2011

Governing Interdependent Financial Systems: Lessons from the Vienna Initiative

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Working Paper No. 396

March 21, 2011

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Abstract:
This paper argues that while financial markets have become transnational, their governance structures have remained national at the core: Fiscal responsibility for crises is ultimately born by the nation state where the crisis occurred – whether or not it bears any responsibility for regulatory or policy failures. The tension between the transnational nature of markets and national responsibility for these markets has been revealed once more by the global financial and the European sovereign debt crises. Against this background, the Vienna Initiative (VI) offers the prospect of an alternative governance regime. The VI was formed to manage the fallout from the global crisis in the former socialist countries of Central and Eastern Europe (CEE). It brought together in an open and deliberative process the key stakeholders in the pan-European financial market, including transnational bank groups, fiscal authorities, regulators and central banks from home and host countries, the European Central Bank (as observer), the European Commission (EC), and several international financial institutions (IFIs). While each of these stakeholders had a manifest interest in a coordinated response, effective coordination required engineering to overcome the collective action problems they faced. The commitments stakeholders ultimately made to fend off a financial collapse went well beyond what they were legally obliged to

[1] Michael I. Sovern Professor of Law, Columbia Law School. I would like to thank Erik Berglöf and Piroska Nagy for many helpful conversations and access to information and people familiar with the process, without which this paper could not have been written. In addition, I would like to thank participants at the Comparative Law and Economics Forum 2010 held at Yale, as well as those at the Conference on Contract Governance in Berlin in October 2010 for helpful comments and suggestions. All remaining errors are mine.

do. The paper explores the institutional and organizational foundations of the VI and suggests lessons it may hold for other transnational governance challenges.

JEL classification: F36, K20, K23, K33

I. Introduction

The liberalization of financial markets has given rise to a complex and highly interdependent financial system, in which events in one of its parts can easily spread and threaten the entire system. The global financial crisis with its origins in the US subprime mortgage market has demonstrated the scale and scope of financial interdependence worldwide. Financial interdependence is particularly pronounced in Europe where commitments to the free flow of capital and financial services are strictly enforced by European Union law and where large transnational financial groups have emerged that control substantial parts of the financial system in countries outside their home state.

The emergence of a complex, interdependent, transnational financial system notwithstanding, the governance of finance has continued to be national. Regulatory and supervisory standards may be harmonized across national systems; supervisory powers may be divided between home and host countries delegated from one national regulator to another, or coordinated in Colleges of supervisors. Yet, in the event of a crisis, national resources must ultimately be mobilized to stabilize a financial system, and where such resources are not sufficient, governments of those countries need to seek outside help, whether from the International Monetary Fund (IMF) or other states. Uncertainties about the ability of countries to mobilize such resources have become the Achilles heel of the global financial system.

In short, the global crisis has re-enforced the notion that the critical ingredient for an effective governance regime in finance is the allocation of last-resort financial responsibility (Goodhart and Schoenmaker 2006). Nonetheless, no international regime has touched fiscal sovereignty, which rests firmly with the nation state. The European Monetary Union has been resolute in preserving fiscal sovereignty,[2] although the establishment of a permanent bailout facility to safeguard the Euro – the European Financial Stability Facility (ESFS) -- acknowledges the need for a European lender of last resort mechanism.[3] Against this background it is not surprising that the immediate responses to the global financial crisis were national across the board: The US acted in 2008 as if the survival of Lehmann Brothers was primarily a matter of US concern, only to be forced to reconsider when the firm's bankruptcy effectively shut down transnational inter-bank lending markets. Even within the European Union, which has sought to integrate financial markets within a harmonized governance structure, the initial response to the crisis was national: Countries whose financial sector was threatened by the crisis moved to protect 'their' financial system. Only in a second step were public commitments made to abstain from

[2] The Euro crisis has called this principle into question, but so far relevant parties have emphasized the exceptional nature of the transnational fiscal bailout, suggesting that they are eager to return to fiscal sovereignty.

[3] The ESFS was established in June of 2010 as a joint stock company under laws of Luxembourg. Its stated purpose is to provide financing to member states of the European Union whose currency is the Euro, subject to an agreement with the EC that stipulates the use of those funds (Art. 3, Statute of the ESFS, available at http://www.efsf.europa.eu/about/legal-documents/index.htm (last visited 15 March 2010)). A framework agreement between the ESFS and several EU member states sets forth details for the operation of the facility. See ibid.

serious beggar-thy-neighbor strategies and ways sought to coordinate crisis management. French President Nicolas Sarkozy coordinated such a meeting when France held the presidency of the Council of the EU in the fall of 2008. Notably, however, the meeting on 12 October 2008 in Paris[4] was limited to the heads of states that were part of the Euro-zone (with the UK joining as an observer), and did not directly address the deepening crisis in CEE. From the perspective of the EU and its leading member states, this was deemed to be a domestic problem of these countries and those whose banks were active in the region, but not a European one.

Perhaps surprisingly, the IMF, which is charged with managing the global financial system, does not much alter the governance lacuna in transnational finance. In fact, it tends to re-enforce fiscal sovereignty by structuring relations with states strictly in a bilateral fashion. In the midst of the East Asian financial crisis of 1997/8, it dealt with each country separately;[5] and not surprisingly, it faulted the domestic institutions in each country for the crisis notwithstanding differences among them.[6] Countries that may be directly affected by an

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[4] For the details of the meeting and the resolutions adopted, see "Summit of the euro area countries: declaration on a concerted European action plan of the euro area countries", available at http://eu2008.fr (last visited 20 March 2011).

[5] Each country signed its own agreement with the IMF, a summary of which was contained in a letter of intent. See for example, the 'letter of intent' signed by South Korea on 24 December 1997, available at http://www.imf.org/external/np/loi/122497.htm (last visited 14 March 2011).

[6] See (Boorman et al. 2000), discussing the key policies the IMF implemented, including macro-economic responses and institutional reforms. The review article highlights the need for institutional reforms, stating that "in particular, reforms in the financial and corporate sectors were needed to address the root causes of the crisis with a view to restoring confidence and preventing a recurrence" (ibid at 9), however, without explaining the alleged institutional dysfunctionalities in any detail.

agreement between the IMF and another member state may not even know about it, much less participate in it. In other words, the IMF may be international in the manner in which it pools resources and establishes governance standards, but is strictly bilateral when it comes to the allocation of these resources and the conditioning of their use. It is therefore not well equipped to facilitate the governance of interdependent financial systems, which requires coordination among multiple countries and governance agencies.

This paper argues that interdependent financial systems require coordinated governance regimes; and that this applies not only to ex ante regulation, but also ex post fiscal responsibility. Governing interdependent financial markets requires mechanisms for managing last-resort public and private financial responsibility during a crisis as well as principles for regulating and supervising financial markets ex ante in a manner that is consistent with the expected ex post allocation of costs associated with a financial crisis.

The paper suggests that such a regime has emerged in the form of the Vienna Initiative (VI). The VI is a multi-stakeholder governance regime that was formed to fend off a financial meltdown in Central and Eastern Europe (CEE) in 2008/9. It brought together transnational banks; regulators, representatives of ministries of finance, and central banks from home and host countries; as well as international financial institutions; and it did so in a manner that gave each of these stakeholders a voice in an open forum that made credible the informal commitments they made to one another. The immediate results of the Vienna

Initiative are impressive: Not a single subsidiary of a transnational bank group in the CEE market has collapsed as transnational groups agreed not to withdraw from Central and Eastern Europe in an uncoordinated fashion and some instead recapitalized subsidiaries located in these countries. Home and host countries effectively shared the burden of supporting transnational financial systems under the auspices of a joint action program that was organized by and with the financial support from international financial institutions (IFIs).

This paper seeks to explain how this task was accomplished against the strong bias in favor of national fiscal sovereignty and the coordination problems actors faced. It also explores the likelihood that the VI can survive, or that similar arrangements might emerge for governing other interdependent transnational systems. The paper argues that important explanations can be found in organizational features of players that assumed a central role in the VI, in particular the European Bank for Reconstruction and Development (EBRD), and draws lessons from the analysis for governing interdependence in other settings.

II. Against the Odds: The Emergence of the VI

The VI derives its name from a series of meetings in Vienna, which, beginning in late 2008, brought together key stakeholders in the pan-European financial system in an effort to save it from destabilization, if not collapse. The participating countries were not limited to EU member states: Participation was based on the actual reach of the pan-European market, and by implication on exposure to its crisis, not on formal treaties.[7] Initial ad hoc meetings with different stakeholder groups (bankers, fiscal authorities from selected countries) culminated in a joint meeting of all stakeholders in March 2009 in Vienna. At the meeting each stakeholder group made public its commitment to prevent the deepening of the crisis. Most of these commitments were subsequently implemented through a process that entailed multi-stakeholder arrangements within each affected country.

The foundations for the emergence of a pan-European financial system were laid in the 1990s when, with the ratification of the Maastricht Treaty, the EU moved towards greater integration of its financial markets. The Maastricht Treaty is best known for preparing the currency union; however, it also laid the groundwork for the deeper integration of financial services. Most importantly, it committed EU member states to full capital mobility not only vis-à-vis one another, but also vis-à-vis third countries.[8] The scope of the pan-European financial market was substantially expanded after the collapse of the socialist system, which ushered in an era of liberal market reforms in the countries of CEE. In their eagerness to transform their economies and catch up with the West, countries throughout the region opened their financial markets to foreign capital and financial services even prior to joining the EU, at which time capital market

[7] The VI included Bosnia and Herzegovina and Serbia. Attempts to also include Ukraine were ultimately unsuccessful, apparently because of political impasses in Ukraine.
[8] See Art. 63 of the Treaty on the Functioning of the European Union (Lisbon Treaty).

liberalization became mandatory. By the same token, these countries became important markets for Western European banking groups that acquired large parts of their domestic banking sectors. As a result, at the outset of the global crisis in 2007, foreign bank groups controlled between 36 (Slovenia) and 98 (Estonia) percent of the banking systems in the new member states of the EU (Enoch 2007). The most active foreign bank groups in the region came from Austria, Sweden, Italy, and France, i.e., from countries whose financial sectors were not among the leaders in the global financial marketplace. For them, the opening of Eastern Europe offered a unique opportunity to expand the regional marketplace. For the most part, foreign groups acquired local subsidiaries, although some also set up branches in CEE host countries (Haselmann, Pistor, and Vig 2009). The presence of foreign banks has been widely credited for the rapid development of financial markets in the region. For some time this looked like benign evidence of the region's catch-up with its Western neighbors, although the pace of change raised some concerns. Credit markets in CEE expanded by an unprecedented rate of between 17 and 67 percent annually in the years prior to their accession to the European Union (Arcalean et al. 2007; Berglöf et al. 2009). Those applauding the rapid expansion of credit markets included foreign bank groups that recorded unprecedented growth figures, and their home regulators. The Austrian National Bank, for example, reports that in the years prior to the crisis the annual rate of growth in credit expansion by Austrian banks in CEE countries was 20 percent on average, and close to 50 percent in

Bulgaria and Romania (ONB 2009). Whether or not these growth rates would have been sustainable absent the global financial crisis remains an open question. The crisis certainly dealt a severe blow to a model practiced in developed and emerging markets alike that relied heavily on high-leverage ratios of financial intermediaries masked by complex capital structures, short-term financing in the inter-bank lending markets, and the general perception that rapid credit expansion would be sustainable in the long term (Claessens et al. 2010; Stiglitz 2010).

When the global crisis unfolded, each stakeholder in the pan-European financial system faced a unique set of incentives. The bank groups had become highly integrated pan-European groups. They had operations in multiple countries and operated them as vertically-integrated groups with little regard to legal differences between branches and subsidiaries, and the regulatory implications associated with this formal distinction (ECB 2005). Decisions were made at headquarters in a centralized fashion and transmitted to local operations. At the outset of the crisis these groups appeared to be sufficiently diversified to survive a shock in one part of the system without having to scale back their operations considerably. Empirical evidence across a large number of transnational bank groups suggests that transnational financial groups tend to cross-subsidize major subsidiaries[9] after downturns in their respective markets in an attempt to stabilize the group (De Haas and Van Lelyveld 2010). Pan-

[9] Defined in the study by de Haas et al as ownership of at least 50 percent.

European bank groups did just that in 2007 and the beginning of 2008, which explains why the financial systems in the CEE region remained fairly stable during the early period of the crisis (Berglöf et al. 2009). This changed, however, when the parent banks themselves were caught in the global financial downturn. They were now confronting the need to re-capitalize core operations and, if necessary, to withdraw capital from more remote places.

The parents' home country regulators re-enforced the impetus to concentrate on the core. Regulators are national institutions and have a mandate to regulate entities within their territorial jurisdiction; they are also accountable to national politicians and their domestic constituencies. Their priority, therefore, was to ensure the stability of entities within their jurisdiction. As the financial crisis deepened, calls for recapitalizing core operations in the parent banks' home markets turned out to be insufficient, so governments devised bailout packages for them (Pisani-Ferry and Sapir 2010). This move galvanized national political accountability. Bailing out domestic banks turned out to be a difficult sale; bailing out foreign subsidiaries was not an option. Domestic bailout packages came with the explicit or implicit condition that they be used exclusively at home.[10] This created the very real danger that transnational bank groups would

[10] The German law on stabilizing the financial sector (Gesetz zur Errichtung eines Finanzmarktstabilisierungsfonds) adopted on 17 October 2008 limits the fund's facilities to financial institutions with headquarters in Germany (See Sec. 2). Similarly, Austria limited its bailout facility to financial institutions regulated under its banking legislation, which includes branches of Austrian banks in other countries, but not their subsidiaries. See Sec. 1 of the Interbank-Market Stabilization Law (Interbankmarktstärkungsgesetz) of 21 October 2008 in combination with Secs. 1-8 of the 1993 Banking Law (Bankwesengesetz).

withdraw capital from CEE in a disorderly fashion, potentially leading to a massive capital flight and financial collapse.

Regulators in CEE countries with strong presence of foreign bank subsidiaries responded to the spread of the crisis by taking defensive measures. Most had initially welcomed the rapid expansion of credit markets. Some had, however, tried to stem the flow of credit in the years leading up to the crisis, as they feared that the initially welcomed credit expansion had morphed into an unsustainable credit boom that could well end in a bust. The countermeasures they took, such as increasing reserve requirements or imposing credit ceilings on banks within their jurisdiction, proved largely unsuccessful (Hilbers, Ötker-Robe, and Pazarbasioglu 2007). Foreign bank groups frequently sidestepped them by lending directly to customers in foreign markets,[11] or by channeling capital through unregulated financial intermediaries.[12] Against this background host countries felt neither an obligation to insure the deposits of foreign subsidiaries nor to provide them with liquidity when the crisis hit. Some even threatened to ring-fence assets of bank subsidiaries as capital was leaving their countries (Popov and Udell 2010).[13]

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[11] This practice was legally rooted in the "European Passport System", which allows a bank that has been duly authorized anywhere within the European Union to offer financial services in all other member states without facing additional entry barriers.

[12] The Austrian National Bank investigated the lending practices of Austrian banks in 2009 and reports that many used leasing companies and direct lending to continue credit expansion in countries where restrictions were imposed on their subsidiaries. See (ONB 2009).

[13] Popov and Udell (2010) document that foreign bank subsidiaries were more likely to curtail credits and reduce their capital than domestic banks.

The European Central Bank (ECB) saw the crisis in CEE unfolding, but was institutionally constrained to intervene because most afflicted countries fell well outside its jurisdiction. Sweden, whose banks had expanded in the Baltics, is not part of the Euro zone, and among the new member states that were at the center of the unfolding financial storm, only Slovenia had already adopted the Euro (in 2007), with Slovakia to follow in 2009. As the crisis deepened, however, the ECB engaged in some liquidity provisioning to the central banks of Denmark, Sweden, Poland and Hungary. These measures fell well short of those taken by the US Federal Reserve (Fed), which extended liquidity provisions for selected countries around the world, accepting local currencies as collateral.[14] In contrast, the ECB required Euro denominated collateral from countries that were not part of the Euro zone (Moessner and Allen 2010).

At first, the EU Commission, its Directorate General for Economic and Financial Affairs, as well as the Committee for European Bank Supervisors (CEBS), the EU's major coordinator for EU-wide banking regulation, also remained on the sidelines. This was somewhat surprising, as no other region in the world has built as many formal institutions to facilitate financial market

[14] Board of Governors of the Federal Reserve System of the US (Fed), Press Release 29 October 2008, announcing temporary reciprocal currency arrangements with the Banco Central do Brasil, the Banco de Mexico, the Bank of Korea, and the Monetary Authority of Singapore, after having previously announced similar facilities with the Reserve Bank of Australia, the Bank of Canada, Danmarks Nationalbank, the Bank of England, the European Central Bank, the Bank of Japan, the Reserve Bank of New Zealand, the Norges Bank, the Sveriges Riksbank, and the Swiss National Bank. Available at http://www.federalreserve.gov/newsevents/press/monetary/20081029b.htm (last visited 15 March 2011).

integration, which one might have expected to be in the first line of response. However, the stress test imposed by the crisis revealed that national sovereignty trumped European coordination. The EU's credibility as a regional governance regime had already suffered a blow when the leading countries of the union – Germany, France, the Netherlands and (less surprisingly) the UK – responded to the crisis by unilaterally creating their own bailout regimes with only scant attention paid to how this would affect the common market and its various member states. The EU Commission's attitude to the crisis was revealed in a Communication of 29 October 2008 entitled "From Financial Crisis to Recovery: A European Framework for Action".[15] The report recognized the threat of a severe credit crunch and called for a coordinated response of central banks and governments, yet failed to formulate such a plan itself and instead called on the IMF and the G20 to ensure a global response to the global crisis.

For their part, the governments of countries that were implicated by the unfolding crisis in CEE were divided on whether to call on European institutions to come to their rescue. Among the CEE countries, Hungary openly sought a common European rescue package for the region, but was turned down.[16] Other CEE countries, however, were opposed to an intervention that could be interpreted by the market as a sign of widespread contagion. The Czech Republic, in particular, sought to distance itself from the Hungarian move in

[15] COM(2008) 706 final.
[16] "Ailing in the East: European Union leaders decline to bail out Eastern Europe", The Economist, 1 March 2009, available at www.economist.com (last visited 15 March 2011).

order to avoid the impression that it was implicated by Hungary's ills. Other member states of the European Union, whose banking systems had long benefited from expanding in the CEE region, were equally hesitant. They apparently did not want to be seen as trying to Europeanize a problem that could be perceived to be a problem of their domestic financial intermediaries. Instead, they hoped that the worse afflicted countries would receive help from the IMF, and that this would mitigate any effect of local meltdowns on the broader system.[17] This hope was not misplaced. In the past, the IMF had repeatedly played the role of lender of last resort and crisis manager in countries that were unable to cope with a financial crisis, whether in Latin America, East Asia, or CEE in earlier 'emerging market' crises.[18] The IMF entered into standby agreements with several countries in the region, including Hungary and Ukraine in October 2008, but the bilateral approach did little to address the problem of the integrated regional market.

In sum, structural incentives of key stakeholders in the pan-European system were not conducive to coordination, even though each stakeholder had a lot to gain from it. A classic prisoner's dilemma story was unfolding in the fall of 2008 with potentially systemic consequences for the regional and global financial systems. The VI emerged in this context. Several stakeholders began to push for a coordinated response in light of the deepening crisis. The heads of several bank

[17] In its financial stability report of June 2009 the Austrian central bank stated with some relief that 'in light of recent rescue measure by the IMF and the EU Commission, extreme scenarios have become much less likely' (ONB 2009).
[18] The role of the IMF in managing these crises has been much disputed. See (Wade 2000).

groups with a strong presence in CEE met and wrote a letter to the European Commission (EC) that was copied to the European Investment Bank (EIB) and the EBRD.[19] The letter sought to put pressure on CEE countries to grant liquidity support to local subsidiaries. By calling simultaneously on the EU Commission and other transnational institutions, the banks were exposing the governance vacuum at the heart of the pan-European financial system: the lack of an ultimate guardian for the system (Pistor 2011).

The banks' call notwithstanding, the EU Commission stayed on the sidelines, as it had throughout the earlier stages of crisis when member states took their fate into their own hands and bailed out their domestic banks. It may have decided that resolving the crisis ultimately involved fiscal resources, which squarely falls within the responsibility – and sovereignty – of individual member states, not the EU; or it may have thought it wise to sit out the crisis and leave responsibility for its fallout to member states, only to emerge with a powerful integration plan once the crisis had run its course.

The most proactive player in the unfolding crisis in CEE was the EBRD. It, in collaboration with the Austrian Ministry of Finance, organized several brainstorming sessions in the fall of 2008, each initially devoted to a single group of stakeholders (banks, ministers of finance, regulators). The EBRD also

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[19] Stefan Wagstyl, "Banks ask for crisis funds for eastern Europe", The Financial Times, 21 January 2009, available at www.ft.com (last visited INSERT DATE). The banks involved in the initiative were Raiffeisen and Erste Bank (Austria); Unicredit and Intessa Sanpaolo (Italy); Societe General (France); KBC (Belgium); Bayerische Landesbank (Germany); Swedbank (Sweden); SEB and EFG Eurobank (Greece).

mobilized the International Finance Corporation (IFC) and the EIB in order to provide resources to pan-European bank groups to prevent a major capital retrenchment in the CEE host countries where they maintained subsidiaries. In addition, the EBRD orchestrated a Joint IFI Action Plan, "In Support of Banking Systems and Lending to the Real Economy in Central and Eastern Europe", which was co-sponsored by the EIB and the World Bank Group.[20] Under the terms of this agreement, €24.5 billion were made available for 2009-10.[21] While these amounts were not sufficient for safeguarding the region, the plan signaled the commitment by IFIs to tackle the crisis as a regional crisis rather than several distinct national ones. The timing of the joint action plan was even more critical than the amounts made available. It signaled a clear commitment to regional financial stability at a time when deteriorating conditions in Romania and Serbia put the region at risk (Nitsche 2010).

Second, the EBRD helped mobilize important stakeholders, including regulators, fiscal authorities, and central banks from both home and host countries of transnational bank groups with strong presence in the region, for a series of meetings in January of 2009 in Vienna, and also facilitated meetings during the same time period in crisis countries with IMF delegations and representatives of bank groups.

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[20] See http://www.eib.org/about/news/joint-support-for-central-eastern-and-southern-europe.htm (last visited 19 March 2011).

[21] Details of the IFI Joint Action Plan are available at http://www.ebrd.com/new/pressrel/2009/090227.htm (last visited 19 March 2011).

These meetings laid the groundwork for a joint meeting in Vienna in March of 2009 at which all major stakeholders were present: banks, IFIs, finance ministries, regulators and central banks from host and home countries, the EC, and the ECB as an observer.[22] After a day of discussions in which each group of stakeholders was able to voice its needs and demands on others, the following commitments were made:[23]

- Bank groups promised not to disengage from CEE, to recapitalize subsidiaries if needed, and to make their commitments public;
- Host countries committed to conduct reasonable macroeconomic policies in accordance with IFI agreements, to provide liquidity and deposit insurance to subsidiaries of foreign bank groups, and not to ring-fence assets;
- Home countries agreed to make bailout money available to bank groups without constraining where these resources were used;
- IFIs offered funding to pan-European bank groups, to stand by individual countries, and to stay engaged in monitoring regional developments.

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[22] One stakeholder arguably was missing, namely the taxpaying public in the home countries of the parent banks. Formally speaking, they were, of course, represented by their home country central banks, regulators, and ministries of finance – as they had been when these very same agents allowed the rapid expansion strategy of home banks without regard to their potential systemic effects.

[23] (Nitsche 2010). Similar commitments were reiterated after an expanded meeting in September of 2009, which was now relabeled the "European Bank Coordination Initiative". See http://www.imf.org/external/np/sec/pr/2010/pr10106.htm (last visited 20 March 2011).

Each of these commitments went well beyond the narrow self-interest that had characterized the immediate responses to the crisis in 2008. This was made possible because they were reciprocated in an open forum by commitments from other stakeholders. As one participant of the meeting observed, the open forum in which multiple stakeholders participated and voiced their concerns induced each one to offer more than they individually had been willing to give: "It pushed them to their limits".[24] None of the commitments were legally binding, nor were sanctions announced for defectors. Neither was the meeting simply a venue for a mediation process between home and host countries, or banks and IFIs. Mediation entails splitting differences typically in a situation where litigation remains a fallback option, or where one party might walk away from the deal unless a reasonable solution is found. In contrast, the VI created ground rules for an informal governance framework that required extensive collaboration among the stakeholders to effectively stabilize the financial system. These ground rules were as simple as they were powerful: open discussion among all relevant stakeholders; publicity about commitments made; and trust and authority bestowed on the EBRD as the coordinator-in-chief.

Between March and June 2009 a series of meetings followed that focused on individual countries one at a time. The meetings served the purpose of identifying specific needs of the country and the bank groups operating in the country, and the role of the IMF and other multilateral lending organizations, as

[24] Interview with VI participants, on file with the author.

well as that of the home country regulators and central banks. Following the procedural rules established by the VI, at each of these meetings parent banks signed commitment letters for the countries in question, and these commitments were made public (Nitsche 2010). In addition, separate meetings were held during the annual spring meeting of the IMF and the Annual Meeting of the EBRD with home and host country representatives to assess the implementation of the VI.

In September 2009, another full VI meeting was held in Brussels, this time under the chairmanship of the Director of the EU's Directorship General for Economic and Financial Affairs (DG ECFIN), John Berrigan. Seventeen parent bank groups, up from six that had called for a European response to the crisis in November of 2008, their home and host country supervisors, and fiscal authorities participated, as did the IMF, the EC with representatives from the Directorate-General for Competition and CEBS, the EIB, the World Bank, and the EBRD.[25]

The EU's embrace of the VI can be seen as an endorsement of its success. It coincided with developments inside the EU, where a reform package for financial sector governance was announced in September 2009 and enacted in

[25] See "Largest Foreign Banks In Hungary Pledge Support To Local units" with a summary of the concluding statement of the joint forum meeting held in Brussels on 24 September. Available at http://www.xpatloop.com/news/62975 (last visited 5 February 2011). See also the IMF release on the commitments made at the meeting, supra note 23.

January 2011.[26] This reform package sought to strengthen the EU's hand in regulating financial markets, but also recognized the limits of further centralization of regulatory and supervisory control at the level of the EU. The new framework strengthens existing committees charged with developing common standards for the regulation of European financial markets, elevating them from 'committees' to 'authorities'. The Committee for European Bank Supervisors (CEBS), for example, was reincarnated as the European Banking Authority (EBA). Critically, the reform proposal explicitly confirmed national sovereignty in fiscal affairs by including a provision that states that the new European System of Financial Regulators shall not take any action that might implicate fiscal sovereignty of the EU's member states.[27] Given the apparent need for fiscal burden sharing in the context of transnational financial crises, this confirmation of formal fiscal sovereignty effectively undermines the EU's quest for a greater governance role in the pan-European financial market. Against this background the VI provides a possible answer to the paradox of national fiscal

[26] See REGULATION (EU) No 1092/2010 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board; and DIRECTIVE 2010/78/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 24 November 2010 amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authority (European Banking Authority), the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority)

[27] See specifically the REGULATION (EU) No 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, which establishes in recital 5 that while the new European supervisors should aim at playing an important role in crisis management, they should not "impinge on the fiscal responsibilities of Member States".

sovereignty in a world of transnational finance: coordinated multi-stakeholder governance.

III. Multi-Stakeholder Governance of Interdependent Financial Systems

The emergence of coordinated multi-stakeholder governance was not a spontaneous response based on the rational assessment of key players that only concerted actions would contain the crisis. Each stakeholder knew this to be true, but each individually faced political and institutional constraints that prevented it from taking the necessary actions to bring about coordination. A critical question, therefore, is how these obstacles were overcome. This goes to the heart of the question how new governance regimes emerge. The global crisis has demonstrated that existing arrangements that are rooted in national regulation and fiscal sovereignty are inadequate for a highly interdependent transnational financial system. New institutions, however, are usually not born out of insights that existing ones do not work. Even more importantly, the scale of re-ordering necessitated by the globalization of finance implies that existing stakeholders would need to make room for new actors who were not effectively represented before – most critically, in the case of Europe, host countries to pan-European financial groups' expansion strategies. Yet few players, if any, voluntarily leave the stage to others.

The emergence of new institutions and new forms of governance[28] is one of the least understood issues in social theory. The importance of institutions for economic, political and social life is widely recognized, yet little is known about how institutions come about – that is, about their 'genesis' (Padgett and Powell 2010). Some stress the importance of exogenous shocks or competitive pressure for ensuring continuous institutional adaptation (Olson 1982). From this perspective, the VI might be explained as a response to a major crisis that literally shocked key agents into action. Yet, as the descriptive account in the previous section has shown, achieving coordinated outcomes takes more than the recognition by all relevant actors that coordination is indispensable for crisis resolution. The relevant stakeholders clearly faced a collective action problem (Olson 1971). Still, no one moved before a group of banks went public; moreover, there was very little certainty as to which actor would be able to effectuate coordination – much less how one might identify such an actor in advance. As noted previously, the bank groups that pushed for a coordinated response wrote a letter simultaneously to three different organizations (the EC, the EIB and the EBRD), which suggests that they too were uncertain as to where to turn for help.

Others emphasize that institutions are devices that shape collective behavior and suggest that change must come from actors that are recognized as

[28] There is much confusion in the literature about the difference between institutions and governance regimes. Institutions are usually understood as the "rules of the game" humans devise to constrain their actions (North 1990). Governance refers to the guidance of others – i.e. to mechanisms that constrain those that are guided. In that sense, there is not much difference between the two concepts. I will therefore use them interchangeably.

authoritative (Greif 2006). Established authorities, however, are only rarely entrepreneurs of institutional change (Hardy and McGuire 2008) – and can hardly be expected to acquire this role when the most important required change is to cede ground to others. By this account the most authoritative agents in the pan-European crisis should have come from within the EU – directly from the Commission or from CEBS. Yet, these were precisely the agents that remained almost completely passive during the initial formative stages of the VI. In a changing world in which private actors compete with sovereigns and international agencies for governing global finance, authority often does not yet exist, but must be gained.

Research on the genesis of institutions has pointed out that institutional invention is often a result of institutional diversity of actors. Actors may be forced together by a crisis, but can also be convened by an agent that has been dubbed "anchor tenant" (Powell 2010). Left in isolation, actors will tend to fall back on established practices and knowledge, rather than break new ground. In contrast, bringing together actors from diverse institutional backgrounds can create an environment in which elements from different institutional domains will be recombined into new institutional solutions. An example comes from the origin of the "partnership system", a new organizational form for long distance finance that emerged in Renaissance Florence and was critical for the emergence of financial capitalism (Padgett and McLean 2006). This invention enabled a controlling partner in a Florentine bank to establish multiple legally independent offshoots in far afield places while retaining control and limiting the risks associated with agency problems. Political upheavals brought together actors from distinct economic and social spheres: domestic *cambio* bankers and international merchant houses. The bankers transposed their accounting and apprentice system into the world of elite merchant houses with established relations of long distance trade; and inter-marriages between merchant and banker families added social stability to the new organizational form.

The political crisis in Florence was a critical moment for bringing together different stakeholders in the city's political and economic system. Yet there is no guarantee that shocks to a system will bring about new institutions; neither are shocks always necessary for joining actors from diverse backgrounds. Instead, an intermediary who is capable of connecting actors from diverse backgrounds can facilitate institutional change. As Powell put it

> The anchor tenant is not disinterested, in the sense of being neutral, but is not directly competitive with the other types of organizations that inhabit the community. The organizations that I dub anchor tenants (...) occupy positions that provide them with access to diverse participants and the legitimacy to engage with and enroll others in ways that facilitate the extension of collective resources. This ability to span disparate domains has proven valuable in high-velocity environments where resources, power, and wealth are constantly shifting. (Powell, 2010)[29]

[29] Literally, the term 'anchor tenant' refers to a critical tenant in a newly established shopping center, one that is capable of attracting other tenants as well as customers. See, for example, (Gatzlaff, Sirmans, and Diskin 1994).

In the context of the 2008 financial crisis in CEE, the EBRD played the role of anchor tenant: As an IFI with the mission to promote economic development in the region it had a stake in the outcome, but it did not compete directly with any of the other players. Its major role was to bring together actors from divergent, yet interdependent, institutional backgrounds and thereby to create a common forum for private, public, national and multinational stakeholders in the emergent pan-European financial system.

The first meetings of the VI were preoccupied with crisis management (Nitsche 2010).[30] However, the VI has moved beyond crisis management to post-crisis governance. In several VI meetings held in 2010, participants agreed to jointly tackle problems of weak financial markets and foreign exchange exposure, and other legacies of the crisis in CEE. Stakeholder interest in these meetings has grown substantially, with over 100 participants attending the March 2010 meeting in Athens.[31] This has prompted organizers to break down the meeting into focus groups on specific policy issues; not, however, to step back from multi-stakeholder involvement. The post-Vienna development of the VI also signifies that this was more than an ad hoc mediation for crisis management. Instead, the VI created the foundation for governing interdependent financial markets outside existing hierarchies and jurisdictional

[30] See also Erik Berglöf, "The crisis has changed the EBRD", EBRD blog, 27 May 2009, available at www.ebrdblog.com (last visited 15 March 2011).

[31] The fact that this meeting of the VI coincided with the Greek sovereign debt crisis, another major crisis in the European financial system beyond the reach of the VI (see below), was somewhat ironic – and had not been planned.

preoccupations, whether at the national or regional level. This is apparent when comparing the VI with the existing formal structures for governing interdependent financial markets – including existing EU structures.

While the EU has adopted a series of directives and regulations in an attempt to standardize financial market regulation, implementation is left to national regulatory authorities. In an ideal setting this allocation of responsibilities may give rise to new forms of governance in a bottom-up fashion within the space created by EU law. According to Sabel and Zeitlin, the EU has developed such an "architecture for experimental governance" in a variety of policy areas (Sabel and Zeitlin 2008). This architecture consists of broad framework policies that are established by EU bodies in collaboration with member states, which are gradually filled with specific content and implemented by stakeholders throughout the EU. In some cases, committees and other agencies created at the EU level facilitate this process, but such structures are not always necessary. Sabel and Zeitlin describe this mode of governance as one of deliberation and exchange of positions and ideas. Specifically, the publicly pronounced frameworks and the process that developed for their implementation have taken the form of "direct, deliberative polyarchy" (DDP). This resembles the multi-stakeholder governance regime the VI has created for the pan-European financial system. Why then did the EU's governance architecture fail in the midst of the crisis, and what differentiates the VI from it?

The answer to this question lies in the difference between the aspiration of the EU's governance regime and its actual operation. In the financial sector, DDP took the form of the so-called "Lamfalussy process" (Lamfalussy 2001), which consists of a multi-tier process for developing and implementing a set of regulations for the financial sector in all EU member states. The Lamfalussy process was first conceived for securities markets, but was subsequently transposed to banking regulation (Vander Stichele 2008). At the first level, EU directives and EU regulations establish the general policy framework. Detailed technical regulation is left to the second level occupied by formal committees that specialize in different financial services – CEBS in the area of banking.[32] The committees convene representatives of regulators and supervisors from member states. They are advised to consult with the regulated industries and ensure that regulators from different member states coordinate with one another. In theory, therefore, CEBS should have been ideally placed to respond to the financial crisis in CEE. It was the place where banking regulators from all EU member states met regularly, discussed and developed implementing guidelines, and consulted with the banking industry. Yet, CEBS remained passive.

The differences between the Lamfalussy process and the VI hold important lessons for improving the governance of interdependent financial markets. The Lamfalussy process has helped harmonize regulation and

[32] Note that CEBS has now been replaced by the European Banking Authority (EBA); see supra note 26.

supervision of financial intermediaries, but is silent about financial burden sharing among member states, or between private and public actors. This turned out to be the most critical issue in the management of the crisis. The Lamfalussy process is also both over- and under-inclusive in relation to the pan-European financial system. It is over-inclusive in that CEBS included 51 regulators from all 27 EU member states without regard to whether each of the represented countries actually participated in the pan-European market as host or home country, which facilitates coalition building and horse-trading among member states over a diverse set of issues at the EU level, but does not coordinate governance of the European financial market. It is under-inclusive because it does not cover non-members of the EU, even though they may be part of the same transnational financial market. In contrast, the VI embraced the interdependent pan-European financial system in its actual scope irrespective of formal jurisdictional boundaries. Finally, the Lamfalussy process of designing and implementing directives in the financial sector has been far less democratic and deliberative than envisioned by Sabel and Zeitlin. They themselves point out that certain problems in DDP remain, in particular the "possible domination by large states/producer interests" ((Sabel and Zeitlin 2008) at 297). Indeed, closer inspection reveals that the interests of home and host countries in CEBS were not well balanced. Most of the relevant financial service directives were promulgated before the new member states joined the EU; yet CEE countries became the primary destination markets for foreign capital. Although the new member states nominally had a voice in CEBS, they were not in the inner circle of country representatives with long-established relations. As a longstanding member of a similar body in the EU system, the European Shadow Financial Regulatory Committee, observed, the mode of deliberation changed considerably when the committee was expanded as a result of the eastward expansion of the EU (Benink and Schmidt 2004). The informal exchange of information and ideas was no longer as easy, nor did members feel as comfortable with one another as they had in the pre-accession period during which they had been able to build personal ties and trust. While not equally well documented, similar changes may well have beset other governance institutions within the EU. The dominance of old member states was equally apparent with respect to private sector involvement within CEBS. Private actors were consulted and commented on draft guidelines issued by CEBS. Such involvement came almost exclusively from the established financial industry and its interest groups, with scant representation of financial intermediaries from the new member states (Pistor 2011). Lastly, the Lamfalussy process suffered from the fact that CEBS, like other bodies within the EU framework, is dominated by representatives of nation states and lacks an anchor tenant that represents pan-European governance needs that may at times conflict with even the majority of member states.

Fiscal sovereignty too has remained vested with the nation state. The VI does not challenge this *de jure*. The fiscal commitments home countries of transnational bank groups made at the VI meetings have, however, modified this principle *de facto*. Specifically, home countries agreed not to prevent cross-border transfers of the nationally provided funds made available for re-capitalizing 'their' banks. They thereby effectively approved the bailout of the banks' foreign subsidiaries with national funds. The major institutional invention that can be associated with the VI was therefore not primarily the avoidance of an uncoordinated withdrawal of capital from the region – as important as this intervention was – but a mechanism for burden sharing for diverse countries and actors that compose the pan-European financial system. It also signaled that unlike earlier financial market crises in emerging markets, the costs of experimenting with rapid financial expansion should not be borne exclusively by countries that served as hosts of foreign bank operations. This could help set the stage for a new bargain over regulatory and supervisory powers and fiscal responsibilities at the ex ante stage.

Existing frameworks for governing transnational finance are based on a clear separation of regulation and fiscal responsibility. Fiscal responsibility is left with the sovereign nation states and regulatory responsibilities are divided between home and host country regulators. The Basel Concordat, first established by the Bank for International Settlement (BIS) in 1983, allocated primary regulatory authority to the country in which a bank is licensed and incorporated, i.e. its home country.[33] Countries where banks maintain branch

[33] The original Basel Concordat of 1983 and subsequent incarnations can be found at http://www.bis.org/publ/bcbsc312.htm (last visited 15 March 2011).

operations are host countries. Subsequent iterations of the Concordat established that home countries of the parent bank carry out consolidated supervision over the entire banking group.[34] The underlying assumption for this division of labor is that parent banks and markets in the parent banks' home country can be put at risk by inadequate regulation and supervision of their foreign subsidiaries. The Concordat paid scant attention to the possibility that instead, parent banks might impose substantial risk on host countries either through their subsidiaries or through their own actions. The global crisis, which erupted in countries with major parent operations, and its repercussion for CEE, however, demonstrated that this is a substantial risk.[35] Consolidated regulation is therefore not a satisfactory answer to the problem of transnational banking regulation. Absent fiscal responsibilities that are aligned with the centralization of regulatory control in the hands of parent bank regulators, this allocation of regulatory powers may in fact increase incentives to externalize the risk of rapid financial expansion to foreign markets.

The VI has instead installed the idea of burden sharing among all stakeholders of the transnational system, including the banks themselves. As such, the VI has come much closer to the vision of DDP described by Sabel and

[34] Principles for home-host country cooperation in the supervision of transnational banking groups were introduced in 1992 and further refined in 1996. See "The Supervision of Cross-Border Banking", a report by the BIS Committee on Banking Supervision and the Off-shore group of Banking Supervisors; available at http://www.bis.org/publ/bcbs27.htm (last visited 15 March 2011).

[35] Some commentators had pointed out the risk of this situation for host countries long before the global crisis. See (Herring 2007).

Zeitlin. For the first time, host countries from the new member states were given a voice; they were heard not only by home country regulators of the bank groups that operate on their territories, but also by the banks themselves. Banks could voice their views about transnational governance not only when asked to comment on new guidelines developed by CEBS or similar bodies; and they did so directly rather than through industry lobbying organizations that tend to have their own agendas. Conversely, home country regulators could learn from banks they regulate as well as from host countries about the risks these entities face and the risks they create as transnational groups. Last but not least, governments extended their fiscal responsibility to cover the markets in which their banks operated even beyond the territorial borders of their nation states.

IV. In Search for an Anchor Tenant

Two critical factors help explain the success of the VI. First, the VI addressed the core problem of transnational finance, namely the allocation of fiscal responsibility in managing the crisis. Second, the VI benefited from the presence of an anchor tenant with the capacity and authority to bring key stakeholders together and encourage them to make credible commitments in managing the crisis. The legitimacy of the EBRD can be explained in large part by institutional design features, in particular its mandate and internal governance structure, which distinguish it from other IFIs.

The EBRD is the youngest of the IFIs, which include the original Bretton Woods Institutions, the IMF and the World Bank, as well as regional development banks in Asia, Latin America and Africa that were closely modeled after them. It was established in 1990 with the mandate to support the transformation in the formerly socialist countries in CEE from centrally planned to market economies.[36] Like other IFIs, its equity holders are states as well as several international organizations. Unlike other IFIs, however, it is explicitly charged with working with and through the private sector.[37] The emphasis on promoting development through the private sector follows from its mandate to overcome socialism in the countries within its jurisdiction. The goal was to strengthen non-state actors and develop viable markets, not to reform state socialism through state institutions. It also reflects the policy sentiment of the time, which placed greater confidence in markets than in governments. At the time the EBRD was established, the IMF and the World Bank endorsed the Washington Consensus, a policy that focused on macroeconomic stabilization, trade and financial liberalization, and privatization (Williamson 1990). The IMF and the World Bank, however, sought to implement these programs through

[36] The Agreement on Establishing the EBRD was signed on 29 May 1990 and entered into force on 28 March 1991. Documents are available at http://www.ebrd.com/pages/research/publications/institutional/basicdocs.shtml. (last visited 16 August 2010).

[37] Art. 1 of the Agreement specifically states that the EBRD's mandate is "to foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism and market economics." Art. 2 specifies as its functions the development of competitive private markets through "private and other interested investors" and the mobilization of domestic and foreign capital to promote these ends.

governments, mostly in the form of fiscal austerity measures, liberalization and de-regulation policies, and institutional reforms aimed at strengthening the private sector (Worldbank 1996). In contrast, the EBRD's approach was to trigger policy change through project finance: the funding of primarily (though not exclusively) private sector projects with the aim of developing sustainable, competitive markets in the former socialist countries.

The EBRD's mandate is reflected in how it spends its money. Less than 20 percent of financial assets are invested in governments (treasury loan investments and treasury share investments); the remaining 80 percent are invested in private sector institutions.[38] Success and failure of the projects are directly reflected in the EBRD's own financial statements. In contrast, the traditional Bretton Woods Institutions are ultimately unaccountable for the policies they prescribe (Woods 2006).[39]

The provisioning of public goods (competitive markets) through private means (project finance) creates some inherent tensions, as the EBRD's objectives as investor are not always compatible with its public policy goals. The EBRD's charter, for example, requires that "sound banking principles" govern all of its operations.[40] The EBRD's ultimate goal, however, is public: the development of sustainable markets for long-term development of the region. Internal

[38] See the EBRD's 2009 financial report at 70. Available at http://www.ebrd.com/pages/research/publications/flagships/financial.shtml (last visited 16 August 2010).
[39] For a comprehensive assessment of international organizations' accountability, see (Barnett and Finnemore 2004).
[40] Art. 13 (i), Charter of the EBRD.

governance structures have been set up to address this inherent tension between public goods and private means. Thus, investment operations and policy development are separated and subject to different monitoring mechanisms. This ensures sound risk management for investment projects on one hand, and greater flexibility for the design of policies that do not commit extensive financial resources. Tensions between the two groups inside the bank – one housed in operations, the other in the office of the Chief Economist – exist, but tend to be mediated by higher-ups in the organization.

The EBRD's mandate to work directly with the private sector has placed it in much closer proximity to private actors than is usually the case for IFIs.[41] This has situated the EBRD at the crossroads of private and public actors, with knowledge of and access to both, instilling the bank with the credibility to bring both sides together in a forum where they could develop solutions that require coordinated action.

Comment [CLS3]: Is this what you meant?

The EBRD's internal organization and governance structure enable the bank to develop innovative policy initiatives outside standardized tool box, which is the staple of the Bretton Woods institutions. The EBRD's policy arm is subject only to light monitoring and therefore capable of formulating and implementing innovative policy approaches without having to first go through an extensive bureaucratic review process. Monitoring mechanisms and reviews

[41] The IFC is a partial exception to this rule, but unlike the EBRD, it does not combine a broader developmental agenda with private sector initiatives.

are, of course, critical for addressing agency problems inside an organization (Barnett and Finnemore 2004). However, as is increasingly recognized in organizational theory, while traditional M-Form organizations with a hierarchical monitoring apparatus may be good for implementing strategies under conditions of certainty but tend to impede innovation, decentralized organizations that resemble U-Forms are more conducive to developing innovative solutions under conditions of uncertainty (Qian, Roland, and Xu 2006). Traditional IFIs resemble highly centralized structures that ensure consistent policy implementation, but at the expense of responsiveness to events that are difficult to foresee. In contrast, the EBRD is not only smaller, but also organized in a more decentralized fashion, which fosters a more agile organizational culture that is more responsive to the challenges of uncertainty.

A potential disadvantage of the EBRD is that its resources are relatively limited. Its annual business volume in 2009 was €7.9 billion; the accumulated net volume €47.7 billion.[42] This forces the EBRD to coordinate with other IFIs or the ECB when excess resources are needed. On the positive side, a small budget limits the temptation to over-lend.[43] Moreover, the EBRD's modest financial prowess has forced the bank to reach out to other IFIs and thereby broaden the scope of participants in the governance of a regional crisis. Both the IMF and the

[42] See the 2009 financial report, supra note 38.

[43] A strong argument can be made that multiplying the sources of finance is of critical importance when financing projects with uncertain outcomes. Having more than one creditor review a decision to extend financing at stage two of the project is an important commitment device against throwing 'good' money after 'bad' money. See (Huang and Xu 2000).

EU have become core stakeholders in the VI. This has greatly expanded the funding sources and added legitimacy to the process.

The VI's success in managing the fallout from the global financial crisis in CEE raises the question whether it offers a viable framework for governing transnational financial markets not only in crisis, but as a continuous governance regime. In light of the recently implemented financial reform package in the EU, one might ask more specifically whether there is still a need for the VI. The new EU regime, however, incorporates many of the old regime's defects. It does not – and, given its structural constraints, cannot – address the over- and under-inclusiveness discussed earlier. It is designed for the European Union, not for countries outside, even though many banks based primary in a member state may have extensive operations outside the EU. Moreover, it gives all member states a voice in the newly created regulatory bodies irrespective of their relation to transnational banks. In fact, the hierarchical management structure created for the new financial supervisors with a chairman and board[44] favors representatives of influential EU countries irrespective of those countries' actual exposure to the risks of financial market integration. The same structural features make it unlikely that the new authorities will respond flexibly to new challenges as they arise. To the contrary, the emphasis on hierarchy and authority is more conducive to the implementation of standardized modes of governance than to

[44] See Arts. 6, 43, 47, 48, 53 of Directive 2010/78/EU, op. cit. at 26.

innovation.[45] Moreover, as demonstrated by the global financial crisis, the EU's formal institutions have little leverage over national interests of member states in times of crisis. Finally, the EU creates no space for the type of open, multi-stakeholder forum that was critical for the VI in averting the crisis in CEE. Such a process greatly increases the pool of information and expertise from which solutions can be drawn. It also affirms the role of private actors not only as targets of regulatory interventions, but as stakeholders in the governance of financial markets with rights and responsibilities.

V. Outlook

This raises the crucial question, whether a process such as the VI can be institutionalized. Institutionalization is typically associated with greater standardization of practices and bureaucratization (Huntington 1965). This, however, is counterproductive for the management of new challenges that cannot be easily anticipated. In this context, flexibility is more important than standardized responses. The paradox that needs to be resolved is if and how flexibility and the ability to challenge existing practices, or 'disruption' (Christensen, Johnson, and Rigby 2002) can be institutionalized. Theoretical work on management organization has long grappled with the contradiction between productivity and innovation, where productivity benefits from standardization,

[45] See supra the discussion of M-Form vs. U-Form organizations under conditions of uncertainty.

but standardization tends to impede innovation. Empirical and experimental evidence suggests that a possible solution is the creation of separate subunits with contradictory tasks within a single organization (March 1991; Adler et al. 2009).[46] Within each subunit, organizational tasks and governance structures are streamlined to ensure efficiency gains; across units, tasks are only loosely coupled and may even be contradictory. For this to work at the level of the organization, the senior team must not only develop its own models for selecting and implementing promising new solutions, but also ensure that experiential learning facilitates diffusion of new models within the existing organization (ibid.). This organizational model resembles the role of anchor tenants in the process of institutional innovation and change discussed above (Powell 2010). In both cases linking diverse practices is the critical element for encouraging learning in uncertain terrain.

Applied to the problem of governing financial markets, the critical institutional design question is the role of the anchor tenant and its convening authorities and powers. The anchor tenant should be an agent that is capable of developing forward-looking strategies while exerting sufficient authority and legitimacy in the eyes of a diverse group of loosely coupled stakeholders to ensure participation in the search for new governance solutions. The absence of such an agent has been painfully apparent in the European sovereign debt crisis, where national interests have once more trumped the search for viable solutions

[46] See also (Raisch and Birkinshaw 2008) for a literature review.

in a transnational system. Based on the analysis presented in this paper, such an agent should have the following institutional features: smallness; a flexible internal governance structure; relations of trust and authority with a diverse set of stakeholders in transnational financial markets; and expertise in and capacity for developing forward-looking solutions based on the input of various stakeholders. In the case discussed in this paper, the EBRD assumed the role of the anchor tenant. While it was not originally designed to perform precisely this task, its design features enabled it to recognize the need for and perform the functions of an anchor tenant. It is likely to continue to play a similar role during the recovery and future governance of financial markets with extensive reach in the region under its jurisdiction. Other markets will require a different anchor tenant. The insights gained from the case study of the VI presented in this paper can be used to identify or help design viable agents to play this role. Whatever the fate of the VI in its current incarnation, it can serve as a model for a new transnational governance regime that is capable of flexibly responding to rapidly changing and inherently risky financial markets.

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