG] [Stock Exchange Act], July 16, 2007, BGBL. I at 1330, as amended, § 37 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/b_rsg_2007/gesamt.pdf.

225. Financial Markets and Services Act, 2000, cl. 8, § 85, paras. 1–2 [hereinafter Financial Services Act] (U.K.).

226. *See* Agreement on the European Economic Area, 1994 O.J. (L 1) 1 (allowing Iceland, Liechtenstein, and Norway to participate partially in the E.U. internal market without a conventional E.U. membership).

227. Financial Services Act, *supra* note 225, para. 5 (a), para. 6 (a), sched. 11A, para. 2.

228. Real Decreto 1310/2005, art. 14, no. 1 (R.D. 2005, B.O.E. 2005, 274) (Spain).

in Italy.[229] The French Implementation[230] extends the same exception also to EEA Member States. The Austrian Capital Market Law grants an identical exemption under the condition that the state issuers themselves exempt securities issued by the Austrian State.[231] Listing requirements generally also do not apply to securities issued by E.U. Member States.[232] In sum, at least E.U. Member States generally enjoy an exemption from the obligation to publish a prospectus, as well as an exemption from the listing requirement.

2. Continuous Disclosure Obligations

Issuers have obligations towards the capital market. After the initial public offering, during which information is provided via the prospectus, there is a need for regular financial reporting that enables investors to make informed investment decisions. The European Transparency Directive[233] deals with the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market. It requires issuers to publish annual and half-yearly financial reports as well as interim management statements.[234] However, Article 8, paragraph 1, clause (a) of the Transparency Directive, exempts from these obligations "a State, a regional or local authority of a State, a public international body of which at least one Member State is a member, the ECB, and Member States' national central banks whether or not they issue shares or other securities."[235] European law therefore does not require that Member State laws

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229. Decreto Legge 24 febbraio, in Gazz. Uff. 123, May 28, 1999, n.58, art. 100, para. 1, cls.(d)–(e) (It.).

230. CODE MONÉTAIRE ET FINANCIER [MONETARY AND FINANCIAL CODE] [C. MON. ET FIN.] arts. L 411-1, L 412-1, L 411-3, nos. 1–2 (Fr.); RÈGLEMENT GÉNÉRAL DE L'AUTORITÉ DES MARCHÉS FINANCIERS [GENERAL RULES OF THE AMF] [RÈGLEMENT GÉNÉRAL DE L'AMF] art. 211-1 (Fr.).

231. Bundesgesetz über das öffentliche Anbieten von Wertpapieren und anderen Kapitalveranlagungen und über die Aufhebung des Wertpapier-Emissionsgesetzes [Federal Law on the Public Offering of Securities and Other Capital Investments and on the Cancellation of the Securities Act Emission] [Kapitalmarktgesetz] [Capital Market Law] § 3, para. 1, nos. 1–2, BGBL. No. 625/1991, as amended (Aus.) [hereinafter Kapitalmarktgesetz].

232. Bundesgesetz über die Wertpapier- und allgemeinen Warenbörsen und über die Abänderung des Börsesensale-Gesetzes 1949 und der Börsegesetz-Novelle 1903 [Federal Law on the Securities and general commodity exchanges and the amendment of the Börsesensale Act 1949 and the Exchange Act Amendment 1903] [BörseG] [Stock Market Act], § 66, para. 5(a), BGBL. No. 555/1989 (Aus.).

233. Directive 2004/109, of the European Parliament and of the Council of 15 December 2004 on the Harmonisation of Transparency Requirements in Relation to Information About Issuers Whose Securities Are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, 2004 O.J. (L 390) 38 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2004L0109:20110104:EN:PDF [hereinafter Directive 2004/109].

234. *Id.* arts. 4–6.

235. *Id.* art. 8, para. 1(a); *see also id.* art. 1, para. 3 (allowing for other possible exemptions: "Member States may decide not to apply the provisions mentioned in Article 16(3) and in paragraphs 2, 3 and 4 of Article 18 to securities which are admitted to trading on a regulated market issued by them or their regional or local authorities"). Interestingly, there is no exemption of sovereign debtors from the obligation to publish, as soon as possible, inside information which directly concerns them. *See* Directive 2003/6, of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (Market Abuse), art. 6, para. 1, 2003 O.J. (L 96) 16 (EU), consolidated version *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2003L0006:20110104:EN:PDF [hereinafter Directive 2003/6]. The exemption in Article 7 is limited to transactions (see *infra* Section III.A.3.) and therefore only covers actions violating a prohibition of the Directive (e.g., Articles. 3, 5) and does not encompass an obligation to act like the ad hoc publication obligation of Article 6. This is

subject sovereign debtors to continuous information requirements. It does not, however, prohibit stricter Member State rules either. While Article 8, paragraph 1, clause (a) of the Transparency Directive 2004/109[236] could be read as requiring Member State law to exempt states, Article 3, paragraph 1 of the Directive clarifies that Member States may impose stricter requirements.[237]

In Germany it is disputed whether sovereign debtors are, under German law, exempt from the continuous information requirements. The relevant obligations are transposed into German law by sections 37v–37z of the German Securities Trading Act[238]—without an explicit exemption for sovereign debtors.[239] Yet, even though there is no explicit exemption under German law and even though European law permits stricter national requirements, the majority of scholars,[240] and more importantly, the Federal Financial Supervisory Authority, do not apply the provisions to sovereign debtors.[241] It is argued that sections 37v–37z of the German Securities Trading Act address undertakings[242] and not issuers and that the term undertaking, in the light of Article 8, paragraph 1, clause (a) of Directive 2004/109,[243] does not refer to states.[244] Others, however, argue that undertaking refers to all issuers, i.e., also to states.[245] In the United Kingdom,

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surprising if one understands the ad hoc publication obligation as an extension of the continuous reporting requirements of the Directive 2004/109 from which sovereign debtors are exempted. Yet, European law treats the ad hoc publication obligation rather as a means of avoiding insider trading which is also the reason why it is found in Directive 2003/6, and not in Directive 2004/109.

236. *See* Directive 2004/109, *supra* note 233, art. 8, para. 1, cl.(a) (exempting the following issuers: "State, a regional or local authority of a State, a public international body of which at least one Member State is a member, the ECB, and Member States' national central banks whether or not they issue shares or other securities").

237. *Id.* art. 3, para. 1 ("The home Member State may make an issuer subject to requirements more stringent than those laid down in this directive.").

238. WpHG §§ 37v–37z.

239. *See id.* § 37z (containing no explicit exemption for sovereign debtors).

240. *See* Roman A. Becker, *in* AKTIENRECHT UND KAPITALMARKTRECHT [CORPORATE LAW AND CAPITAL MARKET LAW], *supra* note 97, § 37v WpHG, para. 12.

241. *See* Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) [Federal Financial Supervisory Authority], Issuer Guideline (May 14, 2009), at 225, *available at* http://www.bafin.de/SharedDocs/Downloads/EN/Leitfaden/dl_Emittentenleitfaden_2009_en.html [hereinafter BaFin Issuer Guideline] (follow "Download: Issuer Guideline [. . .]" hyperlink) ("An additional restriction in the group of entities subject to these obligations is that such obligations only apply to companies. That means that they do not extend, for example, to the German government and to the federal states (Länder) as issuers.").

242. The German word is "Unternehmen," which is more correctly translated as "undertaking," and not, as in the unofficial translation of the Federal Financial Supervisory Agency, as "company." Securities Trading Act, BAFIN, http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html?nn=2821360, §§ 37c–37z (unofficial translation of the WpHG by the BaFin provided for information purposes only); BaFin Issuer Guideline, *supra* note 241 at 225.

243. *See* Directive 2004/109, *supra* note 233, art. 8, para. 1, cl.(a) (stating that State issuers are exempted from Articles 4–6 of the transparency requirements).

244. BaFin Issuer Guideline, *supra* note 241, 225; Becker, *supra* note 240, § 37v WpHG, para. 12; Anna Heidelbach & Guenter Doleczik, *in* KAPITALMARKTRECHTSKOMMENTAR [CAPITAL MARKETS COMMENTARY] § 37v WpHG, para. 7 (Eberhard Schwark & Daniel Zimmer eds., 4th ed. 2010).

245. *See* Henning Hönsch, *in* WERTPAPIERHANDELSGESETZ [COMMENTARY ON THE SECURITIES TRADING ACT] § 37v, para. 8 (Heinz-Dieter Assmann & Uwe H. Schneider eds., 5th ed. 2009) ("Therefore any legal entity of private or public law, including a state, is subject to the requirements of sentence 1."). *But see* Henning Hönsch, *in* WERTPAPIERHANDELSGESETZ [COMMENTARY ON THE SECURITIES TRADING ACT] § 37v, para. 8 (Heinz-Dieter Assmann & Uwe H. Schneider eds., 6th ed. 2012) (the same author now with a much more careful wording, not explicitly including states).

> [t]he rules on annual financial reports . . . , half-yearly financial reports . . . and interim management statements . . . do not apply to a state, a regional or local authority of a state, a public international body of which . . . [at] least one EEA State is a member, the ECB, and EEA States' national central banks.[246]

Austrian, French, and Spanish laws have very similar exemptions.[247]

3. Market Integrity (Prohibition on Insider Dealing and Market Manipulation)

The Market Abuse Directive prohibits insider dealing and market manipulation[248] in order to preserve market integrity and "public confidence in securities and derivatives."[249] Since insider dealing and market manipulation in essence constitute criminal behavior,[250] it is not surprising that there is no general exemption for sovereign debtors. There is, however, a limited exemption in Article 7:

> This Directive shall not apply to transactions carried out in pursuit of monetary, exchange-rate or public debt-management policy by a Member State, by the European System of Central Banks, by a national central bank or by any other officially designated body, or by any person acting on their behalf. Member States may extend this exemption to their federated States or similar local authorities in respect of the management of their public debt.[251]

The exemption is, however, limited to transactions.[252] Its wording clearly indicates that only the buying and selling of financial instruments or other contractual agreements involving financial instruments of E.U. sovereign debtors are privileged. Such activities cannot be construed as constituting insider dealing or market manipulation. With regard to the importance of, and the public interest in, "monetary, exchange-rate or public debt-management policy"[253] this seems reasonable. Given the implied charge of criminal misconduct associated with insider dealing and market manipulation, it seems likewise reasonable indeed that sovereign debtors are not generally exempted.[254] Thus, Luxembourg's Prime Minister Juncker

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246. Disclosure and Transparency Rules, Financial Services Authority, ch. 4, art. 4.4.1 (U.K.), *available at* http://fsahandbook.info/FSA/html/handbook/DTR/4/4.

247. BörseG § 90, para. 1, no. 1; C. MON. ET FIN., *supra* note 230, art. L-451-1-4; RÈGLEMENT GÉNÉRAL DE L'AMF, *supra* note 230, arts. 222-4 to -9; Ley del Mercado de Valores [Securities Market Law] art. 35, para. 5 (B.O.E. 1988, 181) [hereinafter Ley de Valores] (Spain).

248. Directive 2003/6, *supra* note 235, arts. 2–5.

249. *Id.* 2nd recital.

250. *See* WpHG §§ 14, 20a, 38, 39 (describing various securities dealings and transactions that are prohibited under the Securities Trading Act and their persecution); *see also Commission Proposal for a Directive on Criminal Sanctions for Insider Dealing and Market Manipulation*, at 3, COM (2011) 654 final (Oct. 20, 2011), *available at* http://ec.europa.eu/internal_market/securities/docs/abuse/COM_2011_654_en.pdf (stating that the commission or attempted commission of insider dealing and market manipulation should be considered criminal offenses).

251. Directive 2003/6, *supra* note 235, art. 7.

252. *Id.*

253. *Id.*

254. Scholars suggested a narrow interpretation for the comparable predecessor provision of Article 2, paragraph 4 of Council Directive 89/592, of 13 November 1989 Coordinating Regulations on Insider

could not rely on this privilege when on May 6, 2011, he publicly denied that a secret meeting discussing the possibility of Greece leaving the euro area was to be taking place.[255] His later attempt to justify his denial of the meeting, not because he enjoys "an honest lie, but because the New York Stock Exchange was still open,"[256] only confirms that his behavior constituted market manipulation. Prime Minister Juncker deliberately made an untrue statement with the express intention of influencing the market. Normally, this would entail criminal sanctions[257] and private law damage claims.[258]

Generally, national laws seem to mirror the exemption envisaged in Article 7 of the Market Abuse Directive 2003/6.[259] The German Securities Trading Act exempts the above mentioned transactions from its provisions on insider surveillance and its provisions on the monitoring of compliance with the prohibition of market manipulation.[260] The same is true for Italian,[261] Austrian,[262] and Spanish law.[263] U.K.

Dealing, 1989 O.J. (L 334) 30–32 (EC) [hereinafter Directive 89/592]; *see* JOACHIM BECKER, DAS NEUE WERTPAPIERHANDELSGESETZ [THE NEW SECURITIES TRADING ACT] 72–77 (1995) (stating that "the provisions of the section on insider monitoring do not apply to transactions carried out for monetary reasons or as part of public debt management by the federal government, its special funds, a federal state (Land), the Deutsche Bundesbank a foreign government or its Central Bank or any other body or organization entrusted with these transactions or persons acting on their behalf" and further commenting on the limits to this exemption); Klaus Hopt, *Europäisches und deutsches Insiderrecht* [European and German Insider Trading Law], 20 Z.G.R. 17, 45 (1991) (exempting transactions carried out for monetary reasons or as part of public debt management by a state, its central bank, or a thus entrusted organization or persons acting on their behalf, but arguing for a narrow interpretation and not exempting any transactions by these institutions having only pretendingly these reasons); Klaus Hopt, *Insiderwissen und Interessenkonflikte im europäischen und deutschen Bankrecht* [*Insider Knowledge and Interest Conflicts Concerning European and German Banking Law*], *in* FESTSCHRIFT FÜR THEODOR HEINSIUS ZUM 65. GEBURTSTAG AM 25. SEPTEMBER 1991 [COMMEMORATIVE PUBLICATION IN HONOR OF THEODOR HEINSIUS] 289, 292–93 (Friedrich Kübler, Hans-Joachim Mertens & Winfried Werner eds., 1991) (arguing for a strict interpretation of the exemption, not including any transaction carried out for other reasons).

255. On May 6, 2011 several members of the euro area, representatives of the European Commission, the European Central Bank, and Greece met secretly in Luxembourg in order to discuss the crisis, and, possibly, Greece leaving the euro. When "Der Spiegel," a German political magazine, reported the meeting, the chairman of the euro area, Luxembourg's Prime Minister Juncker, had a spokesperson deny that there was a meeting. The French Finance Minister Lagarde, now chairwoman of the International Monetary Fund, also denied it. Sebastian Fischer, et al., *Juncker gerät wegen Gehemeintreffen unter Beschuss* [Juncker Under Attack Due to Secret Meeting], SPIEGEL ONLINE (May 9, 2011), http://www.spiegel.de/politik/deutschland/0,1518,761509,00.html; *Juncker stellt Bedingungen für weitere Griechenlandhilfen* [*Juncker Dictates Conditions for Further Assistance for Greece*], HANDELSBLATT (May 13, 2011), http://www.handelsblatt.com/juncker-stellt-bedingungen-fuer-weitere-griechenland-hilfen/4173608.html [hereinafter *Juncker Dictates Conditions*]; Hendrick Kafsack, *Juncker nach falschen Dementis in der Kritik* [*Juncker Subject to Criticism After Untrue Denial*], FAZ.NET (May 10, 2011), http://www.faz.net/aktuell/wirtschaft/europas-schuldenkrise/nach-geheimtreffen-zu-griechenland-juncker-nach-falschen-dementis-in-der-kritik-1641525.html.

256. *Juncker Dictates Conditions*, *supra* note 255.

257. *Supra* note 250 and accompanying text.

258. *See* Jürgen Oechsler, *in* J. VON STAUDINGER—KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH MIT EINFÜHRUNGSGESETZ UND NEBENGESETZEN [STAUDINGER—COMMENTARY ON THE CIVIL CODE] § 826, paras. 380a–384m (2009) (concerning civil liability for breaches of capital market law which would create a private action for damage against an issuer that intentionally tries to harm investors); Gerald Spindler, *in* BECK'SCHER ONLINE-KOMMENTAR BGB [BECK'S ONLINE COMMENTARY OF THE CIVIL CODE] § 823, paras. 218–218e (Heinz Georg Bamberger & Herbert Roth eds., 2011) (discussing the civil liability that may result from breaches of regulations aimed at protecting investors).

259. Directive 2003/6, *supra* note 235, art. 7.

260. *See* WpHG § 1, para. 3 (excusing transactions of monetary reasons or as part of public debt

law, however, extends the exemption from transactions to behavior.[264] This goes beyond the scope of Article 7 of the Market Abuse Directive 2003/6. The term transactions cannot be construed so broadly that any behavior by the entities covered by the exemption is privileged. There is no basis for such a broad reading. The Directive's wording is unequivocal in this respect, and there is hardly a justification for such a broad exemption. Sovereign behavior should not be generally exempted, especially if it consists of false statements made with the intention to influence the market. Lies do not generate investor trust.[265]

This criticism also applies to the proposal for a new regulation on insider dealing and market manipulation.[266] The proposed legislative act aims to replace the Market Abuse Directive 2003/6, which is addressed to the Member States and needs to be transposed into national law by each Member State, by a regulation that is directly applicable in all Member States.[267] While the proposal continues to prohibit insider dealing and market manipulation,[268] it also significantly extends the exemption for E.U. sovereign debtors. Most importantly, the Commission suggests that the exemption not be limited to transactions any more but extended to behaviors as well.[269] Thus, even though the definition of market manipulation in the

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management from insider surveillance and compliance monitoring provisions).

261. Decreto Legislativo 24 febbraio 1998 [Legislative Decree Feb. 24, 1998], n.58, *in* G.U. GAZZ. UFF., May 28, 1999, n.123, art. 183 (It.).

262. Kapitalmarktgesetz, *supra* note 231, § 48e, para. 1.

263. Ley de Valores, *supra* note 247, art. 81, paras. 2–3.

264. Financial Services Act, *supra* note 225, ch. 8, art. 118A, para. 5, cl.(c).

265. *See* Hubert de Vauplane, *Droit des marches financiers: Dettes souveraines et abus de marché* [*Law of Financial Markets: Sovereign Debt and Market Abuse*], BANQUE & DROIT [BANK & LAW] (hors-série [special edition]) 65, 65–66 (2012), *available at* http://www.revue-banque.fr/medias/content/users/gery/1332257733111.pdf (discussing the unique problems market abuse presents for sovereign debt); Rüdiger Veil & Philipp Koch, *Auf dem Weg zu einem europäischen Kapitalmarktrecht: die Vorschläge der Kommission zur Neuregelung des Marktmissbrauchs* [*Towards a European Capital Market Law: The Commission's Proposal on a Reform of Market Abuse Law*], 65 W.M. 2297, 2299 (2011) (discussing new legal instruments designed to enhance consumer confidence); Steffen Rutter, *Finanzkrise Griechenland: Muntere Marktmanipulation durch den Staat* [*Greek Financial Crisis: Blithe Market Manipulation by the State*], CARTA (Mar. 22, 2010), http://carta.info/24636/finanzkrise-griechenland-muntere-marktmanipulation-durch-den-staat/ (relating the goal of Directive 2003/6—to improve market integrity).

266. *Commission Proposal for a Regulation of the European Parliament and of the Council on Insider Dealing and Market Manipulation (Market Abuse)*, COM (2011) 651 final (Oct. 20, 2011), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0651:FIN:en:PDF [hereinafter *Commission Proposal on Market Abuse*].

267. *See* TFEU, *supra* note 14, art. 288, paras. 2–3 (stating that regulations are directly applicable in all Member States whereas directives are only binding upon the Member States as to the result); *see also supra* INTRODUCTION.B. (discussing the legal requirement of harmonization laws).

268. *Commission Proposal on Market Abuse*, *supra* note 266, arts. 9–10.

269. Exclusion for monetary and public debt management activities and climate policy activities reads:

> 1. This Regulation does not apply to transactions, orders or behaviours carried out in pursuit of monetary, exchange rate or public debt management policy by a Member State, by the European System of Central Banks, by a national central bank of a Member State, by any other ministry, agency or special purpose vehicle of a Member State, or by any person acting on their behalf and, in the case of a Member State that is a federal state, to such transactions, orders or behaviours carried out by a member making up the federation. It shall also not apply to such transactions, orders or behaviours carried out by the Union, a special purpose vehicle for several Member States, the European Investment Bank, an international financial institution established by two or more Member States, which has the purpose to mobilise funding and provide financial assistance to the benefit of its members that are experiencing or threatened by

proposal explicitly covers Prime Minister Juncker's behavior,[270] it is arguably exempted.[271] The same exemption is found in the European Commission's proposal for a directive on criminal sanctions for insider dealing and market manipulation.[272]

4. Assessment of Credit Risk by Banks

Banks are subject to regulatory capital requirements which means that they have to maintain a certain ratio of outstanding loans and own funds.[273] Article 75, clause (a) of Directive 2006/48[274] demands that banks have own funds in the amount of "8 % of the total of their risk-weighted exposure amounts." Thus, the higher their risk-weighted exposure amounts (e.g., their holding of debt or outstanding loans) the greater the need for own funds. E.U. sovereign debt, however, is assigned a risk weight of 0%[275] so that there is no regulatory need for banks to provide for the possible default of a sovereign debtor. In the crisis, regulatory measures only suspended this privilege for E.U. sovereign debt but did not eliminate it.[276] It is even contained in the proposed new regulation on prudential requirements for credit institutions and investment firms.[277]

5. Conclusion Regarding the Privileges Granted to Sovereign Debtors

Private issuers of securities are subject to strict regulation. They have to disclose information when entering the capital market through an initial public

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> severe financing problems or the European Financial Stability Facility. 2. This Regulation does not apply to the activity of a Member State, the European Commission or any other officially designated body, or of any person acting on their behalf, which concerns emission allowances and which is undertaken in the pursuit of the Union's climate policy.

Id. art. 4.

270. *See id.* art. 8, para. 1, cl.(c) (defining market manipulation as "disseminating information through the media, including the Internet, or by any other means, which has the consequences referred to in subparagraph (a), where the person who made the dissemination knew, or ought to have known, that the information was false or misleading"). Subparagraph (a) of that article reads:

> (a) entering into a transaction, placing an order to trade or any other behaviour which has the following consequences: —it gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument or a related spot commodity contract; or—it secures, or is likely to secure, the price of one or several financial instruments or a related spot commodity contracts at an abnormal or artificial level.

Id. cl.(a).

271. *See* Veil & Koch, *supra* note 265, at 2299 (discussing, with a critical tone, the broad exceptions granted to public bodies).

272. *See Commission Proposal for a Directive on Criminal Sanctions for Insider Dealing and Market Manipulation*, *supra* note 250, art. 1, para. 2 ("[The] Directive does not apply to . . . behaviours carried out for the purposes of monetary and public debt management activities and activities concerning emission allowances in pursuit of the Union's climate policy . . . .").

273. *See supra* Section II.C.4. for a more detailed analysis.

274. Directive 2006/48, *supra* note 196 (implementing the provisions on the required level of own funds set by Basel II).

275. *Supra* note 206.

276. *See supra* Section III.A.4.

277. *Commission Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*, art. 109, para. 4, COM (2011) 452 final (July 20, 2011).

offering (IPO),[278] and while listed on the stock exchange they have to disclose information on both a regular and an ad hoc basis.[279] Market integrity is preserved by a prohibition on insider dealing and market manipulation.[280] In contrast, European law exempts sovereign debtors from these provisions and grants them a wide range of privileges.[281] Some are granted to all sovereign debtors,[282] some are limited to certain sovereign debtors, especially Member States of the European Union.[283] Surprisingly, these privileges have hardly been questioned;[284] neither the European Commission nor the German government have shown any initiative for reform. On the contrary, reform initiatives by the European Commission point in the opposite direction, extending privileges for sovereign debtors.[285]

B. *Learning from the Crisis: Treating Sovereign Debtors and Private Debtors More Alike*

As a lesson from the crisis, we should treat sovereign issuers of debt more like private issuers. It is true that sovereign debtors and private debtors are different. Yet, as discussed below, the differences between them do not justify the privileges granted to sovereign debtors.

1. Sovereign Debts Are Not Safer than Private Debts

The consideration underlying the multitude of privileges granted to (some) sovereign debtors seems to be that (certain) sovereign debts are safer for creditors.[286] While it is true that a state is not subject to insolvency proceedings,[287] this does not

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278. *See supra* Section III.A.1.

279. *See supra* Section III.A.2.

280. *See supra* Section III.A.3.

281. *See supra* Section III.A.4.

282. For example, for the obligation to publish financial reports and interim management statements see Directive 2004/109, *supra* note 233, art. 8, para. 1, cl.(a).

283. E.U. sovereign debtors are exempted from many obligations, including the obligation to publish a prospectus. *See* Directive 2003/71, *supra* note 216, art. 1(2)(b) (explaining how Member States are exempt from the obligation to publish a prospectus); *see also* Directive 2001/34, *supra* note 220, art. 2(2)(b) (exempting them from the listing requirements); *see also* Directive 2003/6, *supra* note 235, art. 7 (exempting Member States in certain cases from its scope of application); *see also supra* Section III.A. (explaining the numerous exemptions that apply to sovereign debtors).

284. *But see* de Vauplane, *supra* note 265, at 66–67 (describing state exemption from regulations); Veil & Koch, *supra* note 265, at 2299 (explaining how blanket exemptions for state misconduct might have an especially damaging effect on market integrity).

285. *See Commission Proposal on Market Abuse*, *supra* note 266, art. 4 (exempting E.U. Member States from regulations of certain activities).

286. JAHRESGUTACHTEN 2011/2012, *supra* note 8, para. 134; *see* Jörn Axel Kämmerer, Der Staatsbankrott aus völkerrechtlicher Sicht [Sovereign Default from a Public International Law Perspective], 65 Zeitschrift für ausländisches öffentliches Recht und Völkerrecht [Z.a.ö.R.V.] 651, 651 (2005) (discussing the perception of sovereign debtors as safe).

287. *See, e.g.*, Claus Ott & Mihai Vuia, *in* MÜNCHENER KOMMENTAR ZUR INSOLVENZORDNUNG, BAND 1 [MUNICH COMMENTARY ON THE INSOLVENCY ACT] § 12 InsO, para. 10 (Hans-Peter Kirchhof, Hans-Jürgen Lwowski & Rolf Stürner eds., 2d ed. 2007) (explaining that insolvency proceedings are inadequate for sovereign bankruptcy because their purpose is the satisfaction of creditors, not the consolidation of the commonwealth, and the position of an insolvency administrator "would be inconsistent with the constitutional powers of State organs"); *see also* Kämmerer, *supra* note 286, at 651 (discussing the legal mechanisms by which sovereigns are exempted from the consequences of insolvency

render sovereign debt safer. There may be no risk of a state being wound up and liquidated like an insolvent private debtor,[288] but this is little consolation for creditors. As many historic examples show,[289] a state may nevertheless default. Moreover, in the event of a sovereign default, the creditors are at a significant disadvantage compared to creditors of private debtors. Seizing the state's assets and distributing them to the creditors will prove more difficult and costly, if not impossible, because generally, at least the assets used for official purposes, will be exempted.[290] Finally, unlike private debtors, the state has the power to legislate, which it can use to alter the terms of debt agreements, especially if the debts are governed by its own law, in its favor.[291] In sum, sovereign debt, in some respects, may be riskier than private debt.[292]

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proceedings); Insolvenzordnung [InsO] [Insolvency Act], Oct. 5, 1994, BGBL. I at 2866, as amended, § 12 (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/inso/gesamt.pdf (exempting the federal state as well as the single German states from insolvency proceedings); *see also* Christoph Paulus, *Geordnete Staatsinsolvenz* [Orderly Sovereign Default], 2011 Z.I.P. 2433, 2433 (citing Section 12 of the German Insolvency Act (InsO), which states that insolvency proceedings against states are forbidden); *see also* Christoph Keller, *Umschuldung von Staatsanleihen unter Berücksichtigung der Problematik einer Aggregation aller Anlagegläubiger [Restructuring of Government Bonds, Taking into Account the Problem of Aggregation of All Investment Creditors*], *in* DIE REFORM DES SCHULDVERSCHREIBUNGSRECHT [THE REFORM OF DEBT SECURITY LAW] 157, 164–77 (Theodor Baums & Andreas Cahn eds., 2004) (discussing proposals by the public sector on how to improve the mechanisms for sovereign debtors in financial distress); *see also* Kratzmann, *supra* note 143, 322–25 (explaining why an insolvency procedure for states does not exist and how one could be introduced). *But see* Peter Sester, *Beteiligung von privaten Investoren an der Umschuldung von Staatsanleihen im Rahmen des European Stability Mechanism (ESM) [The Participation of Private Investors in Restructuring Bonds in the Framework of ESM*], 65 W.M. 1057, 1057–62 (2011) (discussing mechanisms to resolve sovereign debtor's financial difficulties; collective action clauses, an insolvency procedure for states and the case of Argentina's debt restructuring); Menno Aden, *Insolvenzverfahren über Fiskalvermögen eines Staates [Insolvency Proceedings Relating to State Assets*], 43 ZEITSCHRIFT FÜR RECHTSPOLITIK [Z.R.P.] 191 (2010) (discussing how one might impose insolvency proceedings against a sovereign using Argentina's debt crisis as an example).

288. *See* Kämmerer, *supra* note 286, at 651 (stating that no private or public investor, be it domestic or foreign, may force a state into insolvency proceedings and liquidation).

289. *See id.* at 651–52 (describing how ninety countries over the past 200 years have defaulted on sovereign debt including the majority of major European powers, and discussing the most recent default on sovereign debt by Argentina from 2001 to 2002); Kratzmann, *supra* note 143, at 319–22 (listing historical examples of state financial difficulties and the mechanism used to resolve them); Carmen Reinhart & Kenneth Rogoff, *This Time is Different: A Panoramic View of Eight Centuries of Financial Crises* 24 (Nat'l Bureau of Econ. Research, Working Paper No. 13882, 2008), *available at* http://www.nber.org/papers/w13882 (displaying a table of when and how many states have been in default); Matthias Herdegen, *Der Staatsbankrott [Sovereign Default*], 65 W.M. 913 (2011) (citing several examples of restructuring of sovereign debt).

290. *See, e.g.*, Zivilprozessordnung [ZPO] [Civil Procedure Statute], Dec. 5, 2005, BGBL. I 3202, 2006, 431, 2007, 1781, as amended, § 882a, para. 2 (Ger.), *available* at http://www.gesetze-im-internet.de/bundesrecht/zpo/gesamt.pdf, English translation of the statute *available at* http://www.gesetze-im-internet.de/englisch_zpo/index.html ("Compulsory enforcement is not admissible against objects that are indispensible for the performance by the debtor of tasks governed by public law, or the disposition over which is contravened by public interest"); *see also* Aden, *supra* note 287, at 191 (for German law); Christoph Ohler, *Der Staatsbankrott* [Sovereign Default], 60 J.Z. 590, 592 (2005) (asserting that under German law public assets are exempt from claims by creditors).

291. *See, e.g.*, Herdegen, *supra* note 289, at 913–14 (explaining that the state's power to legislate only covers the restructuring of debts that are subject to the state's jurisdiction); Ohler, *supra* note 290, at 593 (discussing a state's limited regulatory authority over its own citizens or people located within its territory); Paulus, *supra* note 287, at 2433 (describing how sovereign debt can be cancelled by passage of a new law when the majority of the debt is owed to the debtor country's own citizens or when the debt is governed by the country's own national law); *see also* Rachel Donadio, *Greek Premier Says Creditors May*

2. Sovereign Debtors Have the Same Incentives for Opportunistic Behavior

The hope that sovereign debtors might treat creditors more honestly so that formal disclosure obligations and prohibitions on market manipulation and insider dealing are superfluous is not justified. Sovereign debtors have the same incentives for opportunistic behavior as private issuers. The actors in a state are subject to substantial pressure from many sides (voters, parliament, courts, trade unions, employers' associations, private industry, (corporate) donors, and lobbyists),[293] and are therefore not likely to, of all the interests, put the creditors' interest first. The best scenario would be that the public interest is given priority, which is, of course, something politicians are elected and expected to do. Yet, they should try to prevent a crisis rather than trying to solve it at the expense of the state's creditors and by employing methods otherwise considered as illegal and even criminal. In any event, sovereign debtors are just as likely as private debtors to put their interests first—at the expense of their creditors. Arguably, they are even more likely to do so because the people in charge feel (or can at least argue) that they are acting in the public interest. Therefore, in the case of a sovereign debtor, there is just as much, if not more, need for creditor protection.

3. Individual Exemptions Are Not Justified

These general considerations already point strongly towards the result that exemptions for sovereign debtors cannot be justified. The tendency is reinforced when one looks at the exemptions individually. A one-by-one analysis of the exemptions not only makes their lack of justification apparent, it also shows that their abolition can have a beneficial effect on market integrity by promoting the prevention of a future crisis.

a. Prospectus Requirement

Regarding the exemption from the obligation to publish a prospectus,[294] the underlying rationale is that sovereign debtors who are E.U. Member States or members of the European Economic Area are considered first-rate debtors whose solvency is not in doubt.[295] Obviously, sovereigns have demonstrated that this

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Be Forced to Take Losses, N.Y. TIMES, Jan. 18, 2012, at A6, *available at* http://www.nytimes.com/2012/01/18/world/europe/papademos-says-greece-could-force-creditors-to-take-losses.html (reporting Greek government's threat to enforce the voluntary haircut with legislation if necessary).

292. *See* Kratzmann, *supra* note 143, at 319 (describing the historically poor reliability of sovereign debtors by citing different sources).

293. *Cf.* Leszek Balcerowicz, *Sovereign Bankruptcy in the EU in the Comparative Perspective* 3–4 (Peterson Inst. for Int'l Econ., Working Paper 10–18, 2010), *available at* http://www.bt.iie.com/publications/wp/wp10-18.pdf (discussing the pressure on governments in the context of sovereign default).

294. *See supra* Section III.A.1.

295. *See* WOLFGANG GROß, KAPITALMARKTRECHT [CAPITAL MARKETS LAW] § 1 WpPG, para. 5, § 37 BörsG (4th ed. 2009) (implying that E.U. Member States are very safe debtors); Andreas Grosjean, *in* AKTIENRECHT UND KAPITALMARKTRECHT [CORPORATE LAW AND CAPITAL MARKET LAW], *supra* note 97, § 1 WpPG, para. 4 (stating that the exemption from prospectus requirements debtors like the Member States of the European Economic Area are based on their solvency); Uwe Hamann, *in* KAPITALMARKTGESETZE, BAND 2 [CAPITAL MARKET LAW] § 1 WpPG, para. 13 (Frank Schäfer & Uwe

premise is wrong.[296] Interestingly, the German Investment Act, which applies to investments offered to the public in Germany and not evidenced by securities as defined in the Securities Prospectus Act,[297] shows less naïveté. Even though it exempts E.U. Member States and EEA signatory states without reservation, it is more cautious with respect to OECD Member States and stipulates that such a state is only exempted, if it has not "rescheduled its foreign debt or . . . had similar financial difficulties within the last five years."[298]

This could be a starting point for future regulation: However, introducing a differentiation between Member States along the lines of the five-year-rule of the Investment Act would be an inferior solution. As the current crisis shows European institutions and E.U. Member States are—for political and economic reasons—reluctant to call a spade a spade and formally admit that a Member State is in financial difficulty or has (had) to reschedule its foreign debt. Striking examples include the insistence in 2011 that Member States' loans to Greece carried a market interest rate[299] in order to disguise a possible contravention of the no-bail-out clause,[300] and, in 2011 and 2012, the insistence on a "voluntary" haircut to avoid a credit event, which in reality had already occurred in all but name.[301] Abolishing the exemption in general and requiring all sovereign debtors to publish a prospectus seems to be the better approach. This would align the statutes' assumption with reality i.e., the fact that E.U. Member States might default as well, and at the same time avoid any differentiation between Member States that could become an incentive for new contra-factual assumptions. If everybody has to publish a prospectus, there is no stigma attached to this obligation.

Hamann eds., 2d ed. 2010) ("It is assumed that the mentioned issuers have a sufficient financial standing, so that investor protection does not require a prospectus."); Anna Heidelbach, *in* KAPITALMARKTRECHTSKOMMENTAR [CAPITAL MARKETS COMMENTARY], *supra* note 244, § 1 WpPG, para. 9 ("As the solvency of [the sovereign issuers] is assumed the adequate investor protection is kept even without prospectus."); Joachim Hennrichs, *in* KAPITALMARKTRECHTSKOMMENTAR [CAPITAL MARKETS COMMENTARY], *supra* note 244, § 8f VerkProspG, para. 32 (stating that public service organizations are exempted from prospectus obligations given the liquidity and reliability of their offers); Corinna Ritz & Michael Zeising, *in* WERTPAPIERPROSPEKTGESETZ (WPPG) UND EU-PROSPEKTVERORDNUNG [SECURITIES PROSPECTUS ACT AND PROSPECTUS REGULATION] § 1 WpPG, para. 16 (Clemens Just, et al. eds., 2009); Gerald Spindler, *in* WPPG [COMMENTARY ON THE SECURITIES PROSPECTUS ACT], *supra* note 218, § 1 WpPG, paras. 10, 14–16. *But see* WOLFGANG GROß, KAPITALMARKTRECHT [CAPITAL MARKETS LAW] § 1 WpPG, para. 5, § 37 BörsG (5th ed. 2012) (now with a much more critical assessment of the actual solvency of E.U. Member States); de Vauplane, *supra* note 265, at 65, 67 (criticizing the distinction between private and sovereign debtors).

296. *See* Cord Gebhardt, *in* KAPITALMARKTGESETZE, BAND 2 [CAPITAL MARKETS LAW], *supra* note 295, § 36 BörsG, para. 2 (criticizing these provisions).

297. Gesetz über Vermögensanlagen [Vermögensanlagengesetz - VermAnlG] [Investment Act], Dec. 6, 2011, BGBL. I at 2481, § 1, as amended (Ger.), *available at* http://www.gesetze-im-internet.de/bundesrecht/vermanlg/gesamt.pdf.

298. *Id.* § 2, no. 7, lit.(a).

299. *See supra* note 147 and accompanying text.

300. TFEU, *supra* note 14, art. 125, para. 1; *see also supra* Section II.B. (discussing the no-bail-out-clause).

301. *See* Donadio, *supra* note 291 (discussing "voluntary" restructuring of the Greek public debt).

b. Continuous Disclosure of Information

Sovereign debtors are exempted from the regular financial reporting requirements.[302] The rationale behind this exemption differs from the rationale behind the exemption from the prospectus requirement. Whereas the prospectus requirement exemption seems to consider certain sovereign debtors above suspicion and treats other sovereign debtors differently,[303] the regular financial reporting requirement exemption does not distinguish between creditors of different creditworthiness. All sovereign debtors are exempted.

The underlying consideration seems to be that information on sovereign debtors i.e., states, is publicly available anyway, so that there is no need for regular financial reporting. This, however, is not convincing. First, it does not seem to sit easily with the requirement that some states, as issuers of bonds, have to publish a prospectus.[304] If the assumption that relevant information on states is publicly available is true, then that would also have to be true for information contained in a prospectus. This differentiation cannot be explained by pointing out that a prospectus is necessary in order to provide information on the bonds issued, because if this were the case, then all states would have to be required to publish a prospectus and not just some. Second, publicly available information is not provided by creditors to investors, i.e., their (potential) debtors. It comes from a multitude of sources and is used in the sphere of politics, e.g., information on the budget, the calculation of the deficit, or unemployment figures. Many of these sources are not tailored for use in investment decisions. The figures displayed in the budget have little to say about economic prospect or future developments. The courts of audit may produce reliable data, yet they are concerned with past conduct and are not a reliable basis for a prognosis of future performance. Other sources and figures (like government programs and other political statements, employment figures, and economic forecasts) may be of more relevance, but are highly political and often disputed, selectively presented and interpreted, or even distorted. Against this background, publicly available information appears more likely to be incorrect, incomplete, misleading, or at the very least contradictory—in short less reliable than information specifically addressed to investors by an issuer.[305] Again, it is simply not tailored for use in investment decisions. The lower degree of reliability of such publicly available information means additional costs for investors.

By contrast, abolishing the exemption and requiring sovereign debtors to publish a formal document addressed to investors would first provide investors with more reliable, comprehensive, and investment-focused information on sovereign debtors. It would be evident for both the person signing the document and the persons to whom it is addressed that it is different from a political statement and requires, bluntly put, honesty. Second, it would also set incentives that would help prevent opportunistic behavior by a sovereign debtor or, respectively, its agents.

For normal private law issuers the Transparency Directive requires them to include in their annual financial report

302. Directive 2004/109, *supra* note 233, art. 8, para. 1, cl.(a).

303. *See supra* Section III.A.1.

304. *Id.*

305. *Cf. Unternehmen statt Staaten: Anleger denken bei Anleihen um* [*Corporate Instead of Sovereign Debt: New Investment Strategies*], HANDELSBLATT, Dec. 16–17, 2011, at 48 (describing transparency as a competitive advantage of private issuers).

> statements made by the persons responsible within the issuer ... to the effect that, to the best of their knowledge, the financial statements ... give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer ... and that the management report includes a fair review of the development and performance of the business and the position of the issuer . . . , together with a description of the principal risks and uncertainties. . . .[306]

The same is true for the half-yearly financial report.[307] The Directive also demands "that responsibility for the information to be drawn up and made public ... lies at least with the issuer or its administrative, management or supervisory bodies . . . ."[308] Article 28 also calls for appropriate penalties.[309] This has been transposed into German law,[310] according to which a false statement is punishable by a fine or by up to three years imprisonment.[311] Read in conjunction with German tort law[312] a contravention would also entail civil liability.[313] This corresponds to the balance sheet oath as demanded by section 302 of the Sarbanes-Oxley Act in the United States.[314]

Why not also require a similar statement from government officials? Why not make the heads of government and their ministers of finance sign a formal document

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306. Directive 2004/109, *supra* note 233, art. 4, para. 2, cl.(c).

307. *Id.* art. 5, para. 2, cl.(c). These requirements have been transposed into German law by § 37v, para. 2, no. 3, § 37w, para. 2, no. 3 of the WpHG and § 264, para. 2, sentence 3 of the HGB.

308. Directive 2004/109, *supra* note 235, art. 7.

309. *Id.* art. 28.

310. HGB, *supra* note 84, § 331, no. 3a.

311. *See* Sascha Ziemann, *Der strafbare "Bilanzeid" nach § 331 Nr. 3a HGB* [*"Balance-Sheet Oath" Under HGB § 331, no. 3a*], 26 ZEITSCHRIFT FÜR WIRTSCHAFTS- UND STEUERSTRAFRECHT [WI. STRA.] [MAGAZINE FOR BUSINESS AND TAX CRIMINAL LAW] 292 (2007) (explaining section 331 No. 3 (a) HGB in general which makes a false balance sheet oath an offense). *See generally* Holger Fleischer, *Der deutsche "Bilanzeid" nach § 264 Abs. 2 Satz 3 HGB* [*The German "Balance-Sheet Oath"*], 2007 Z.I.P. 97 (discussing the balance-sheet-oath and its consequences in Germany).

312. *See* Bürgerliches Gesetzbuch [BGB] [Civil Code], Jan. 2 2002, BGBL. I at 42, 2909 & 2003 BGBL. I at 738, as amended, § 823, para. 2 (Ger.), *available* at http://www.gesetze-im-internet.de/bundesrecht/bgb/gesamt.pdf, English translation of the Code *available at* http://www.gesetze-im-internet.de/bgb/index.html (stating that liability for compensation exists for "person who commits a breach of a statute that is intended to protect another person").

313. *Cf.* Fleischer, *supra* note 311, at 103 (imposing civil liability for a false statement); Hanno Merkt, *in* HANDELSGESETZBUCH [COMMENTARY ON THE COMMERCIAL CODE] § 264, para. 26 (Adolf Baumbach & Klaus Hopt eds., 35th ed. 2012) (stating that a false statement may result in civil liability).

314. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002); *see also* Securities Exchange Act, Publ. L. No. 73-291, § 13(a), § 15(d), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78 (2012)); SEC Rule, 17 C.F.R. § 240.13a-14, § 240.15d-14 (2011) ("adopting rules to require an issuer's principal executive and financial officers each to certify the financial and other information contained in the issuer's quarterly and annual reports"). *See generally* Brian Kim, *The Sarbanes-Oxley Act*, 40 HARV. J. ON LEGIS. 235, 245–46 (2003); Christian Kersting, *Auswirkungen des Sarbanes-Oxley-Gesetzes in Deutschland* [*Effects of the Sarbanes-Oxley Act in Germany*], 2003 Z.I.P. 233, 233–34, 237–38 (describing the balance sheet oath introduced by the Sarbanes-Oxley Act); Bernhard Kuschnik, *The Sarbanes Oxley Act: "Big Brother Is Watching You" or Adequate Measures of Corporate Governance Regulation?*, 5 RUTGERS BUS. L.J. 64, 73–78 (2008); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1540–43 (2005). *See also* Sarbanes-Oxley Act §§ 906, 304 (requiring forfeiture of certain profits and bonuses when an issuer fails to comply with the Act); Securities Exchange Act § 18 (establishing a cause of action for fraudulent statements); SEC Rule, 17 C.F.R. § 240.10b-5 (2011) (for private and criminal law sanctions).

as the equivalents of the CEO and CFO? This is not unprecedented, given the fact that the E.U. Prospectus Regulation requires some sovereign debtors to have their registration document accompanied by a similar declaration by the persons responsible.[315] Government officials and politicians might be more reluctant to operate with incomplete, false, or misleading information if they personally had to certify their correctness.[316] It is even conceivable to attach criminal and civil liability to incorrect certifications.[317] Even if such liability was limited to intentional misconduct and did not apply in case of mere negligence,[318] it would set the right, or at least better, incentives. It would not only deter from intentional misconduct, but also probably from conduct that could be construed as intentional.

c. Market Integrity (Prohibition on Insider Dealing and Market Manipulation)

It is understandable that the Market Abuse Directive does not apply to "transactions carried out in pursuit of monetary, exchange-rate or public debt-management policy."[319] Prohibiting the state from entering into transactions would impair its ability to pursue policy objectives, especially since the policies mentioned are of systemic importance. Yet, any attempt to extend this exemption to behaviors as suggested by a European Commission proposal for a new regulation[320] and the corresponding proposal for a directive on criminal sanctions,[321] goes too far.[322]

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315. *See* Commission Regulation 809/2004, *supra* note 218, art. 19 *in conjunction with* Annex XVI, art. 20 *in conjunction with* Annex XVII. Annex XVI, point 1.2 of this Regulation reads:

> A declaration by those responsible for the Registration Document that, having taken all reasonable care to ensure that such is the case, the information contained in the registration document is, to the best of their knowledge in accordance with the facts and contains no omission likely to affect its import. As the case may be, declaration by those responsible for certain parts of the registration document that, having taken all reasonable care to ensure that such is the case the information contained in the part of the registration document for which they are responsible is, to the best of their knowledge, in accordance with the facts and contains no omission likely to affect its import.

316. For an example of the intended functions of a balance-sheet oath, see Fleischer, *supra* note 311, at 103–05 (discussing the purpose of the required statement and the possible practical effects); *see also* Kuschnik, *supra* note 314, at 74–75 (noting that, under the Sarbanes-Oxley Act, CEOs and CFOs are personally liable for misrepresentations on periodic reports, thereby creating an incentive to file accurate reports).

317. Kuschnik, *supra* note 314, at 75 (regarding U.S. law); *supra* notes 311, 313 (regarding German law).

318. Section 264, paragraph 2, sentence 3 of the HGB demands that the officers certify financial reports to the best of their knowledge, which does not allow for liability in case of mere negligence. *See* Fleischer, *supra* note 311, at 100–01, 103 (stating that the obligation for the statement only requires the statement to be made to the best of their knowledge); *see also* Norbert Winkeljohann & Mathias Schnellhorn, *in* BECK'SCHER BILANZ-KOMMENTAR [BECK'S ACCOUNTING LAW COMMENTARY], § 264, para. 69 (Helmut Ellrott, et al. eds., 8th ed. 2012) (stating that intentional conduct, not mere negligence, may yield legal consequences); Michael Kozikowski & Daniel Gutman, *in* BECK'SCHER BILANZ-KOMMENTAR [BECK'S ACCOUNTING LAW COMMENTARY], § 331, para. 38 (stating that liability is limited to cases of intentional misconduct). Civil liability based on Section 826 of the BGB requires intent ("A person who, in a manner contrary to public policy, intentionally inflicts damage on another person is liable to the other person to make compensation for the damage."). Oechsler, *supra* note 258.

319. Directive 2003/6, *supra* note 235, art. 7.

320. *See supra* Section III.A.3.; *see also supra* note 266 and accompanying text.

321. *See supra* note 272 and accompanying text.

Exempting state behavior from the scope of the European market integrity provisions would enable the state to engage in behavior otherwise considered to be criminal. The state would be allowed to manipulate the market at the expense of investors without even having to enter into a market transaction.

There is no justification for this.[323] It may be argued that public interest may force public officials to make false statements in order to avoid market reactions detrimental to the public good. This is, however, unconvincing. The proposed regulation itself explicitly addresses the public need for secrecy as a possible justification in the context of private law issuers and only permits the delay of public disclosure of insider information if: (1) "the information is of systemic importance;" (2) "it is in the public interest to delay its publication;" and (3) "the confidentiality of that information can be ensured."[324] The publication of misleading information is therefore never permitted, not even if the correct information "is of systemic importance," and "it is in the public interest to delay its publication."[325] Similarly, a delay in publication is not permitted if confidentiality cannot be ensured. This is true even if the information was of systemic importance and delaying its publication in the public interest.[326] Thus, once there are rumors about a significant meeting that could influence the market, the fact that the meeting is taking place has to be publicly disclosed; immediate publication is required simply because confidentiality can no longer be ensured.

It is difficult to see why this should not also apply to sovereign debtors. States (or their agents) should not be allowed to give false or misleading information. They should not be allowed to keep correct information a secret despite a lack of confidentiality. There is no reason to privilege states or their agents in this respect. The current crisis shows that they are by no means more trustworthy than private issuers. Moreover, their opportunistic behavior may damage investor confidence more. If investors cannot trust the state to be an honest market participant, they are likely to draw negative inferences regarding the general level of investor protection and market integrity in that jurisdiction.[327] A *carte blanche* for public officials to manipulate the market in pursuit of monetary, exchange rate, or public debt management policy would thus mean a significant loss of investor trust, especially since, according to the proposed exemption, false and misleading information by the state may not only relate to sovereign debt, but also to all financial instruments.

d. Assessment of Credit Risk by Banks

Banks are subject to minimum regulatory capital requirements calculated according to their exposure to risk. Exposure to E.U. sovereign debtors, however,

322. *Cf.* de Vauplane, *supra* note 265, at 66–67 (commenting that an extension of the Market Abuse Directive to public debt management policy would be appropriate); Veil & Koch, *supra* note 265, at 2299 (questioning the justification for giving public bodies blanket exceptions from the Market Abuse Directive); Rutter, *supra* note 265 (arguing the Market Abuse Directive should not exempt state actors).

323. *See supra* notes 263–67 and accompanying text.

324. *Commission Proposal on Market Abuse*, *supra* note 266, art. 12, para. 5.

325. *Id.*

326. *Id.*

327. *See* Veil & Koch, *supra* note 265, at 2299 (arguing that market manipulation by public bodies is uniquely detrimental to confidence in market integrity).

only carries a risk weight of 0%, i.e., it is not taken into account.[328] This gives banks an incentive to invest in E.U. sovereign debt.[329] It is understandable that in the current crisis this is not changed, because any change would create an incentive to disinvest, which would put prices for sovereign bonds under even greater pressure. The creation of a temporary capital buffer, calculated on past holdings of sovereign debt in order not to set incentives for disinvestment,[330] is indeed the better alternative.[331]

The 0% risk weight for E.U. sovereign debt should, however, be abolished in the long run.[332] Again, there is no legitimate reason for treating a sovereign debtor better than a private debtor.[333] Banks should take a realistic view of risk and be required to meet minimum regulatory capital requirements accordingly. This corresponds exactly to the approach taken by the new proposal for an amendment to the rating agency regulation, which tries to reduce mechanistic reliance on external credit ratings by requiring certain financial institutions to assess credit risks independently.[334]

4. Need for Sovereign Immunity?

It could be argued that the state is not an ordinary market participant, but on a higher level also responsible for setting the legal framework, and in that capacity, for balancing different objectives and interests. Against that background, it could be considered legitimate that the state exempts itself from certain investor protection rules in order to further other objectives. In that sense, the state might try and safeguard its ability to finance social welfare at the expense of investor protection. Also, the state could favor the freedom of the political debate over the investor protection provisions that require accuracy, completeness, and correctness with regard to the financial position of the state.

This argument is nevertheless unconvincing; there should be no immunity for the state and its agents. First, freedom of political debate and protection of investors are not alternatives. A formal financial report document addressed to investors could supplement the publicly available information. Investors could rely on the information provided to them in the formal document. Any inconsistencies between the correct information in the formal document and other publicly available information or political statements could be addressed in the political debate or, if it is the formal document that proves to be inaccurate, in an action for damages against its signatories.

328. *See supra* Section III.A.4.

329. *Id.*

330. *See, e.g.*, Press Release, European Banking Authority (EBA), The EBA Details the EU Measures to Restore Confidence in the Banking Sector (Oct. 26, 2011) (EU), *available at* http://eba.europa.eu/News--Communications/Year/2011/The-EBA-details-the-EU-measures-to-restore-confide.aspx (for more detailed information follow link Question & Answers) (arguing in favor of a capital buffer as a response to "increasing concerns regarding sovereign debt").

331. *Cf. supra* Section II.C.4.

332. *See* Sester, *supra* note 124, at 89 (arguing against any regulatory incentive to invest in sovereign debt without taking the risks into account).

333. *Cf.* Schmitt, *supra* note 207, at 2349 (highlighting the competitive advantage of states compared to small- and medium-sized enterprises).

334. *See supra* Section II.C.3.; *Proposal on Credit Rating Agencies*, *supra* note 187, art. 1, para. 6.

Second, safeguarding the state's ability to finance social welfare expenses all sounds very well and important, but does that mean safeguarding it at the expense of investor protection? Looking at the exemptions discussed above, this means that the state should be allowed to try and safeguard its ability to finance certain projects, e.g., by engaging in market manipulation, insider trading, or by misrepresenting its position in order to refinance itself more cheaply. There is no fairness in that. What about investments in Greek debt? European governments in 2011 assured investors that Greece would not default.[335] After the first rescue package they forcefully encouraged banks to buy new Greek debt.[336] In the end, investors suffered a haircut that was voluntary only in name, and rating agencies declared that Greece partially defaulted.[337] In sum, investors who, believing in government statements bought Greek bonds, have made an extra contribution to the rescue package for Greece; basically, they have been subjected to an extra tax. Arguably, the European governments who reassured investors did not plan this from the outset. But even if they did not, it should be clear that such a plan would be illegal. This, however, requires that states not be exempted from the prohibition on market manipulation. In general, they should not be allowed to pursue policy objectives at the expense of (foolish) investors. The money required for the pursuit of policy objectives should come from the state's budget and thus be financed by everybody.

Third, the state is free to choose between financing through taxes or through debt. Yet, if it chooses to finance its budget through debt, it should be bound by this choice. The choice of private law requires the state to abide by this choice and deal with its creditors on an equal footing.[338] In cases in which a state issues bonds under a

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335. For example, the French Minister of Economic Affairs insisted in July 2011 that "La Grèce va rembourser sa dette" [Greece will pay its debts]. Hayat Gazzane, *Baroin et Pècresse saluent le plan pour la Grèce* [*Baroin and Pècresse Welcome the Plan for Greece*], LEFIGARO.FR (July 22, 2011), http://www.lefigaro.fr/conjoncture/2011/07/22/04016-20110722ARTFIG00275-grece-la-france-ne-veut-pas-parler-de-defaut-de-paiement.php. Also, in July 2011, German Chancellor Angela Merkel stated that she had confidence in the assessments of the E.U. Commission, the European Central Bank and the International Monetary Fund. *Merkel schmettert Bedenken der Ratingagenturen ab* [*Merkel Rejects Rating Agencies' Concerns*], HANDELSBLATT ONLINE (July 5, 2011), http://www.handelsblatt.com/politik/deutschland/griechenland-hilfen-merkel-schmettert-bedenken-der-ratingagenturen-ab/4359748.html; *see also* Melanie Amann, *Herr Papademos, wir sehen uns vor Gericht* [Mr. Papademos, I'll See You in Court], FRANKFURTER ALLGEMEINE SONNTAGSZEITUNG (Mar. 18, 2012), at 42 (discussing the possibility of a claim for damages against the state).

336. *See* Alex J. Pollock, *Default and the Nature of Government,* THE WALL STREET JOURNAL ONLINE (Mar. 14, 2012), http://online.wsj.com/article/SB10001424052702304450004577277830065320286.html (noting that "governments always promote government debt and can induce or pressure banks into buying it"); *see also* Stephen J. Lubben, *Greece's Sovereign Debt Lesson,* DEALBOOK N.Y. TIMES (Mar. 22, 2012), http://dealbook.nytimes.com/2012/03/22/greeces-sovereign-debt-lesson/ ("[N]obody bought Greek debt because of government pressure, with the possible exception of some Greek banks.").

337. Greece was downgraded by Standard & Poor's on February 28, 2012 from "B" to "SD." Stefan Schaaf, *Was die jüngste Hellas-Herabstufung bedeutet* [*What the Latest Hellas-Downrating Means*], FTD.DE (Feb. 28, 2012), http://www.ftd.de/politik/konjunktur/:schuldenschnitt-was-die-juengste-hellas-herabstufung-bedeutet/60174877.html. But on April 25, 2012, Standard & Poor's raised the rating from "SD" to "CCC" (Currently Vulnerable). Patrick Rizzo, *S&P Boosts Greece's Rating out of Default Status,* ECONOMY WATCH (May 2, 2012), http://economywatch.msnbc.msn.com/_news/2012/05/02/11500823-sp-boosts-greeces-rating-out-of-default-status?lite.

338. *Cf.* Klaus Hopt, *Insiderwissen und Interessenkonflikte im europäischen und deutschen Bankrecht* [*Insider Knowledge and Interest Conflicts Concerning European and German Banking Law*], *in* FESTSCHRIFT FÜR THEODOR HEINSIUS ZUM 65. GEBURTSTAG AM 25. SEPTEMBER 1991 [COMMEMORATIVE PUBLICATION IN HONOR OF THEODOR HEINSIUS], *supra* note 254254, at 292

foreign private law this becomes especially clear. This is, however, just as true in cases in which the state issues bonds under its own domestic law. Thus, a state's specific need for secrecy cannot justify the withholding of information from the capital market and good intentions to pursue the public interest cannot justify the publication of incorrect, incomplete, or misleading information.

Finally, exempting the state from investor protection provisions in order to pursue the public interest makes investments in sovereign debt riskier. Investors will therefore demand compensation in the form of higher interest rates. Hence, abolishing the exemption would have the beneficial effect of reducing risk premiums on the interest rates. Borrowing would probably become cheaper for the state.

C. *Conclusion*

A further lesson that can be learned from the crisis is that sovereign debtors should be treated more like private debtors. Sovereign debtors enjoy privileges that are not justified. They should be subjected *de lege ferenda* to a prospectus requirement and to a continuous financial reporting obligation. The regular financial reports should be contained in a formal document addressed to the creditors, possibly with liability attaching both to the issuer and to the signatories of the document. Rules against insider trading and market manipulation should as far as possible also be applicable to sovereign issuers. Regarding regulatory capital requirements, there should be no statutory risk weight of 0% for exposure to E.U. sovereign debt. Rather, banks should be required to assess their exposure risk to sovereign debt individually.

These proposals correspond to the European legislative proposal on ratings, which calls for market participants not to rely mechanistically on external ratings and on the authorities not to refer to external ratings. Privileges for sovereign debtors can be viewed as statutory external ratings declaring sovereign debt to be risk-free and sovereign issuers to be trustworthy. Yet, just as market participants should not mechanistically rely on external ratings, investors in sovereign bonds should by no means (mechanistically) rely on these statutory ratings. The statutory ratings are not a reliable basis for an investment decision because, first, they come from an interested party, i.e., the issuer, and, second, they are evidently wrong since sovereign debt is not risk-free and sovereign debtors are not always trustworthy.

SUMMARY AND CONCLUSIONS

The financial crisis has been a challenge for the European Union and its Member States. In as far as the fields of corporate and securities law are concerned, both have so far risen to this challenge. The European Union and its institutions as well as the twenty-seven Member States and their institutions have acted in a manner that was both coherent and—given cultural, historical, and legal differences between

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(regarding an earlier exemption for sovereign transactions in Article 2, paragraph 4 of Insider Directive 89/592, *supra* note 254: "Der Zweck der marktorientierten Regelung der Richtlinie gebietet es, daß der Staat oder andere öffentliche Stellen, wenn sie am Markt auftreten, keine Sonderstellung erhalten, sondern sich dem Wettbewerb unter den gleichen Bedingungen wie private Unternehmen stellen müssen." ["The purpose of the market oriented provisions of the directive demands that the state or other public bodies who enter the market must not receive special treatment, but have to face competition under the same conditions that apply to private actors."]). BECKER, *supra* note 254, at 72–73.

the Member States—divergent enough to address the subprime crisis and—until now—the sovereign debt crisis.

The crisis was mainly dealt with by the Member States who had to provide the money in their budgets for the financial aid granted to financial sector undertakings and who also had to provide a corporate law way of injecting the money into the undertakings. The European Commission supported the Member States' efforts. It quickly resolved the issue of the prohibition of state aid by providing guidelines regarding the granting of exceptions. Also, the European Commission successfully pressed for changes in the International Financial Reporting Standards designed to reduce the need for write-offs in the companies' balance sheets and thus alleviate their pro-cyclical effects. It then quickly incorporated the changes into E.U. law. Even though European law sometimes impeded certain national corporate law measures designed to deal with the crisis by providing for a fast way to recapitalize companies, it left enough room for other measures that in the end proved effective. While being still desirable, it is therefore not absolutely necessary to introduce exceptions for emergency situations, e.g., in the Capital Directive 2012/30.

Due to capital being allowed to move freely,[339] any regulation in the field of securities law requires broad application in order to be effective. Otherwise, market participants in a regulatory arbitrage would choose jurisdictions with laxer rules in order to escape stricter regulation elsewhere. Nevertheless, it was again mainly the Member States who took steps in the field of securities law to deal with the crisis. This worked in the current crisis because Member States took a coherent approach with, e.g., Germany supporting the United Kingdom's ban on short selling. It was, however, realized that a European approach was necessary because in situations in which time is of the essence one cannot always rely on twenty-seven Member States and their different supervisory agencies to take coherent securities law measures. In the wake of the subprime crisis, this led to the creation of European supervisory agencies which, in cases of urgency, have the power to directly intervene. Also, national measures that proved to be effective have been transferred to the European level, e.g., by the European regulation on short selling and credit default swaps. Other identified shortcomings have been addressed as well, e.g., a European regulation now regulates rating agencies. An important further step in this regard is the proposed amendment to this new rating agency regulation. The amendment's objective is to reduce the (mechanistic) reliance by market participants on external ratings and to require them to make their own credit risk assessment. This is particularly important because the more market participants assess credit risk independently, the more likely it becomes that dangerous developments will be noticed. Also, different assessments by different actors reduce the risk of the entire market being affected by ratings that in the end prove to be erroneous.

With regard to the financial aid offered to the E.U. Member States in financial distress, the results are mixed. On the one hand, it has so far been possible to avoid the default of a Member State and the negative repercussions on the financial system associated with such a default. On the other hand, a sustainable solution to the sovereign debt crisis has not been found yet. Moreover, in order to provide financial aid measures of questionable legality are being taken. This leads to an erosion of

339. *See* TFEU, *supra* note 14, art. 63(1) ("[A]ll restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.").

trust in the rule of law. Member States will have to rebuild the trust by demonstrating that they are not above the law and that contractual obligations—both under public international, European, and national private law—will be kept and, if need be, enforced.

This last aspect also points to a blind spot in the European regulation of capital markets—the regulation of sovereign debtors. European securities law grants E.U. sovereign issuers of bonds a number of privileges as compared to private issuers of shares or bonds. This means that Member States exempt themselves from the application of the law in this context as well. Whereas the granting of financial aid to certain Member States is arguably illegal, there is no doubt that the exemptions for Member States in the field of securities law are legal and do not constitute a violation of the law. However, in the light of a financial crisis, which is mainly fuelled by an imminent default of E.U. sovereign debtors, the question as to the justification for these privileges is nevertheless raised. Against this background the last part of this Article argued that privileges for sovereign debtors cannot be justified and should be abolished as far as possible. Sovereign and private debtors should be treated more alike. Market participants should be enabled to make their own assessment of sovereign debt by providing them with high quality, reliable information and by prohibiting insider dealing and market manipulation. They should not be forced to rely on the self-assessment of their debtor who is not only an interested party but also bases his assessment on the erroneous assumptions that sovereign debt is risk-free and that sovereign debtors are always trustworthy.

A Critical Look at the Current International Response to Combat Trade-Based Money Laundering: The Risk-Based Customs Audit as a Solution

LAURA HOFFMANN*

SUMMARY

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INTRODUCTION

Money laundering[1] continues to pose a significant threat to countries and financial systems around the world.[2] It is a fundamental enabler of criminal groups[3] and is closely related to terrorism financing.[4] Although terrorism financing and money laundering, frequently carried out by drug smugglers,[5] are distinct activities, both raise similar concerns and use many of the same techniques to exploit vulnerabilities in countries' financial systems.[6] These activities threaten the very foundation "of financial institutions and systems, discourage foreign investment, and distort international capital flows."[7] Significantly, money laundering is the financial livelihood of criminal groups, and therefore enables these groups' violent and harmful activities.[8]

Estimates of money laundering activity worldwide run from $590 billion to $1.5 trillion annually.[9] The lower amount equates to the gross domestic product of an average-sized European country.[10] The full magnitude of global money laundering, however, is largely unknown as it is extremely difficult to quantify.[11] Not surprisingly, jurisdictions that do not closely regulate their financial systems or provide for oversight are particularly attractive to money launderers because these lax regulations enable large amounts of funds to be moved without detection.[12]

The international trade system is susceptible to money launderers taking advantage of trade import and export transactions through trade-based money laundering (TBML).[13] One TBML system, the Black Market Peso Exchange, facilitates the movement of $5 billion in drug proceeds per year from the United

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1. The International Monetary Fund (IMF) defines money laundering as a "process by which the illicit source of assets obtained or generated by criminal activity is concealed to obscure the link between the funds and the original criminal activity." INTERNATIONAL MONETARY FUND, THE IMF AND THE FIGHT AGAINST MONEY LAUNDERING AND THE FINANCING OF TERRORISM 1 (2012), *available at* http://www.imf.org/external/np/exr/facts/pdf/aml.pdf [hereinafter INTERNATIONAL MONETARY FUND].

2. FINANCIAL ACTION TASK FORCE, GLOBAL MONEY LAUNDERING & TERRORIST FINANCING THREAT ASSESSMENT: A VIEW OF HOW AND WHY CRIMINALS AND TERRORISTS ABUSE FINANCES, THE EFFECT OF THIS ABUSE AND THE STEPS TO MITIGATE THESE THREATS para. 2 (2010), *available at* http://www.fatf-gafi.org/media/fatf/documents/reports/Global%20Threat%20assessment.pdf [hereinafter FATF GTA].

3. *Id.* para. 28.

4. INTERNATIONAL MONETARY FUND, *supra* note 1, at 1 (explaining that money laundering and terrorism financing "exploit the same vulnerabilities in financial systems").

5. *See* FATF GTA, *supra* note 2, paras. 8–10 (summarizing the main sources of terrorism financing and money laundering, which include drug smuggling).

6. INTERNATIONAL MONETARY FUND, *supra* note 1, at 1.

7. *Id.*

8. FATF GTA, *supra* note 2, annex C, at 65–66, (discussing some of the harms associated with criminal and terrorist activity, including higher risk of physical violence, drug abuse, kidnapping, corruption of governments, and exacerbated failure of states).

9. *Money Laundering FAQ*, FINANCIAL ACTION TASK FORCE, http://www.fatf-gafi.org/pages/faq/moneylaundering/#howmuchmoneyislaunderedperyear (last visited Sept. 2, 2012).

10. *See id.* (noting that "the lower figure was roughly equivalent to the value of the total output of an economy the size of Spain").

11. *See* FATF GTA, *supra* note 2, para. 18 ("The GTA does not attempt to quantify the value and volume of ML/TF activity due to the lack of reliable and consistent statistics at a global level.").

12. *See id.* para. 35 (acknowledging that the existence of vulnerabilities or weaknesses in jurisdictional monitoring systems make them attractive for money launderers to use).

13. *Id.* para. 116.

States to Colombia.[14] TBML is defined as "the process of disguising the proceeds of crime and moving value through the use of trade transactions in an attempt to legitimise their illegal origins or finance their activities."[15] Inherent weaknesses in the trade system, including considerable volume of trade flow and the ability of money launderers to integrate the proceeds into legitimate businesses, results in large-scale laundering over the long term.[16] Additionally, the nature of the trade system allows criminals[17] to separate themselves from the money laundering process.[18] This makes it even more difficult for law enforcement officials to conduct successful investigations into the origins of the activity.[19]

Traditionally, countries aimed anti-money laundering (AML) and counter-terrorism financing (CFT) efforts in both the public and private sectors at financial institutions.[20] As a result, there is comparatively less knowledge and education concerning TBML. This makes the trade system an increasingly attractive means for criminals to transfer their illicit proceeds.[21] Additionally, inherent weaknesses in the trade system itself, including volume of trade and complexity of the system, make it easier for criminals to disguise their transactions and evade enforcement.[22]

This Note will discuss the problems associated with TBML, particularly focusing on customs misrepresentation—the most prevalent type of TBML. It will explore the current regimes that exist to combat TBML and critically examine their strengths and weaknesses. Finally, a new solution will be proposed to combat the problem utilizing the Risk-Based Customs Audit, which balances the risks of TBML with the limited resources at countries' disposal.

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14. U.S. DEP'T OF THE TREASURY ET AL., U.S. MONEY LAUNDERING THREAT ASSESSMENT 41 (2005), *available at* http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/mlta.pdf [hereinafter U.S. ML THREAT ASSESSMENT 2005].

15. FATF GTA, *supra* note 2, para. 117.

16. *Id.* paras. 123–25.

17. By "criminals," this Author refers to both criminal and terrorist groups for simplicity, although the two types of groups are certainly different in some respects.

18. *See* FATF GTA, *supra* note 2, para. 124 ("Proceeds can be integrated into otherwise legitimate businesses which are involved in trade. The predicate offence and the individuals involved in them thus remain distanced from the activity.").

19. U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 41.

20. FATF GTA, *supra* note 2, para. 126.

21. *Id.*; *see also A Current Assessment of Money Laundering and Terrorist Financing Threats and Countermeasures: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. 33 (2006) (statement of Kevin Delli-Colli, Deputy Assistant Dir., Fin. Trade Investigations Div., Office of Investigations, U.S. Immigration & Customs Enforcement, U.S. Dep't of Homeland Sec.), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_senate_hearings&docid=f:39713.pdf [hereinafter *Hearing*] ("A number of the money laundering trends we have developed in response to the Bank Secrecy Act and the robust anti-money laundering programs instituted by the U.S. financial industry. As a result, criminal organizations are increasingly forced to resort to bulk cash smuggling, trade-based money laundering, and other schemes to move their illegal proceeds.").

22. FATF GTA, *supra* note 2, para. 127.

I. DISCUSSION OF THE PROBLEM: TYPES OF TRADE-BASED MONEY LAUNDERING

TBML takes a variety of forms and varies from basic systems to complex schemes that are extremely difficult to detect. The Financial Action Task Force (FATF), an intergovernmental organization created to assist countries in combating money laundering,[23] has recognized three specific types of TBML: (1) customs misrepresentation, (2) legitimate trade used to move value,[24] and (3) carousel fraud.[25] Sophisticated criminal groups combine different aspects of these more basic types into integrated channels and complex systems.[26] For example, the *hawala* system[27] uses TBML, as does the Black Market Peso Exchange,[28] which is the largest known system of TBML in the Americas. This Note will focus on one general type of TBML: customs misrepresentation.[29]

Customs misrepresentation through distortion of customs invoices is one of the most common forms of TBML globally.[30] The main purpose of customs misrepresentation is to disguise proceeds from illegal activity.[31] It can be carried out

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23. *About the FATF*, FINANCIAL ACTION TASK FORCE, http://www.fatf-gafi.org/pages/0,3417,en_32250379_32236836_1_1_1_1_1,00.html (last visited Mar. 14, 2012) ("The Financial Action Task Force (FATF) is an intergovernmental body established in 1989 by the Ministers of its Member Jurisdictions. The objectives of the FATF are to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing, and other related threats to the integrity of the international financial system.").

24. This Note will not discuss this type of TBML in detail, but it is important to note that this is also a type of TBML for countries to keep in mind when designing regulatory or administrative responses to TBML. The FATF describes this type of TBML as follows: "In this case, debts incurred with legitimate companies are placed under control of the money launderer. These debts are then settled using value received from criminal groups, mostly located in third countries. The company may not be aware of the true source of the funds used to settle the debts." FATF GTA, *supra* note 2, para. 118.

25. *Id.* para. 119. This "type of TBML relates to laundering associated with value added tax (VAT)" and may or may not involve the actual movement of goods. *Id. See generally* FINANCIAL ACTION TASK FORCE, LAUNDERING THE PROCEEDS OF VAT CAROUSEL FRAUD (2007), *available at* http://www.fatf-gafi.org/media/fatf/documents/reports/Laundering%20the%20Proceeds%20of%20VAT%20Caroussel%20Fraud.pdf [hereinafter FATF CAROUSEL FRAUD] (describing carousel fraud in detail).

26. FINANCIAL ACTION TASK FORCE, TRADE BASED MONEY LAUNDERING 7 (2006), *available at* http://www.ctif-cfi.be/website/images/EN/typo_fatf/TBML.pdf [hereinafter FATF TBML REPORT].

27. *Hearing*, *supra* note 21, at 68 (statement of Kevin Delli-Colli, Deputy Assistant Dir., Fin. Trade Investigations Div., Office of Investigations, U.S. Immigration & Customs Enforcement, U.S. Dep't of Homeland Sec.) ("Alternative remittance systems, such as *hawalas*, have also long utilized trade to balance payments between *hawaladars*.").

28. *Id.* at 48 (prepared statement of Stuart Levey Under Sec'y, Office of Terrorism & Fin. Intelligence, U.S. Dep't of the Treasury) ("Some of the largest and most complex methods of money laundering harness trade into and out of the United States. Trade-based money laundering takes many forms including the Black Market Peso Exchange, which poses a particular challenge to law enforcement because it separates the crime from the cash early in the money laundering process. Under this scheme, drug dealers are able to hand off their illicit dollars in the United States to professional money launderers, who make clean currency available in Colombia or elsewhere."); U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 41 ("The most common method of trade-based money laundering in the Western Hemisphere is the Black Market Peso Exchange (BMPE), in which Colombian drug traffickers swap illicit dollars in the United States for clean pesos in Colombia.").

29. The term "customs misrepresentation" is a term unique to this Author to describe TBML through distortion of customs invoices.

30. FATF TBML REPORT, *supra* note 26, at 5.

31. *Id.* at 1.

through price misrepresentation with over- or underpriced invoices.[32] In addition, "the quality or quantity of the goods can be misrepresented."[33] The basic techniques of customs misrepresentation include: (1) multiple invoices, (2) over- and underpricing, (3) false descriptions, and (4) over- and undershipment.[34] In order to understand customs misrepresentation, it is helpful to utilize some practical examples:

Example 1: Price Distortion (also known as the over- and underpricing of invoices): Group A wants to move $5 million (the proceeds of illegal activities) to Group B. Group A purchases 500 diamond rings for $10,000 each. Then Group A exports the 500 rings to Group B for $10 each. Group B is able to sell the rings for $5 million.[35]

Example 2: Undervaluing (also known as misrepresenting or providing false descriptions of the quality of goods): Customs agencies can generally only see one side of a trade transaction, and money launderers use this to their advantage.[36]

> For example, if a U.S. exporter sends $1 million dollars worth of computers to Brazil, U.S. customs officers do not know what is being reported upon entry to Brazil. A Brazilian importer in collusion with the exporter could easily change the paperwork to reflect the value of shipment as $500,000. This would allow the Brazilian importer to justify a reduced payment of $500,000 to the U.S. exporter, transferring $500,000 additional dollars in value to Brazil.[37]

If this transferred value represents illicit proceeds (e.g., to fund terrorist activities or as part of a drug scheme), then it is considered money laundering.

Criminal organizations employ multiple techniques in TBML schemes.[38] Any approach to combat customs misrepresentation must take all of these different techniques into account.

In addition to the individual risks that customs misrepresentation creates for the trade system, TBML in general poses significant problems for international trade. These problems include undermining the stability of the financial sector and countries' borders, threatening the credibility of the trade system, and manipulating the trade system in order to avoid paying duties, tariffs, and taxes, thereby causing

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32. *Id.* at 4.

33. FATF GTA, *supra* note 2, para. 117, at 29.

34. FATF TBML REPORT, *supra* note 26, at 4.

35. Diamonds and precious gems are frequently used in money laundering activities to transfer value. U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 43. This is due to the fact that many times it is difficult to trace the source of where the diamonds are mined, and "[e]ven when diamonds are transported openly, it is relatively easy to mislabel the quality/value of a diamond for money laundering purposes." *Id.*

36. U.S. IMMIGRATION & CUSTOMS ENFORCEMENT, *Homeland Security Investigations: Trade Transparency Unit*, VVI:3 THE CORNERSTONE REPORT 2 (Winter 2011), *available at* http://www.ice.gov/doclib/news/library/reports/cornerstone/cornerstone7-3.pdf [hereinafter CORNERSTONE REPORT 2011].

37. *Id.* at 2–3.

38. FATF TBML REPORT, *supra* note 26, at 7.

governments to lose legitimate revenue.[39] Certain countries and regions are more vulnerable than others to TBML. For example, Free Trade Zones are particularly susceptible to TBML due to the lack of oversight, transparency, or an integrated system for sharing trade data.[40]

II. A CRITICAL LOOK AT CURRENT ATTEMPTS TO COMBAT TRADE-BASED MONEY LAUNDERING

In order to understand the difficulties of implementing an effective solution to target TBML, it is necessary to discuss the strengths and criticisms of the current attempts to combat TBML. This section first examines recommendations from the Financial Action Task Force (FATF). It then analyzes the current response from individual countries, particularly focusing on two distinct approaches: those of the United States and Australia.

A. *The Financial Action Task Force Response*

In 2008, the FATF published *Best Practices on Trade Based Money Laundering*, (*FATF Best Practices*) which offers recommendations on steps that countries can take to effectively combat TBML.[41] While the paper does offer some helpful recommendations, it is only a small first step in addressing this complex problem. First, the FATF recognizes that one of the most basic problems in combating TBML is a lack of awareness and training among competent authorities.[42] It suggests as one possible solution that "in order to raise awareness and build expertise," countries could incorporate TBML into existing AML training programs.[43] For countries with fewer resources available to combat TBML, this seems like an attractive option. This approach is too weak, however, and may incentivize countries to only take this minimum step. In other words, countries may choose to incorporate information regarding TBML into existing AML training programs instead of undertaking meaningful investigations into effective responses for specific threats in their home countries. Some governments, especially in countries with more limited resources, will take this minimum step in order to give the appearance to the international community that their countries are targeting TBML without actually tackling the problem in a meaningful way. This is especially problematic because countries have developed existing AML initiatives with the financial sector, not the trade sector, in mind. Hence, solely incorporating TBML education into existing programs will not

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39. FATF GTA, *supra* note 2, para. 121–22.

40. FINANCIAL ACTION TASK FORCE, MONEY LAUNDERING VULNERABILITIES OF FREE TRADE ZONES para. 54 (2010), *available at* http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20vulnerabilities%20of%20Free%20Trade%20Zones.pdf For example, in the United States, "[w]hen U.S.-based manufacturers import parts and materials outside of a Foreign Trade Zone (FTZ) [also known as a Free Trade Zone], they pay import duties based on the value of the finished product rather than the value of the component parts. Operating in an FTZ allows manufacturers to defer, reduce, or even eliminate U.S. Customs duties." U.S. ML THREAT ASSESSMENT 2005, *supra* note 14, at 42–43.

41. FINANCIAL ACTION TASK FORCE, BEST PRACTICES PAPER ON TRADE BASED MONEY LAUNDERING (2008), *available at* http://www.fatf-gafi.org/media/fatf/documents/recommendations/BPP%20Trade%20Based%20Money%20Laundering%202012%20COVER.pdf [hereinafter FATF BEST PRACTICES].

42. *Id.* para. 11.

43. *Id.*

train the authorities who would be the most effective in combating the problem (e.g., customs agents or employees of similar agencies). For example, the 2006 FATF report on TBML acknowledged that out of thirty-six countries asked to complete a survey, only one-third had training in place for customs agents on TBML.[44] The *FATF Best Practices* itself identifies multiple agencies whereby countries would benefit from providing TBML training.[45] These include: "the staff of trade authorities,[46] investigative authorities, customs agencies, tax authorities, the financial intelligence unit, prosecutorial authorities, [and] banking supervisors."[47] The FATF identifies "misuse of the trade system as one of the *main methods* by which criminal organisations and terrorist financiers move money for the purpose of disguising its origins and integrating it into the formal economy" (emphasis added).[48] There must be higher expectations for the international community to defend against one of the main methods of illicit movement of money than by merely requiring training materials to be inserted into programs that are already in place to combat other types of money laundering. TBML is a distinctive form of money laundering and poses unique threats.[49] Therefore, training programs on TBML should be focused instead of grouped together with other forms of money laundering.

The FATF suggestions for financial and trade data analysis and techniques are more effective. These suggestions seem particularly helpful for customs misrepresentation. They include, among others, recommendations such as:

a) Comparing domestic and foreign import/export data to detect discrepancies in the Harmonized Tariff Schedule, country of origin, manufacturer, importer/exporter, ultimate consignee, broker, unit price, commodity activity by time period, and port of import/export.

b) Analysing financial information collected by the FIU to identify patterns of activity involving the importation/exportation of currency, deposits of currency in financial institutions, reports of suspicious financial activities, and the identity of parties to these transactions.

c) Examining cargo movements through the comparison of import/export documentation between two counties [sic] to verify that the data reported to one country's authorities matches the data reported to the other country's authorities.

d) Examining domestic import data with an automated technique, such as Unit Price Analysis, to compare the average unit price for a

44. FATF TBML REPORT, *supra* note 26, at 21.

45. *See* FATF BEST PRACTICES, *supra* note 41, para. 12 ("[C]ountries are encouraged to provide training on TBML/FT techniques to the staff of trade authorities, investigative authorities, customs agencies, tax authorities, the financial intelligence unit, prosecutorial authorities, banking supervisors and any other authorities that the country identifies as being relevant to the fight against TBML/FT . . . .").

46. "[*T*]*rade authorities* refers to the authorities who are responsible for collecting, analysing and/or storing trade data." *Id.* para. 7.

47. *Id.* para. 12.

48. *Id.* para. 1.

49. *See generally* FATF TBML REPORT, *supra* note 26 (comparing TBML and adequate preventative measures to other money laundering techniques).

particular commodity and identify traders who are importing commodities at a substantially higher or lower price than the world market.

e) Comparing information such as the origin, description and value of the goods, particulars of the consignee and consignor, and the route of shipment with intelligence information in existing databases to detect any irregularities, targets or risk indicators . . . .[50]

Recommendation (d) regarding "Unit Price Analysis" could be an effective mechanism for combating the over- and underpricing of goods in customs invoice misrepresentation. Additionally, a combination of recommendations (c), (d), and (e) bears a resemblance to a computer-based system used in the United States to detect TBML (discussed later in this section). Although the Unit Price Analysis combined with a data comparison between two countries may be a plausible solution for some types of goods (i.e., easy-to-value goods that have a readily identifiable market price), this type of analysis will be less effective for other types of goods such as rare carpets, antiques, or pieces of artwork.[51] High-priced items, such as works of art, present valuation difficulties because of their limited markets and inherently speculative or uncertain true values.[52]

In addition to the recommendations above, there are general recommendations, such as making publications available containing information on TBML and holding interagency conferences and seminars.[53] Countries are encouraged to conduct further study nationally and in partnership with foreign countries regarding the effects and new trends of TBML.[54] The *FATF Best Practices* suggests that countries "develop a domestic mechanism to link the work of authorities responsible for collecting, analysing and storing trade data with authorities responsible for investigating money laundering and terrorist financing."[55] This information could be facilitated by using mechanisms such as "memoranda of understanding [i.e., to address legal barriers and facilitate information sharing between relevant agencies], information sharing agreements, the use of liaison officers[,] . . . the establishment of multi-agency task forces" or the use of a specialized unit, such as the Trade Transparency Unit in the United States, to analyze trade data and compare discrepancies.[56] In instances "[w]here domestic privacy and data protection laws

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50. FATF BEST PRACTICES, *supra* note 41, para. 13.

51. *See generally* Hannah Purkey, *The Art of Money Laundering*, 22 FLA. J. INT'L L. 111, 122–28 (2010) (discussing the problems associated with how criminals use art to launder money and arguing that customs agents are not qualified to detect this type of laundering of illicit funds).

52. FATF GTA, *supra* note 2, para. 189.

53. *See* FATF BEST PRACTICES, *supra* note 41, para. 16 ("To ensure that a sufficiently wide audience benefits from awareness raising and training on TBML/FT, countries are encouraged to consider using a combination of delivery methods, such as: offering or participating in conferences, seminars, workshops and other events, including those organised by the private sector; making presentations; holding inter-agency meetings; developing internet-based learning tools (e-learning); publishing guidance; posting information on the websites of competent authorities; including relevant information in the annual reports or other publications of competent authorities; or sending relevant materials to contacts directly.").

54. *Id.* paras. 19, 26.

55. *Id.* para. 20.

56. *Id.* para. 22; *see also Trade Transparency Unit*, U.S. IMMIGRATION & CUSTOMS ENFORCEMENT, http://www.ice.gov/trade-transparency/ (last visited Sept. 15, 2012) [hereinafter *Trade Transparency Unit*] (explaining the role of specialized Trade Transparency Units in the United States and foreign affiliates).

inhibit the dissemination of data at the domestic level, countries are encouraged to" undertake studies to examine the possible effects of this information.[57] Mechanisms in place that would "redact sensitive or identifying information from trade data," thereby allowing the data to be used to analyze trade trends or to share information with other countries, would also be helpful.[58]

Finally, the *FATF Best Practices* emphasizes that countries should develop gateways and mechanisms for sharing trade data with other foreign counterparts.[59] A single database that allows the participating countries to share trade data and is subject to data collection safeguards could be useful.[60] This step could be important in understanding the global magnitude of the problem and developing cross-national solutions. By identifying the impact on affected countries, many countries may be more receptive to a cooperative commitment of resources to address TBML. This could be critical because various governments and institutions are reluctant to participate without knowledge of the magnitude of the TBML problem.

In addition to the *FATF Best Practices*, the FATF is well-known for the *FATF 40 Recommendations* (*40 Recommendations*), the international standard for combating money laundering. One hundred and thirty countries endorsed these recommendations, which include necessary procedures for national criminal justice and regulatory systems, objectives for financial institutions and certain other businesses and professions, and provisions for cooperation on an international level.[61] The *40 Recommendations* were amended in 2003 and were complemented by nine "Special Recommendations" specifically targeted toward terrorist financing (collectively the 40 + 9 Recommendations).[62] These recommendations have been highly effective, resulting in implementation of a large number of domestic mechanisms that comply with the FATF recommendations and endorsement by over 180 jurisdictions as of 2010.[63] Surprisingly, despite the FATF's repeated recognition of the threat of TBML for the international community, not one of the 40 + 9 Recommendations specifically addresses TBML.[64] Recently, in February 2012, the FATF released a revised version of the recommendations (2012 FATF Recommendations).[65] The new revisions address emerging threats, elaborate on

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57. FATF BEST PRACTICES, *supra* note 41, para. 26.

58. *Id.* para. 27.

59. *Id.* para. 30.

60. *Id.*

61. FINANCIAL ACTION TASK FORCE, FATF 40 RECOMMENDATIONS 2 (2003), *available at* http://www.fatf-gafi.org/media/fatf/documents/FATF%20Standards%20-%2040%20Recommendations%20rc.pdf [hereinafter FATF 40 RECOMMENDATIONS].

62. *Id.*; FINANCIAL ACTION TASK FORCE, FATF IX SPECIAL RECOMMENDATIONS (2001), *available at* http://www.fatf-gafi.org/media/fatf/documents/reports/FATF%20Standards%20-%20IX%20Special%20Recommendations%20and%20IN%20rc.pdf [hereinafter FATF IX SPECIAL RECOMMENDATIONS].

63. FATF GTA, *supra* note 2, at 3.

64. *See generally* FATF 40 RECOMMENDATIONS, *supra* note 61; FATF IX SPECIAL RECOMMENDATIONS, *supra* note 62 (stating detailed recommendations for countries regarding AML and steps to combat terrorist financing, but not specifically mentioning TBML).

65. FINANCIAL ACTION TASK FORCE, THE FATF RECOMMENDATIONS: INTERNATIONAL STANDARDS ON COMBATING MONEY LAUNDERING AND THE FINANCING OF TERRORISM & PROLIFERATION (2012), *available at* http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF%20Recommendations%20(approved%20February%202012)%20reprint%20May%202012%20web%20version.pdf.

existing obligations, and integrate many of the Special Recommendations regarding terrorist financing throughout the 2012 FATF Recommendations, thereby "obviating the need for the Special Recommendations."[66] The revised 2012 FATF Recommendations still do not address TBML.[67]

In order to monitor the progress of implementation of the *40 Recommendations* in member countries, the FATF established certain mechanisms.[68] These mechanisms include a mutual evaluation program conducted by the FATF, which contains detailed country reports and evaluations by the International Monetary Fund.[69] Also, in 2000, the FATF implemented a series of reports and started placing countries on a Non-Cooperative Countries and Territories (NCCT) list if they did not meet the standards in the *40 Recommendations*.[70] In order to be removed from the list, countries must enact laws and regulations in accordance with international standards to overcome deficiencies noted in the NCCT report.[71] Of the fifteen jurisdictions that were initially identified as NCCTs, all have been de-listed.[72] If the FATF added a recommendation regarding TBML, an assessment of a country's implementation of mechanisms regarding TBML could be included in a country report and as one of the criteria for the NCCT list.

Some academics have argued that there should be greater incorporation between the *FATF Best Practices* and the FATF recommendations.[73] For example, Delston and Walls would add a recommendation that would require "traders," as

66. *Id.* at 8.

67. *See id.* (listing the updated FATF Recommendations, which have detailed recommendations for combating terrorist financing and money laundering, but still do not specifically address TBML).

68. *See Mutual Evaluations*, FINANCIAL ACTION TASK FORCE, http://www.fatf-gafi.org/topics/mutualevaluations/ (last visited Feb. 18, 2013Mar. 13, 2012) (explaining that the FATF conducts peer reviews of members and providing links to the individual reports); *see also Hearing*, *supra* note 21, at 63 (prepared statement of Michael Morehart, Chief, Terrorist Fin. Operations Section, Fed. Bureau of Investigation) ("All member countries have their implementation of the forty recommendations monitored through a two-pronged approach: An annual self-assessment exercise and the more detailed mutual evaluation procedure.").

69. *See* FINANCIAL ACTION TASK FORCE, AML/CMT EVALUATIONS AND ASSESSMENTS HANDBOOK FOR COUNTRIES AND ASSESSORS 4, 18, 44 (2009), *available at* http://www.fatf-gati.org/media/fatf/documents/reports/Handbook%20for%20assessors.pdf (stating that the FATF handbook is for teams taking part in an IMF assessment and that authorities of the country completing the questionnaire may refer to "reports, assessments, or reviews" published by the IMF); *see, e.g.*, FINANCIAL ACTION TASK FORCE, MUTUAL EVALUATION REPORT: ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM: AUSTRIA (2009), *available at* http://www.fatf-gati.org/media/fatf/documents/reports/mer/MER%20Austria%20full.pdf (providing a detailed country evaluation of the AML/CFT in Austria by the International Monetary Fund, among others); FINANCIAL ACTION TASK FORCE, MUTUAL EVALUATION REPORT: ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM: STATE OF KUWAIT (2011), *available at* http://www.fatf-gati.org/media/fatf/documents/reports/mer/Kuwait%20MER%20full%20report.pdf (providing a detailed country evaluation of the AML/CFT in Kuwait by the International Monetary Fund, among others).

70. FINANCIAL ACTION TASK FORCE, ANNUAL REVIEW OF NON-COOPERATIVE COUNTRIES AND TERRITORIES 2006–2007: EIGHTH NCCT REVIEW 2–3 (2007), *available at* http://www.fatf-gafi.org/media/fatf/documents/reports/2006%202007%20NCCT%20ENG.pdf [hereinafter FATF ANNUAL REVIEW OF NCCT].

71. *Id.* at 11.

72. *Id.* at 13.

73. *See, e.g.*, Ross S. Delston & Stephen C. Walls, *Reaching Beyond Banks: How to Target Trade-Based Money Laundering and Terrorist Financing Outside the Financial Sector*, 41 Case W. Res. J. Int'l L. 85, 88–89 (2009) (discussing the proposition that "for any new Recommendation to be effective, the FATF needs to go further than it has in the past").

defined in the *FATF Best Practices*, to implement customer due diligence and record keeping, Suspicious Activity Reports, and similar protocols.[74] This is similar to what was already required of financial institutions and certain "non-financial businesses and professions" under current anti-money laundering and counter-terrorism financing (AML/CFT) efforts in the 40 + 9 Recommendations.[75] Customer due diligence would require, among other things, identifying and verifying customer identity, assessing respondent institutions' money laundering and terrorist controls, and maintaining detailed records of all transactions for at least five years.[76] Suspicious Activity Reports should require, by law or regulation, reporting of *any* suspicious transaction.[77] These requirements would impose significant regulation on many non-financial institutions, as the term "trader" in the *FATF Best Practices* encompasses importers and exporters, shippers, air couriers, and any company that operates principally to import and export goods.[78] Alternatively, Delston and Walls suggest a recommendation that would require "countries ... to adopt detection mechanisms, enhanced scrutiny for trade transactions" and other similar measures.[79]

However, Delston and Walls' approach seems to conflict with the *FATF Best Practices* themselves, which emphasize the importance of "ensuring that legitimate trading activities are not unreasonably hindered or obstructed" and "ensuring that regulatory considerations are addressed in a way that does not impose unnecessary financial and administrative burdens on reporting entities."[80] There needs to be more of a balance. This would entail a stronger commitment by the FATF towards TBML by including a special provision targeting TBML in the 2012 FATF Recommendations, while at the same time keeping in mind that this recommendation needs to be carefully tailored so as to stay in line with the FATF goal of not hindering legitimate trade between countries.

B. *Individual Country Response*

To date, individual countries have done very little to address TBML. The United States and Australia present two opposite sides of the spectrum regarding the amount and types of efforts in place to combat TBML.

Australia has taken a very limited regulatory approach to TBML. In response to an unfavorable report by the FATF that Australia was not complying with the 40 + 9 Recommendations, Australia introduced the Anti-Money Laundering and Counter-Terrorism Financing Act (AML/CTF Act) in 2006 to regulate the financial sector and related businesses.[81] There has been discussion that this Act may be

74. *Id.* at 88–89.

75. *Id.* at 94.

76. FATF 40 RECOMMENDATIONS, *supra* note 61, at 5–7.

77. *Id.* at 8.

78. *See* FATF BEST PRACTICES, *supra* note 41, para. 10 ("The term *trader* refers to anyone who facilitates the exchange of goods and related services across national borders, international boundaries or territories.").

79. Delston & Walls, *supra* note 73, at 107.

80. *Id.* at 114.

81. CLAIRE SULLIVAN & EVAN SMITH, TRADE-BASED MONEY LAUNDERING: RISKS AND REGULATORY RESPONSES 22 (Austl. Inst. of Criminology ed., 2011), *available at* http://www.aic.gov.au/

extended to other sectors such as real estate, accounting, and law, but there are no current plans to extend it to trade.[82]

There are concerns with extending the AML/CTF Act to trade in Australia. The main concerns are that it would be too costly and impose too high of a budgetary and regulatory burden; that there is lack of research on the topic, particularly as to how large of a threat TBML is for Australia; and that traders lack sophisticated mechanisms that were present in financial institutions for implementing this type of compliance.[83] Alternatively, the Australian approach, at least presently, is to comply with the FATF recommendations by extending their current education and awareness training among regulated entities and government agencies to include information about TBML.[84] Additionally, Australia already collects trade data and has strict border and customs regulations that put it at a lesser risk to TBML than areas like the European Union with Free Trade Zones.[85]

Thus, Australia has chosen to take the narrower approach outlined in the *FATF Best Practices*. Specifically, it will emphasize education and awareness in an effort to minimize undue regulatory restrictions on business and trade until there is greater knowledge and information regarding the nature of TBML in Australia.[86] While it is understandable that Australia does not want to impose huge costs on its business and trade industries before taking further action to study the effects of TBML, this type of response is just the type of concern that was expressed in Section A of this Note. Because the FATF has offered this narrower education and awareness approach as a viable option for countries to combat TBML, it will not be surprising if more countries opt to take this less costly approach and leave development of further techniques to countries with greater resources, like the United States.

The approach taken by the U.S. Government to combat TBML closely resembles the ideas in the *FATF Best Practices*. This is not surprising, as representatives from both the U.S. Federal Bureau of Investigation and the U.S. Department of the Treasury have openly stated in Congressional hearings that they have taken leadership roles within the FATF.[87] Since 2004, the U.S. Immigration and Customs Enforcement (ICE) has been leading investigations on TBML in the United States through the establishment of the Trade Transparency Unit (TTU).[88] The TTU, operated by ICE, forms partnerships with TTUs in U.S. trading partner countries.[89] The TTU analyzes trade import and export data and trade information obtained from both the United States and partnership countries and searches for

documents/A/0/3/%7BA03716CB-BFD3-46B3-93EC-66FD9D9029A7%7Drpp115.pdf [hereinafter AIC TBML REPORT].

82. *Id.* at 23.

83. *Id.* at 23–24.

84. *Id.* at 24.

85. *Id.* at iii, 25.

86. *Id.* at 26.

87. *Hearing*, *supra* note 21, at 48 (prepared statement of Stuart Levey, Under Sec'y, Office of Terrorism & Fin. Intelligence, U.S. Dep't of the Treasury) ("[T]he United States, with Treasury as its head of delegation, has taken a leadership role in the Financial Action Task Force (FATF) to establish and promulgate international standards for combating money laundering and terrorist financing."); *Id.* at 63 (prepared statement of Michael Morehart, Chief, Terrorist Fin. Operations Section, Fed. Bureau of Investigation) ("As it relates to international money laundering enforcement, the FBI is an active participant in the Financial Action Task Force (FATF).").

88. *Trade Transparency Unit*, *supra* note 56.

89. *Id.*

anomalies using a computerized program called Data Analysis and Research for Trade Transparency System (DARTTS) (discussed below).[90] This enables relevant authorities to be able to see trade data declared at both the origin and destination of transactions.[91] The analysis seems to target customs misrepresentation, but also mentions carousel fraud as one of many red flags. The TTU official red flag indicators of TBML are:

- Payments to vendor made in cash by unrelated third parties,
- Payments to vendor made via wire transfers from unrelated third parties,
- Payments to vendor made via checks, bank drafts or postal money orders from unrelated third parties,
- False reporting, such as commodity misclassification, commodity over-valuation or under-valuation,
- Carousel transactions (the repeated importation and exportation of the same high-value commodity),
- Commodities being traded do not match the business involved,
- Unusual shipping routes or transshipment points,
- Packaging inconsistent with commodity or shipping method, and
- Double-invoicing.[92]

The TTU is an interagency initiative including "representative[s] of the customs service, financial intelligence unit, law enforcement agencies and, where applicable, the judiciary."[93] The TTU is not aimed solely at TBML. It targets "money laundering, customs fraud, contra-band smuggling, and the evasion of duties and taxes."[94] The likely effectiveness of the TTU is difficult to predict because of the many crimes it targets. On the one hand, these activities may be so related and interconnected that it only makes sense for one entity to target all of them together. This could be an advantage by lowering administrative start-up costs, particularly for countries that do not have knowledge or studies of the effect of TBML in their country and are therefore skeptical of spending high start-up costs on technology and

90. *Id.*; *Hearing*, *supra* note 21, at 48 (prepared statement of Stuart Levey, Under Sec'y, Office of Terrorism & Fin. Intelligence, U.S. Dep't of the Treasury) ("These units allow countries to compare import and export logs to uncover anomalies that may indicate money laundering, and represent a serious advance in our worldwide anti-money laundering efforts.").

91. *Trade Transparency Unit*, *supra* note 56; *see also Hearing*, *supra* note 21, at 60 (prepared statement of E. Anthony Wayne, Assistant Sec'y for Econ. Affairs, U.S. Dep't of State) ("The TTU's will enable the [Triborder Area] countries and the [U.S. Government] to compare trade data declared at origin and destination of trade transactions . . . .").

92. *Trade Transparency Unit*, *supra* note 56.

93. *Hearing*, *supra* note 21, at 60 (prepared statement of E. Anthony Wayne, Assistant Sec'y for Econ. & Bus. Affairs, U.S. Dep't of State).

94. CORNERSTONE REPORT 2011, *supra* note 36, at 3.

personnel solely to target TBML. On the other hand, by using TTUs to investigate all of these different crimes, it could be possible that their resources are being spread too thin. Many of the reports discussing the TTUs are unclear regarding allocation of resources to the different crimes or in what area most of the investigations are targeted.[95]

ICE uses a specialized computer program to aid in its TTU investigations called DARTTS, mentioned above.[96] In order to determine which trade transactions warrant further investigation, ICE investigators must first analyze and compare trade data from both importing and exporting countries in order to detect discrepancies or anomalies.[97] DARTTS is an automated system that makes this process more efficient.[98] DARTTS uses trade data from foreign governments and other federal agencies, including U.S. Customs and Border Enforcement, U.S. Department of the Treasury, and other similar agencies, as well as currency reports, Suspicious Activity Reports, and related forms.[99] Most of these agencies obtain data from individuals or institutions, such as banks, that are required to fill out import-export reports.[100] Once DARTTS identifies a statistically suspicious transaction, ICE agents examine the transaction to determine if further investigation is needed.[101] Otherwise stated, the first step in the investigative process is that DARTTS identifies suspicious transactions through an automated analysis, which searches for discrepancies or anomalies.[102] As a second step, after DARTTS identifies a suspicious transaction, ICE agents investigate further by using the TTU red flags mentioned above in order to determine if further investigation is warranted.[103]

What is most apparent about the DARTTS system is that it is automated. Like the Unit Price Analysis described by the *FATF Best Practices*, one of DARTTS' pervading weaknesses is that it would be very difficult for the program to identify hard-to-value goods if there were no discrepancy or anomaly in the import-export forms. This could incentivize launderers to resort to using hard-to-value goods to hide their funds in order to remain undetected. However, the system does save administrative costs, as it would be highly inefficient for ICE agents to analyze all the trade data by hand. Assuming that launderers are more likely to misrepresent the price of a good on one form (e.g., an export form), but not the other (e.g., an importer's form in another country), DARTTS may be quite effective in identifying TBML transactions, particularly when coordinated with further investigation by ICE agents looking for the TTU red flag indicators. Further study would be helpful in order to identify which types of goods and what types of TBML are most prevalent in certain regions so that the authorities can better target the crimes. Additionally, if

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95. *See, e.g.*, FATF TBML REPORT, *supra* note 26, at 21; CORNERSTONE REPORT 2011, *supra* note 36, at 3; U.S. DEP'T OF HOMELAND SECURITY, PRIVACY IMPACT ASSESSMENT FOR THE DATA ANALYSIS & RESEARCH FOR TRADE TRANSPARENCY SYSTEM (DARTTS) 2 (2008), *available at* http://www.dhs.gov/xlibrary/assets/privacy/privacy_pia_ice_dartts.pdf [hereinafter PRIVACY IMPACT ASSESSMENT FOR DARTTS] (describing the crimes the TTUs target, but failing to mention the allocation of resources to the different crimes).

96. *Trade Transparency Unit*, *supra* note 56.

97. PRIVATE IMPACT ASSESSMENT FOR DARTTS, *supra* note 95, at 2.

98. *Id.*

99. *Id.* at 3–5.

100. *Id.* at 3.

101. *Id.* at 2.

102. *Id.*

103. PRIVATE IMPACT ASSESSMENT FOR DARTTS, *supra* note 95, at 2.

this automated system combined with certain red flags has led to successful investigations in the past, sharing this information with other trading partners would be one effective way to convince other countries to invest in the TTUs, so that the United States is not responsible for funding all the start-up costs as is the current situation.

The United States established the first foreign-based TTU in Colombia in 2005 to combat financial crimes, specifically the Black Market Peso Exchange.[104] Since that time, the United States also established TTUs in Brazil (2006), Paraguay (2007), Mexico (2008), and Argentina (2006), which have purportedly identified millions of dollars of lost government revenue.[105] For example, TTU investigations in Mexico have allegedly "resulted in the seizure of currency and contraband valued at approximately $21 million last fiscal year. In fiscal year 2008 to date, TTU related investigations have resulted in more than 100 seizures totaling more than $3.7 million."[106] In 2010, with funding from the U.S. Department of State's Bureau of International Narcotics and Law Enforcement Affairs, Panama became the newest link in the network of U.S. TTUs.[107] Some examples of work that the Panamanian TTU has accomplished include:

> [T]he discovery of a network of banks and exchange houses that moved euros from Colombia, using Panamanian banks, to the U.S. and Europe; the use of harmonized tariff codes for perfumes, video gaming and precious metals to identify several companies in the [Colon Free Trade Zone] involved in commercial fraud and possible trade-based money laundering; and, information that reveals possible export tax incentive fraud.[108]

It is interesting to note, that although the report mentions TBML, it only states that there was possible TBML, and many other successes do not involve TBML at all.[109] It is unclear from these reports what resources from the TTU are allocated to TBML or how effective the TTUs are at combating TBML, specifically given that the TTUs target many different types of crime and do not solely target TBML. ICE claims that eventually it envisions a global network of TTUs, established with all U.S. trading partners, which would provide open exchange of information from all participating countries.[110] This is a very ambitious vision, especially as it looks like the U.S. agencies have been providing the start-up funding for all the TTUs currently in place.

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104. BUREAU FOR INT'L NARCOTICS & LAW ENFORCEMENT AFFAIRS, U.S. DEP'T OF STATE, INTERNATIONAL NARCOTICS CONTROL STRATEGY REPORT: VOLUME II MONEY LAUNDERING AND FINANCIAL CRIMES 83 (2011), *available at* http://www.state.gov/documents/organization/156589.pdf [hereinafter INT'L NARCOTICS CONTROL STRATEGY REPORT 2011].

105. *Id.* at 12, 69, 152; *Trade Transparency Unit Program to Combat Money Laundering*, EMBASSY OF THE U.S., BUENOS AIRES, ARG. (July 18, 2006), http://argentina.usembassy.gov/evento_laundering.html; *ICE Launches Trade Transparency Unit in Mexico City as Part of Bi-lateral Cooperation with Mexico Customs: ICE Opens Mexico City TTU To Combat and Eliminate Trade-Based Money Laundering Systems*, U.S. Immigration & Customs Enforcement (June 12, 2008), http://www.ice.gov/news/releases/0806/080612mexicocity.htm [hereinafter *TTU in Mexico City*].

106. *TTU in Mexico* City, *supra* note 105.

107. INT'L NARCOTICS CONTROL STRATEGY REPORT 2011, *supra* note 104, at 12.

108. *Id.* at 150.

109. *Id.*

110. *Trade-Based Money Laundering*, U.S IMMIGRATION & CUSTOMS ENFORCEMENT,

One example of customs misrepresentation that TTUs are meant to target relates to the example of undervaluing goods in customs invoices described in Section 1 of this Note. In the example, Company A, in Country X, exported goods worth $1 million to Company B, in Country Y. The launderers misrepresented the goods on the customs invoice, however, and imported at a value of $500,000. The benefit of having a TTU in both Country X and Country Y is that both the importing and exporting countries will have the trade information, and, in theory, will be able to detect the discrepancies in the two different invoices. The picture becomes more complicated, however, when goods are exported first from countries that are not part of the TTU network. For example, Company C could export from Country Z, which is not part of the TTU network, who then sends the goods to Company A, in Country X, and then the goods finally end up with Company B, in Country Y. Because Country Z is not part of the TTU network, Country X is not able to tell if the goods were valued at the same price when they were exported as when they were imported. Unless all or most of the countries that frequently trade together are part of the TTU network, there is much room for sophisticated criminals to circumvent detection.

The U.S. approach has high start-up and administrative costs that make its system impractical in developing countries or countries where there is little known about the true effects of TBML.[111] In countries like Australia with limited study on the effects of TBML, the high start-up costs may not be justified by a significant enough problem.[112]

III. THE RISK-BASED CUSTOMS AUDIT AS A SOLUTION TO TRADE-BASED MONEY LAUNDERING THROUGH CUSTOMS MISREPRESENTATION

This section proposes a new approach to combat TBML: the Risk-Based Customs Audit. Customs audits are used in many countries currently to target other trade-based crimes, such as tax evasion, but have not been used to target TBML.[113] First, this section will discuss justifications for this new approach to combat TBML and briefly describe how customs audits are used currently by some countries, using Korea as a model. Next, it will explain how countries can target TBML using a customs audit and why the Risk-Based Customs Audit is the best solution for combating TBML. Finally, the section will conclude with a discussion of possible challenges to the new approach.

Both the FATF and U.S. approaches to combat TBML make the implicit assumption that information sharing between countries is always superior; however, this may not necessarily be the case. For example, governments may not want to share trade information in fear that other foreign governments may be in collusion with money launderers and could use this information to circumvent actions being taken to combat TBML. Assuming that a country does not want to develop a TTU

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http://www.ice.gov/cornerstone/money-laundering.htm (last visited Mar. 14, 2012).

111. AIC TBML REPORT, *supra* note 81, at 2, 23–26.

112. *Id.* at 25–26.

113. *See, e.g.*, CUSTOMS & TARIFF BUREAU, MINISTRY OF STRATEGY & FIN., KOREA CUSTOMS AND TARIFF 27 (2010), *available at* http://idn.mofat.go.kv/kor/as/idn/images/res/2010_Korea_Customs_and_Tariff.pdf [hereinafter KOREA CUSTOMS AND TARIFF] ("The purpose of [the] planned audit is to examine intensively the transactions of particular goods . . . in order to prevent tax evasion activities.").

or similar information-sharing database, is a developing country without a large amount of available funds to allocate to combating TBML, or is a country that does not yet have enough information on the effects of TBML on its trade system to justify the expense involved with TTUs, what can the country do to protect itself? Although countries are not familiar with targeting money laundering through the trade system, they are used to targeting other types of trade-based crimes, including tax evasion[114] and "dumping."[115] These crimes involve some of the same forms of customs misrepresentation that are used in TBML, including over- and under-invoicing (tax evasion)[116] and undervaluing of goods (dumping).[117] Implementing a customs audit system in order to accelerate customs clearance and target tax evasion is becoming fairly common globally, particularly in World Trade Organization member states.[118] The customs audit currently does not target TBML,[119] but as will be shown, the Risk-Based Customs Audit is a viable solution for countries to protect their borders from TBML.

A. Current Use of the Customs Audit to Target Tax Evasion

A customs audit "means the audit conducted by the customs on the basis of the account books and vouchers, customs declaration documentations or data, commercial documents and goods of the traders with the purpose [of] identify[ing] the authenticity and validity of the trade."[120] Authority for countries to conduct these audits and access this information is usually granted under a national regulation or directive. For example, in the European Union, Article 78(2) of Regulation 2913/1992 (Community Customs Code) and Article 27 of Regulation 450/2008 (Modernised Customs Code) afford customs authorities the authorization to

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114. FATF TBML REPORT, *supra* note 26, at 2–3.

115. *See Anti-dumping*, WORLD TRADE ORGANIZATION, http://www.wto.org/english/tratop_e/adp_e/adp_e.htm (last visited Feb. 18, 2013) (defining dumping as occurring when "a company exports a product at a price lower than the price it normally charges on its own home market . . .").

116. FATF TBML REPORT, *supra* note 26, at 2.

117. *Anti-dumping*, *supra* note 115.

118. The large group of countries that have implemented a customs audit system includes such diverse countries as the United States, Australia, Malaysia, New Delhi, and Papua New Guinea. *See generally* U.S. CUSTOMS & BORDER PROT., CBP TRADE STRATEGY: FISCAL YEARS 2009–2013 16 (2009), *available at* http://www.cbp.gov/linkhandler/cgov/trade/trade_outreach/trade_strategy/cbp_trade_strategy.ctt/cbp_trade_strategy.pdf [hereinafter U.S. CBP STRATEGY]; AUSTRALIAN CUSTOMS SERV., A GUIDE TO CUSTOMS COMPLIANCE AUDITS (2007), *available at* http://www.customs.gov.au/webdata/resources/files/audits1.pdf; KPMG, *Malaysia: Customs Audits on the Rise*, ASIA-PACIFIC TRADE & CUSTOMS NEWS, Jan.–Feb. 2012, at 1, *available at* http://www.kpmg.com/cn/en/IssuesAndInsights/ArticlesPublications/Documents/Asia-Pacific-Trade-Customs-News-O-201201-01.pdf; DIRECTORATE GEN. OF AUDIT CUSTOMS & CENT. EXCISE, NEW DELHI, ANNUAL REPORT: 2008–2009 2 (2010), *available at* http://www.dgauditces.gov.in/WriteReadData/3_Annual%20Report%202008-09.pdf; *Post Clearance Audit*, PAPUA NEW GUINEA CUSTOMS, http://www.customs.gov.pg/05_commercial_trade_and_compliance/92_post_clearance_audit.php (last visited Apr. 29, 2012) (each discussing customs audits in their respective countries).

119. FATF TBML REPORT, *supra* note 26, at 2–8.

120. Negotiating Group on Trade Facilitation, *Draft Consolidated Negotiating Text: Revision*, TN/TF/W/165/Rev.2 (Apr. 30, 2010), *available at* http://trade.ec.europa.eu/doclib/docs/2010/june/tradoc_146247.pdf.

investigate details of a customs declaration after customs releases the goods.[121] In the United States, the authority to conduct audits and impose liability for taxes, duties, and fees is found in 19 U.S.C. 1509.[122]

The Korean system for customs audits could serve as a good TBML customs audit model. Of particular significance is the fact that this system should be attractive for countries that do not have many resources to provide for customs investigations,[123] and it is already highly effective at targeting tax evasion through the trade system.[124] For example, Post Audit Teams allegedly brought in about $480 million in additional revenues in 2004 from detection of tax evasion and other false import declarations.[125] The system boasts the additional benefit of accelerating customs clearance, which was the initial central purpose behind instituting this program[126] and is similar to the goal of many other customs programs of facilitating legitimate trade movement.[127]

The Korean audit system conducts both pre-audits before goods enter the country (at the point of declaration of goods) and post-audits (conducted after goods are released).[128] Officials select declaration for pre-audit based on numerous criteria including duty or tax exempt goods, goods declared by a delinquent taxpayer, goods with a fluctuating international price, or goods declared by a less compliant importer.[129] Post-audit, performed by regional customs authority, is determined based on a company's classification as an honest importer, quasi-honest importer, importer under general surveillance, and importer under special surveillance.[130] The Korean system divides post-audit into three categories: First, an immediate "case by case" audit within a short amount of time after clearance and based on risk factors and review of customs clearance documents.[131] These auditors determine if proper import duties and taxes were paid on the goods.[132] Second, a planned audit based on goods with a high risk of tax evasion, which is performed by an audit officer at companies themselves.[133] Upon a finding of serious irregularities, the auditor refers

121. Council Regulation 2913/92, art. 78(2), 1992 O.J. (L 301) (EEC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992R2913:en:NOT; Council Regulation 450/2008, art. 27, 2008 O.J. (L 145) (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32008R0450:en:NOT.

122. U.S. CUSTOMS & BORDER PROT. OFFICE OF STRATEGIC TRADE, REGULATORY AUDIT DIV., FOCUSED ASSESSMENT PROGRAM PRE-ASSESSMENT SURVEY AUDIT PROGRAM 3 (2003), *available at* http://www.cbp.gov/linkhandler/cgov/trade/trade_programs/audits/focused_assessment/fap_documents/exh2c.ctt/exh2c.pdf.

123. *See* Negotiating Group on Trade Facilitation, *Communication from Korea*, para. 13, TN/TF/W/55 (July 22, 2005) ("Furthermore, based on KCS' experience, it is noted that the Post-Clearance Audit system is one of the effective means to facilitate clearance procedure that does not require significant investment in IT infrastructure or additional manpower.").

124. *Id.* paras. 12, 14.

125. *Id.* para. 12.

126. *Id.* para. 14.

127. *See, e.g.*, U.S. CBP STRATEGY, *supra* note 118, at 14 ("CBP's trade vision is to develop a swift, safe, and secure system by which legitimate imports enter the United States.").

128. KOREA CUSTOMS AND TARIFF, *supra* note 113, at 26.

129. *Id.*

130. *Id.* at 25.

131. *Id.* at 27.

132. *Id.*

133. *Id.*

the company or transaction for further investigation.[134] Third, a comprehensive audit based on a company's trade volume and credibility, determined by information analysis on company risk factors.[135] After the audits, "the companies are classified into different groups based on credibility and law compliance."[136] The comprehensive audit is a self-assessment audit by selected companies to relieve some of the pressure of future audits and help the customs clearance process run more efficiently.[137]

B. Adapting the Customs Audit into a Risk-Based Customs Audit to Target Trade-Based Money Laundering Through Customs Misrepresentation

A Risk-Based Customs Audit, which would be a completely new approach to the problem, could be very effective for targeting TBML. Countries could keep a similar customs audit structure and incorporate risk-based analysis. First, countries would conduct a pre-audit before goods arrive using a risk assessment of TBML factors to evaluate declarations and target suspicious transactions for further inspection upon arrival. Next, TBML specialists or customs agents trained in TBML would inspect cargo and examine customs documentation from pre-identified high-risk transactions. This would be followed by a post-audit after goods have been released, looking at the customs documentation in more detail, reserving inspection on arrival for only very high-risk predetermined transactions (e.g., identified by a name or a particular good that has been identified to be used frequently in money laundering activities). Finally, a self-audit could be made available to help identify legitimate businesses or traders not engaged in money laundering.[138] An incentive for companies to engage in a self-audit is that if customs officials trust these companies, the companies' transactions will be more likely to move through the customs process quicker as identified compliant traders.

Under the current Korean customs audit system, risk factors focus on tax evasion.[139] Once TBML is incorporated into the customs audit, risk factors should also be tailored to money laundering. An effective risk-based approach can manage effective risk by using various categories. The commonly used FATF risk categories are "geographic risk; customer risk; and product/service risk."[140] Countries posing a

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134. KOREA CUSTOMS AND TARIFF, *supra* note 113, at 27.

135. *Id.* at 28.

136. *Id.* at 28.

137. *Communication from Korea*, *supra* note 123, at 2.

138. The United States also has a very similar system for targeting other types of crimes such as counterfeiting and evasion of duties. *See* U.S. CBP STRATEGY, *supra* note 118, at 6–11 (describing the U.S. customs inspection process).

139. *See generally*, OFFICE OF INSPECTOR GEN., DEP'T OF HOMELAND SEC., CUSTOMS AND BORDER PROTECTION'S OFFICE OF REGULATORY AUDIT, OIG-12-117 (2012), *available at* http://www.oig.dhs.gov/assets/Mgmt/2012/OIG_12-117_Sep12.pdf (noting that the audit system is in place to ensure compliance with duties and taxes).

140. FINANCIAL ACTION TASK FORCE, GUIDANCE ON THE RISK-BASED APPROACH TO COMBATING MONEY LAUNDERING AND TERRORIST FINANCING: HIGH LEVEL PRINCIPLES AND PROCEDURES para. 3.3 (2007), *available at* http://www.fatf-gafi.org/media/fatf/documents/reports/High%20Level%20Principles%20and%20Procedures.pdf [hereinafter FATF GUIDANCE ON THE RISK-BASED APPROACH].

geographic risk may include those subject to U.N. sanctions, those lacking in effective AML/CFT laws, those suspected of providing funding to terrorist organizations, and those identified as having a high level of criminal activity.[141] Other TBML risk factors could include names and addresses used in previous money laundering activities as well as specific goods (e.g., hard-to-value goods) or industries that are more commonly abused by money launderers. Additionally, the current customs audit in Korea seems to be targeted mostly at companies; however, customs audits targeting TBML should evaluate both individual as well as company transactions.

The Risk-Based Customs Audit is an attractive alternative for countries that do not have very many financial resources available to allocate to combating TBML. It enables countries to combine resources to target both tax evasion and TBML. Combining resources in this manner to target both crimes makes sense because TBML often results in tax evasion even if it is not the money launderer's principal aim.[142] The current customs audit system (using Korea as a model) will need to be modified and adjusted to include TBML risk factors and specialists that are trained to target TBML. Assuming a country already has a customs audit in place, everyone engaged in these audits should be trained and given guidance on how to target TBML as well as specific protocols and steps for incorporating TBML into the current customs audit system. For countries that do not have a customs audit currently in place, agents should be trained in targeting both tax evasion and TBML from the inception of a Risk-Based Customs Audit initiative.

The customs audit system lends itself well to incorporating TBML because many customs audit systems are already risk-based.[143] A risk-based approach is important to AML efforts because it allows resources to be allocated efficiently and effectively in order to give the most significant risks the utmost attention.[144] The FATF previously recognized this as an option to discharging AML initiatives mainly relating to financial institutions,[145] but a risk-based approach is arguably even more important for effectively combating TBML as trade grows in volume, value, and complexity.[146] As an example, in the United States alone in fiscal year 2007, there were "nearly $2 trillion in imports combined with over $1 trillion in exports," and an increase in the value of goods by sixty-five percent from fiscal year 2001 to 2007.[147] Therefore, even in highly developed countries, a risk-based approach to combat TBML is not only encouraged, it is necessary. Additionally, an effective risk-based approach should incorporate information about past compliance as well as up to date information on new trends.[148] The *U.S. Customs and Border Protection Trade Strategy Report 2009–2013* emphasizes that risk management of the customs

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141. *Id.* para. 3.5.

142. AIC TBML REPORT, *supra* note 81, at viii.

143. *See* U.S. CBP STRATEGY, *supra* note 118, at 12 ("In the face of increasing volume, CBP must assess the risk of incoming cargo to efficiently and effectively set the level and environment for inspection and review. CBP must enhance risk assessment tools and models to better integrate new data, trade information, and enforcement action results. This will improve overall targeting efficiency and ensuing effectiveness of enforcement actions.").

144. FATF GUIDANCE ON THE RISK-BASED APPROACH, *supra* note 140, para. 1.7.

145. *Id.*

146. U.S. CBP STRATEGY, *supra* note 118, at 6.

147. *Id.*

148. *See id.* at 17 (listing strategies to "maintain comprehensive and responsive risk profiles").

inspection process is crucial due to the high volume of trade and limited resources; because "the vast majority of imports are compliant," it is important to allow compliant transactions to move through the customs process quickly, while utilizing resources in the most efficient way possible.[149] This is consistent with the *FATF Best Practices* emphasis of the importance of guaranteeing that legitimate trade activities are not inhibited or interrupted.[150]

Another reason that the customs audit lends itself well to targeting TBML is that World Trade Organization (WTO) members with a customs audit in place already have a valuation method for detecting customs fraud that is based on the *World Trade Organization General Agreement on Tariffs and Trade*.[151] The main purpose of the WTO valuation is to ensure that import duty rates are administered uniformly and are not arbitrary.[152] For the valuation, most countries use a transactional valuation, which is "the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8 [of the Agreement on Implementation of Article VII of GATT]."[153] If the transactional valuation fails, there is a hierarchy of other valuation methods as alternatives.[154] One of the most crucial difficulties in targeting TBML through customs misrepresentation is valuing the goods. Although there may be some problems with using the WTO valuation methods, for example with hard-to-value goods, at least it is an option for countries to use to begin targeting TBML through the customs audit process.

Although there are many benefits to the Risk-Based Customs Audit approach, including effective and efficient allocation of resources and flexibility in adapting to new threats and trends, there are also challenges to this approach. First, a risk-based approach is challenging because it requires specialized knowledge and expertise to define and identify risks effectively.[155] Although one advantage of this approach is that it will allow countries to target TBML on their own without sharing information between different countries, countries would benefit from sharing information between competent authorities *within* their own boundaries.[156] The approach will be most effective if other sectors, such as the financial sector, cooperate with trade

149. *Id.* at 16.

150. *See supra* Part II.A. (discussing how the Delston & Walls approach is at conflict with the *FATF Best Practices* goal of not hindering legitimate trade).

151. *See* General Agreement on Tariffs and Trade 1994, art. VII, para. 2(a), 15 Apr. 1994, 1867 U.N.T.S. 187, *available at* http://www.wto.org/english/res_e/booksp_e/analytic_index_e/gatt1994_04_e.htm#article7 ("The value for customs purposes of imported merchandise should be based on the actual value of the imported merchandise on which duty is assessed, or of like merchandise, and should not be based on the value of merchandise of national origin or on arbitrary or fictitious values.").

152. *See* Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (Customs Valuation Agreement), General Introductory Commentary, 1868 U.N.T.S. 279, *available at* http://www.wto.org/english/res_e/booksp_e/analytic_index_e/cusval_01_e.htm#article1 ("[r]ecognizing the need for a fair, uniform and neutral system for the valuation of goods for customs purposes that precludes the use of arbitrary or fictitious customs values . . .").

153. *Id.* art. 1.

154. *Id.* arts. 2–6; *see also* KOREA CUSTOMS AND TARIFF, *supra* note 113, at 23 (describing the Korean method of customs valuation in accordance with the WTO agreement on customs valuation).

155. FATF GUIDANCE ON THE RISK-BASED APPROACH, *supra* note 140, para. 1.20.

156. *See id.* (stating that a risk-based approach "will always benefit from information sharing by competent authorities").

authorities to assist in identifying high-risk factors. It will also be important for enforcement agencies to cooperate with customs audit officials so that once suspicious transactions are identified as likely TBML transactions, enforcement officials can take action against the money launderers.

Second, the risk-based approach will require customs auditors and inspectors to make judgments based on determination of risk, which officials may not be comfortable with at first.[157] Officials may over- or underestimate risk resulting in less efficient detection; however, many professions require some judgment determinations, and these officials are likely to improve with experience. Making over- or underestimates of risk is better than making no determination at all. Countries should acknowledge that it may take a couple of years to realize return on the initial investment of resources for combating TBML until officials are more familiar with the protocols and what approaches work best.

A statistical analysis of a country's trade data could help mitigate problems associated with risk determinations in the customs audits. Professor John S. Zdanowicz at Florida International University has suggested this type of analysis by utilizing a special data mining methodology to detect discrepancies in trade pricing.[158] Professor Zdanowicz used trade import and export data produced in the U.S. Merchandise Trade Database and pricing norms for suspicious transactions from the U.S. Internal Revenue Service tax code as part of a statistical analysis to determine what goods from different countries were being over- and undervalued.[159] The numbers from the statistical analysis can be used to create country-based and product-based risk indexes.[160] These indexes could be used to aid the Risk-Based Customs Audit at both the pre- and post-audit stages. If a country has the resources to allocate to develop such a program, it would be helpful in identifying trade price discrepancies. In December 2011, the United States started allowing U.S. Customs and Border Protection as well as private auditors, subject to certain restrictions, to start using this type of statistical sampling method to detect trade discrepancies for duties and fines, but not for TBML.[161] It will be interesting to see how well this method works in practice. Although this type of statistical analysis could be helpful for determining risk, it would not be feasible for countries with very limited resources. It would be most helpful as a tool for more developed countries that want to use the Risk-Based Customs Audit approach instead of an approach like the TTUs in the United States that rely heavily on sharing information between

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157. *Id.* para. 1.21.

158. John S. Zdanowicz, *Detecting Money Laundering and Terrorist Financing via Data Mining*, 47 COMM. OF THE ACM 53, 54 (2004), *available at* http://www2.econ.uu.nl/users/unger/papers/Zdanowicz%202.pdf.

159. John S. Zdanowicz, *Trade-based Money Laundering and Terrorist Financing*, 5 FLA. INT'L REV. L. & ECON. 856, 863–64 (2009). Professor Zdanowicz's process is described as follows: "Every import record was evaluated and compared to the country-specific import upper quartile price to determine if it was overvalued. The dollar amount of overvaluation for every import transaction was determined. Similarly, every export record was evaluated and compared to the country specific export lower quartile price to determine if it was undervalued. The dollar amount of undervaluation for every export transaction was determined. The dollar amounts of all undervalued export transactions and all overvalued import transactions for every commodity, for every country were aggregated." Zdanowicz, *supra* note 158.

160. *Id.* at 870.

161. Luis Abad, *New U.S. Customs Audit Rules and Proposed Transfer Price Adjustment Rules Ring in the New Year for U.S. Importers*, What's News In Tax (KPMG), Jan. 12, 2012, at 1, *available at*, http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/jan-13-2012-tp-customs.pdf.

countries. Countries that attempt to develop this type of statistical risk-based determination for customs audits should keep in mind that it will work for over- and under-invoicing, but may not detect hard-to-value goods used by money launderers.

Finally, the last criticism of the Risk-Based Customs Audit as a solution to TBML through customs misrepresentation revolves around who benefits from the current non-system and the incentives for various countries to participate in a new system. There are many factors including historic, cultural, and political considerations that weigh against an accepted common system among various countries.[162] The political will and economic circumstances are so variable that it is problematic to have a widely accepted solution that fits all of the various conditions for these countries. However, this variability is also a strength of the Risk-Based Customs Audit. The Risk-Based Customs Audit can be used at different levels to fit a country's needs and resources. Additionally, it gives countries an option to implement a system that is more effective than the current Australian education and awareness approach, while not focusing on a need for sharing information and cooperation between countries like the U.S. approach does. There are unique situations including bribery, corruption, and political and economic alliances, which negatively impact an agreement among all affected entities. Although these could still be problems within individual countries, there is more likely to be agreement within one country than between many dissimilar countries.

CONCLUSION

TBML is a serious and significant problem that threatens the stability of countries' financial institutions and the safety of individuals and countries from the perilous activities of terrorist organizations and criminal groups that are increasingly resorting to misuse of the trade system in order to finance and disguise their illicit activities. It took from the time the FATF was established in 1989 until the aftermath of the September 11 attacks on the United States in 2001 for countries to begin seriously implementing mechanisms and regulations to effectively target money laundering and terrorist financing in the financial sectors.[163] It would be unfortunate if it took another tragic event, like Iran selling a nuclear weapon to terrorists, for countries and institutions to start getting serious about combating TBML.

Therefore, it is imperative that countries start taking effective action to target TBML. The Risk-Based Customs Audit is a viable alternative for countries that is more effective than the limited Australian approach suggested by the *FATF Best*

162. *See* FATF GUIDANCE ON THE RISK-BASED APPROACH, *supra* note 140, paras. 2.22–2.29 (describing factors for forming national risk assessments to tailor different risk-based approaches for individual countries).

163. For example, the NCCT list was started in 2000 and the Mutual Evaluation reports were resumed in 2003 after a four-year absence. FATF ANNUAL REVIEW OF NCCT, *supra* note 70, at 2; FINANCIAL ACTION TASK FORCE, FINANCIAL ACTION TASK FORCE ON MONEY LAUNDERING: ANNUAL REPORT 2003–2004 9 (2004), *available at* http://www.fatf-gafi.org/media/fatf/documents/reports/2003%202004%20ENG.pdf.

Practices, but it does not demand as many resources and start-up costs as the current U.S. approach. The Risk-Based Customs Audit provides an effective and efficient option for countries to protect themselves against TBML without having to share privileged customs data or confidential trade strategy and policies with other countries.

T I L J