Bank Resolution in Europe: the Unfinished Agenda of Structural Reform

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Abstract

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BANK RESOLUTION IN EUROPE: THE UNFINISHED AGENDA OF STRUCTURAL REFORM

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I. Introduction

This chapter argues that the work of the European Banking Union ('EBU') remains incomplete in one important respect, the structural re-organization of large European financial firms that would make resolution of a systemically important financial firm a credible alternative to bail-out or some other sort of taxpayer assistance. Resolution is a critical piece of the EBU, because without a credible capacity to resolve a large financial firm, a supervisor is deprived of the ultimate disciplinary tool to control moral hazard and to constrain excessive risk-taking. As it now stands, the resolution procedure for EU firms will fail two critical tests for the preservation of systemic stability. Firstly, short-term credit claims will be insufficiently protected, meaning that financial distress could easily lead to an exacerbating spiral of runs, fire sale asset dispositions, and credit market freezes. Secondly, financial distress may have uneven impact along national dimensions, which will lead to national ring-fencing *ex ante* and *ex post*. The consequence will be an unacceptable risk of a disorderly resolution that will, in prospect, produce regulatory forbearance and may well lead to a more calamitous failure later, a bail-out or some other form of taxpayer rescue.

But there is an alternative: for EU financial firms to move to a holding company structure so that the focus of resolution can be at the holding company level, minimizing disruption of the ordinary business of the operating financial subsidiaries. Such a holding company structure arose by accident in the United States but has provided the basis for the current implementation of Dodd-Frank's mandate for orderly resolution of a failed financial firm, 'Single Point of Entry' ('SPE'). Under this approach, losses at the bank subsidiary would be upstreamed to the holding company ('HoldCo'), first to be charged against HoldCo's capital and then, if necessary, to trigger a resolution in which HoldCo only is put into resolution—the 'single point'—so that further losses can be charged to unsecured term debt held at the HoldCo level. This unsecured term debt, which is structurally subordinated to credit claims against the subsidiaries because held by HoldCo, is thus 'bailed in' and converted into equity. The objective is to reduce financial distress by protecting the value of the resolved firm, minimizing contagion throughout the financial sector, and minimizing jurisdictional competition for assets.The perceived credibility of this resolution approach has been reflected in the reduced funding advantage for large US final firms over smaller ones, suggesting that a credible resolution threat can mitigate 'too big to fail'.[1]

In 2014, the EU had proposed a 'Structural Measures Regulation', which chiefly considered whether to adopt a form of the US 'Volcker Rule' to limit proprietary trading by large credit institutions and to require a separately capitalized subsidiary for trading activities that remained permissible.[2] Unfortunately, that proposal was eventually withdrawn in 2018.[3] Our argument is that a vital addition to structural renovation is the requirement of a holding company form for systemically important financial institutions in the EU. It might be possible to achieve such an outcome via a number of different channels: through the 'living wills' review process under the Bank Recovery and Resolution Direction ('BRRD')[4] as the supervisor comes to decide that a holding company structure is essential for 'feasibility of resolution' of a particular firm; through capital requirements under the Capital Requirements Regulation ('CRR') and the Capital Requirements Directive IV ('CRD IV');[5] through the assessment of extra capital charges for a firm without a holding company structure in the stress tests administered by the European Central Bank ('ECB') or the European Banking Authority, or a structurally-sensitive systemic risk assessment on a Global Systemically Important Bank ('G-SIB') as contemplated by Basel III. Concerns for the stability of the system as a whole—macroprudential considerations—would argue for a prescriptive adoption of an organizational structure for systemically important financial firms that would minimize a

[1] US Government Accountability Office, 'Large Bank Holding Companies—Expectations of Government Support', July 2014, GAO-14-621. See generally on the connection between a credible resolution system and banks' risk-taking, Magdalena Ignatowski and Josef Korte, 'Wishful Thinking or Effective Threat? Tightening Bank Resolution Regimes and Bank Risk-Taking' (2014) 15 Journal of Financial Stability 264.
[2] Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, COM(2014) 43 final (29 January 2014).
[3] Withdrawal of Commission proposals (2018/C 233/05), [2018] OJ C233/6.
[4] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU, and 2013/36/EU, and Regulations (EU) 1093/2010 and (EU) 648/2012, of the European Parliament and of the Council, [2014] OJ L173/190 ('BRRD').
[5] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L 176/338 (CRD IV); Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012, [2013] OJ L 176/1 ('CRR').

resolution shock. Precisely because the resolution of any systemically important financial firm carries the risk of systemic distress and of high externalities, G-SIBs should not have the option of persisting in an organizational form that increases such risks. Thus the mandatory structure should become a public HoldCo parent for the operating subsidiaries of the banking group, set up so that the assets of HoldCo consist of shares in its subsidiaries, and that its liabilities are confined to unsecured term debt. This was the missing piece of the proposed Structural Measures Regulation and remains a missing piece for a credible Single Resolution Mechanism (SRM) in the Banking Union.

This chapter means to operate on two levels. It argues for the reorganization of European G-SIBs away from the current universal bank structure into the holding company structure to facilitate SPE as an efficient resolution methodology. Yet there is more at stake than just a technology for minimizing the financial distress associated with the failure of an important financial firm, and a claim that an approach that happens to fit well in the US case ought to be transplanted elsewhere. The reason in a nutshell is this: The most effective possible resolution mechanism is necessary because the European-wide ambitions embodied in the Banking Union project are not matched by European resources than can reliably be counted on to protect the European financial sector in a crisis. Banking assets have been a multiple of some national budgets; few if any governments can offer credible deposit guarantees. There is no agreement on how to pool resources at the EU federal level to mutualize failure risks. Thus large financial institutions must self-insure. Yet we need a mechanism that can minimize the costs of self-insurance so as not to unduly burden the European financial system.

The most effective possible resolution mechanism is also necessary to break the link between sovereigns and banks. Without an effective resolution mechanism, the supervisors ultimately are at the mercy of Member State governments, who have resources, financial and political, and reason to shield national champions. Yet this will open the way to Member State insistence on supervisory forbearance. It will also sustain ties between national G-SIBs and Member States in which such prospective shielding is the quid pro quo for the bank’s finance of sovereign indebtedness beyond a margin of safety. Moreover, the complicated structure of EU federalism, in which Member States retain sovereignty in the set-up of their local financial system, in which governments will be strongly sensitive to national interests in a crisis, argues for a system that minimizes pressures and opportunities for value-destructive ring-fencing.

One consequence of the European financial crisis has been to undermine popular confidence in the management of the European financial system. An organizational form that convincingly demonstrates the non-taxpayer sources of loss-bearing in a subsequent crisis will help restore trust. Thus an advantage of the holding company structure with sufficient loss-bearing unsecured term debt in the public parent is the transparency of the private, not public, exposure to losses.

16.07 Finally, the Banking Union also bears an important relationship to the ongoing Capital Markets Union project.[6] Financial firms may become more complex; new forms of credit institutions may well arise. An organizational form that comprehends such changes, that is built to handle resolution from the start, is an important element.

II. The Regulatory Aftermath of 2007–2008 and the Emergence of EU Bank Resolution

The 2007 financial crisis triggered two major regulatory reform waves. The first wave, near completion, has been generated by the most remarkable surge of global governance in the financial realm since Breton Woods in 1944. The hallmark has been a series of G-20 Leaders' Summits that in turn catalysed an unprecedented regulatory outpouring. Shortly after the financial crisis exploded in September 2008 with the bankruptcy of Lehman Brothers, then US President George W. Bush convened a meeting of the leaders of the twenty most significant global economic players, both developed and emerging market countries, the so-called G-20.[7] This particular multinational grouping was first assembled in 1999 to address the East Asian financial crisis but had not played a genuinely significant role in global economic co-ordination in the following decade. But the financial crisis showed the value of global financial co-ordinating bodies, even

[6] See Green Paper, 'Building a Capital Markets Union' COM (2015) 63 final, 18 February 2015.
[7] See Colin I Bradford, Johannes F Linn, and Paul Martin, 'Global Governance Breakthrough: The G20 Summit and the Future Agenda', Brooking Policy Brief No 168, December 2008 (available online at <www.brookings.edu/research/papers/2008/12/g20-summit-bradford-linn>).

purportedly ineffectual ones, because they presented a pre-existing structure for collaboration.

Beginning with the November 2008 Leaders' Summit, and continuing through many successive summits over the years, the G-20 has played a major role in driving the agenda for global financial reform. The G-20 transformed a toothless Financial Stability Committee into the Financial Stability Board (FSB), tasked with a major agenda-setting role.[8] The Basel Committee on Banking Stability, the international standard-setting body of central bankers that had laboured for six years to produce the Basel II accords,[9] quickly produced a revision, Basel 2.5, to control risk-taking in the bank's trading book, and then, in December 2010, Basel III, which provided for comprehensive strengthening of the bank's balance sheet. The various elements of the Basel III accord were filled out in December 2017.[10] By the end of 2018, all global banks should have 'fortress' balance sheets, including at least 13% in risk-weighted capital (counting various buffers and minimum surcharges), a 'supplementary leverage ratio' of at least three per cent, and, to protect against run risks and other adverse effects of a liquidity squeeze, a suitable 'liquidity coverage ratio' and a 'net stable funding ratio'.[11]

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[8] See James R Barth, Chris Brummer, Tong Li, and Daniel E Nolle, 'Systemically Important Banks (SIBs) in the Post-Crisis Era: "The" Global Response and Reponses Around the Globe for 135 Countries' in Allen N Berger, Philip Molyneux, and John O S Wilson (eds), *The Oxford Handbook of Banking* (2nd edn, Oxford University Press, 2015) ch 26 (describing G20-FSB interaction and initiatives); Daniel E Nolle, 'Who's in Charge of Fixing the World's Financial System? The Under-Appreciated Lead Role of the G20 and the FSB' (2015) 24 Financial Markets, Institutions & Instruments 1.

[9] Daniel K Tarullo, *Banking on Basel: The Future of International Banking Regulation* (The Peterson Institute for International Economics, 2008).

[10] The particulars are spelled out online at < https://www.bis.org/bcbs/publ/d424.htm>.

[11] For a general summary see Mark Carney, 'The Future of Financial Reform' Speech at the 2014 Monetary Authority of Singapore Lecture, 17 November 2014 (available online at <https://www.bankofengland.co.uk/speech/2014/the-future-of-financial-reform>; Paul Tucker, 'Regulatory Reform, Stability, and Central Banking', Hutchins Center of Fiscal and Monetary Policy at Brookings, 16 January 2014 (available online at <https://www.brookings.edu/wp-content/uploads/2016/06/16-regulatory-reform-stability-central-banking-tucker.pdf>); Jaime Caruana, 'Building a Resilient Financial System', keynote speech, 2012 ADB Financial Sector Forum on 'Enhancing Financial Stability—Issues and Challenges', Manila, 7 February 2012 (available online at <www.bis.org/speeches/sp120208.pdf>).The Basel Committee monitors transposition of the Basel III standards into domestic law on a semiannual basis. The May 2019 report is available online at <https://www.bis.org/bcbs/publ/d464.pdf>. Most jurisdictions were found to have made progress in implementing regulatory requirements in a timely way, except for the Net Stable Funding Ratio (NSFR) (available online at <https://www.bis.org/press/p190507.htm>. In the EU, the NSFR will be implemented, with a number of adjustments, as an amendment to the Capital Requirements Regulation by virtue of the 2019 Banking Package, see online at <https://www.consilium.europa.eu/en/press/press-releases/2019/05/14/banking-union-council-adopts-measures-to-reduce-risk-in-the-banking-system/>.

This reform wave has also produced an international consensus on the need for a special mechanism: resolution rather than bankruptcy, for a large failing financial institution and an insistence that the costs of failure should be borne by the firm's shareholders and creditors rather than taxpayers.[12] The FSB produced a guidance document, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', adopted in 2011 and updated in 2014, reflecting and shaping this consensus.[13] This influential guidance contemplated an administrative receiver with significant discretionary authority, modelled on the US Federal Deposit Insurance Corporation (FDIC). It also contemplated advance planning by large financial institutions that would facilitate an orderly resolution process, so-called 'living wills', modelled after comparable provisions of the US Dodd-Frank Act.[14] The companion element of this consensus, so-called 'bail-in', is now reflected in the FSB's Total Loss Absorbency Capacity ('TLAC') standard (roughly, equity plus subordinated term debt) scaled to a least twice the amount of required equity capital on both risk-weighted and leverage measures.[15] The objective is to enable a resolution authority to recapitalize a failed systemically important financial firm by effecting the conversion of existing unsecured term debt into equity. The firm-specific required level of TLAC will vary, depending on the particular institution, from at least 16% up to 25% of risk-weighted assets.[16] In effect each firm will 'pre-fund' its resolution costs. By taking taxpayers off the hook in recapitalizing the failed firm, the TLAC requirement will make the resolution threat more credible as well as reducing the knock-on effects from the resolution of any particular firm.

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[12] This two-sided consensus has been dubbed a '"bookends' strategy": make financial institutions a lot more resilient but also make them resolvable without taxpayer solvency support'. See Tucker (n 11) 6.
[13] FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions', 15 October 2014 (available online at <http://www.fsb.org/wp-content/uploads/r_141015.pdf>). See also FSB, 'Understanding the Key Attributes: Guidance on the implementation of the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions', 22 August 2016 (available online at <http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/understanding-the-key-attributes/>).
[14] Dodd-Frank Act, §165(d).
[15] FSB, 'Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet' (9 November 2015), available at <http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf>. In Europe, the TLAC concept is implemented by virtue of the 2019 Banking Package (n 11).
[16] FSB (n 15) 10. The threshold limits were based on calculation of losses during the recent financial crisis in an earlier consultation document. See FSB, 'Issues for Consideration in the Development of a Proposal on Adequacy of Loss Absorbing Capacity in Resolution', memo to Steering Committee, SC/2013/45, 18 December 2013.

But there was a second major reform wave, with a European focus. This second wave, generated by the urgent need to respond to the Eurozone-specific aftershock of the financial crisis, resulted in the creation of the Banking Union. In the effort to mitigate the threat to European banks as the global financial crisis unfolded in autumn 2008, EU Member States provided sweeping forms of state support, ranging from direct state backing for recapitalization of particular banks to broad guarantees of the entire banking system.[17] Because banking assets were commonly a multiple of some Member States' GDP, such broad commitments threatened to exceed the funding capacity of the sovereigns that made them.[18] Moreover, the financial crisis immediately put the Member States into recession, which placed additional stress on national budgets, sovereign creditworthiness, and the capacity to support an ailing banking sector. The problem was exacerbated by the heavy loading of own-sovereign and other EU-sovereign debt on bank balance sheets. This was partly a function of: (i) Basel rules that carried a '0%' risk-weighting for OECD sovereign debt (which permitted banks to earn a 'risky' spread on purportedly risk-free assets[19]); and (ii) the implicit Eurozone guarantees behind all Eurozone member sovereign debt issued after European Monetary Union. Thus as sovereign credit came under attack (reflected in widening credit default swap spreads), banks faced a double whammy: (i) rising solvency risk because of the deterioration of both the sovereign portfolio and the private lending portfolio; and (ii) diminishing capacity of many Member States to provide financial support either through recapitalization or credible guarantees.

To much-simplify a complicated scenario: the distinctly European financial crisis came to a head over Greece, in two distinct episodes over the 2010–2012 period, an ongoing

[17] The European Commission has estimated the level of state aid as €4.9tn (39% of EU GDP), of which €1.7tn (13.5% of EU GDP) was actually deployed. Guarantees and liquidity support maxed out in 2009 at €906bn (7.7% of EU GDP). See also 'High-level Expert Group on Reforming the Structure of the EU Banking Sector: Final Report', chaired by Erkki Liikanen, Brussels, 2 October 2012 (Liikanen Report) 20–5 (available online at <https://ec.europa.eu/info/system/files/liikanen-report-02102012_en.pdf>). The Liikanen Report also provides a useful account of the Eurozone crisis of 2010–2012 at 8–11.

[18] See Alberto Gallo et al, 'The Revolver—European Banks: Still too Big to Fail', RBS Macro Credit Research, 23 January 2014 (available online at <http://cfa.wpengine.netdna-cdn.com/marketintegrity/files/2014/03/Alberto_Gallo_The_Revolver.pdf>); see also Liikanen Report (n 17), 11–19, 39–41, 119.

[19] See Viral V Archarya and Sascha Steffen, 'The "Greatest" Carry Trade Ever? Understanding Eurozone Bank Risks' (2015) 115 Journal of Financial Economics 215; Daniel Gros, 'Banking Union with a Sovereign Virus: The Self-serving Treatment of Sovereign Debt' (2013) 2 Intereconomics 94.

sovereign debt crisis that threatened to bring down large European banks that held large amounts of Greek sovereign debt. Moreover, the contagion from Greece's fiscal troubles threatened to close down the sovereign debt markets for other Eurozone countries, initially Portugal and Ireland but spreading, which exacerbated the pressure on bank balance sheets. In short strokes: Greece faced the risk of sovereign default in mid-2010, but was 'bailed-out' through a package of loans from the International Monetary Fund ('IMF') and the EU and liquidity support from the ECB, in exchange for an austerity programme that would purportedly reduce debt burden as a percentage of GDP. Sovereign creditors were fully protected. As economic conditions continued to deteriorate, in 2011 Greece once again faced imminent sovereign default, unable to rollover its existing debt or undertake new issuances—Portugal and Ireland came under similar pressure in this time frame. The EU/IMF parties provided additional financial support to Greece (and others), accompanied by various sorts of economic conditionality. This time, however, Greece defaulted, albeit in an orderly manner, as private sovereign bondholders (but not the ECB) were required to take a 50% nominal haircut on their holdings, as high at 75% in real terms. The negotiations over the actual bail-out/haircut terms were protracted, a gruelling six months over the period October 2011–March 2012. This was the crucible within which the EBU was formed.[20] Its creation has been described as a 'revolution' and the 'most ambitious project since the creation of the euro'.[21] What does 'Banking Union' entail? In critical part it means a 'Single Supervisory Mechanism' through which the ECB organizes the supervision of all 'significant' banks in the Eurozone, and a 'Single Resolution Mechanism' that prescribes a procedure for addressing the failure of large banks in the Eurozone. A common deposit guarantee scheme, which was planned initially, does not appear to be forthcoming in the near future. The SRM was a highly controversial element of Banking Union. This was for two reasons. Firstly, the SRM would put the fate of a national champion bank in the hands of

[20] The relevant history with supporting footnotes and more detail is described in Jeffrey N Gordon and Wolf-Georg Ringe, 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take' (2015) 115 Columbia Law Review 1297. The following paragraphs draw from that paper.

[21] Commissioner Michel Barnier, 'The EU and US: Leading Partners in Financial Reform', speech at the Peterson Institute for International Economics, Washington DC, 13 June 2014 (available online at <http://europa.eu/rapid/press-release_SPEECH-14-465_en.htm?locale=en>).

federal Eurozone banking authorities at a time of financial distress. This would limit the capacity of governments to use the bank as an instrumentality of national purpose through, for example, concessionary loans to favored domestic borrowers that do not appear on the public balance sheet, and as an agent of public finance, as a guaranteed purchaser of government debt. Secondly, the SRM came packaged with a funding mechanism, the Single Bank Resolution Fund, which will comprise at least €55bn (ultimately 1% of deposits) available to support a failed bank during the resolution process, although it is not designed to take losses, to bail-out any bank creditors. In effect, the Eurozone Member States had agreed to mutualize the responsibility for reorganizing a large bank, at least to a limited extent. This apparently raised the specter of cross-government subsidies, even though the fund was to be filled through a levy on the banks themselves. To quiet political and constitutional concerns, the funding proposal was outsourced into a separate intergovernmental agreement.

Precisely because resolution of a large bank touches on sovereignty, the enabling legislation created an elaborate triggering mechanism that culminates with a final sign-off by the European Commission and Council. First, the legislation established a 'Single Resolution Board' which interacts with the ECB in deciding whether to initiate a resolution and how to manage it. The ECB (as supervisor) determines whether the bank is failing or likely to fail and notifies the Board. The Board then decides whether such a failure would present a systemic threat, whether there is a private alternative, and then whether to make an allocation from the Fund to support the resolution.[22] The resolution scheme thus formulated is presented to the European Commission and Council, which has 24 hours to accept or reject the proposal. Because of the exigencies of time and circumstance, it is likely that the joint decision of the ECB and the Board will be determinative.

The central move in the creation of a EBU is the federalization of key elements of bank regulation even for entities that are regarded as 'national champions'. The goal is to break apart the link between sovereigns and their banks that figured so prominently in the

[22] The Single Resolution Board consists of two tiers of members: an executive committee of four permanent members that decides specific cases and a 'plenary' consisting of representatives from the Eurozone Member States, which controls allocations from the Fund.

distinctly Eurozone phase of the global financial crisis. Breaking this linkage works only if a financial firm can be successfully resolved without sovereign support and only if the resolution itself does not trigger a follow-on wave of failures of other financial firms. This is where the structural dimension becomes critical.

The core message of Basel III is that banks should not look to sovereigns for rescue. At one level this is a response to taxpayer outrage at bail-outs (appreciating all the messiness in distinguishing a 'bail-out' from 'liquidity support by a lender of last resort'). But even more importantly, Basel III is shaped for a global financial environment in which no sovereign (except for the US, as issuer of the world's reserve currency) can credibly stand behind its banking system. Many banks, especially in Europe, are simply too large relative to the states that charter them. In the run-up to the crisis the US may have permitted financial firms that were 'too big to fail'; Europe was filled with banks that were 'too big to save'. The G20's approach to this dilemma is TLAC: on top of a balance sheet structured to reduce the risk of failure—the capital and liquidity requirements described above—a bank must carry a level of bail-in-able term debt sufficient to recapitalize the bank even after the equity cushion is fully wiped out by losses.[23] The previous mechanism of providing systemic stability through a crisis, deposit insurance—a scheme by which banks pool risks in a mutual insurance scheme run by a particular government and backstopped by the government as a 'reinsurer'—plays no obvious role

[23] The concept of recapitalization through bail-in is already reflected, for the EU, in the Bank Resolution and Recovery Directive's concept of Minimum Requirement for Eligible Liabilities (MREL). Some have questioned why TLAC should consist of subordinated term debt rather than equity, since equity is unambiguously loss-absorbing whereas debt is loss-absorbing only through operation of law. There are at least three reasons. Firstly, term debt will be cheaper than equity, both because of clientele effects as well as the tax preference for debt. Some financial intermediaries that can hold a bank's subordinated term debt may be unable or unwilling to hold equity either because of practical portfolio needs (matching payout obligations with term liabilities) or legal reasons (constraints on holding equity versus debt). The tax preference for debt is a separate (private) cost-reducer. Secondly, debt and equity will trade differently in ways that will provide regulators and other observers with useful signals. Changes in market prices net of interest-rate factors and credit default swap spreads will reflect useful assessments by market participants of the bank's solvency. Thirdly, bail-in of term debt will effect an ownership change; existing shareholders are replaced by post-conversion shareholders; presumably new directors are installed. This is a more dramatic 'resolution' than just the dismissal and replacement of senior managers following a regulator's determination that the equity has fallen below a target level and may give current equity holders a stronger incentives to monitor against excessive risk-taking.

in this regulatory plan. The point is to take sovereigns out of the picture and, through bail-in, to require banks to self-insure.[24]

This setup will work only if the losses that are recognized in the resolution process are less than TLAC, if the resolution does not trigger an own-firm run, and if the own-firm resolution process does not trigger runs by credit suppliers at other financial firms. It is also important for a resolution scheme to facilitate cross-border financial stability, meaning that for transnational financial firms, the resolution system should not encourage opportunistic intra-firm 'runs', designed to reallocate losses within the firm on a national basis, which will in turn spur pre-emptive host country ring-fencing. By these measures, the current structure of the EU's banks will impede efficient resolution. Systemically important European banks, typically organized as 'universal banks',[25] have a complex organizational structure in which various financial services are provided by divisions of the bank or through subsidiaries of the bank.[26] Putting an operating bank or some other operating financial entity through a resolution procedure will have unpredictable effects on the solvency of other subsidiaries which may not be put into resolution and will have unpredictable effects on the claims of various credit suppliers, counterparties, and customers of the bank or affiliated financial firm. Such uncertainty is the trigger for a destructive spiral that will destroy value for the bank under resolution with knock-on effects for the financial system.

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[24] On the development and shortcomings of bail-in legislation, see Wolf-Georg Ringe, 'Bank Bail-In between Liquidity and Solvency' (2018) 92 American Bankruptcy Law Journal 299.

[25] See Jordi Canals, *Universal Banking: International Comparisons and Theoretical Perspectives* (Oxford University Press 1997).

[26] See James R Barth, Daniel E Nolle, and Apanard Prabha, 'Banking Structure, Regulation, and Supervision in 1993 and 2013: A Cross-Country Comparison' (2014) 13 Journal of International Business and Law 231; World Bank, 'Bank Regulation and Supervision Survey' (2011) (available online at <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html>); James R Barth, Daniel E Nolle, and Tara N Rice, 'Commercial Banking Structure, Regulation and Performance: An International Comparison Office of the Comptroller of the Currency', Office of the Comptroller of the Currency (OCC) Working Paper 97-6, March 1997, Tables 5, 6a, and 6b (available online at <www.occ.gov/publications/publications-by-type/economics-working-papers/1999-1993/working-paper-1997-6.html>). Richard J Herring and Anthony M Santomero, 'The Corporate Structure of Financial Conglomerates' (1990) 4 Journal of Financial Services Research 471, 481–9; Richard Herring and Jacopo Carmassi, 'The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety and Soundness' in Allen N Berger, Philip Molyneux, and John O S Wilson (eds), *The Oxford Handbook of Banking* (Oxford University Press 2010).

The potential for uncertainty and value destructivity is immediately apparent in two places. First, in the BRRD the protection for short-term credit providers is incomplete. Insured deposits, €100,000 or less, are protected through national deposit guarantee schemes. Deposits that exceed the insurable amount may be given priority over other unsecured credit claims that are not in form deposits, the so-called 'deposits first' principle, under the BRRD. But many sources of short funding by a bank or its financial affiliates are not deposits and thus seem disqualified for special protection. Take the reach-in of the bail-in tool in Article 44(2) of the BRRD, which excludes from bail-in, beyond covered deposits, certain liabilities with a maturity of less than seven days. Apart from its limited scope,[27] this exemption is not the same as protection from loss of value in the ultimate settling up of claims on the failed institution. Unlike insured deposits, those claims are at risk of a haircut and parties will respond accordingly. Whatever the justice of *pari passu*, as a practical matter short-term creditors, to avoid the prospect of such losses, can 'run' simply by refusing to roll over their credit claims. This will trigger the immediate need for a financially stressed bank or its financial affiliates to shrink their balance sheet to match the corresponding fall off in funding. This is how financial crises begin.

A second source of uncertainty and value destructivity in the European approach to resolution becomes apparent in the TLAC concept itself. One of the specifically identified areas of concern is the prepositioning of TLAC in the various material subsidiaries of the bank, based not only on line of business but also on home/host considerations, so as to assure that TLAC is reliably available to recapitalize subsidiaries as necessary to support resolution.[28] Such efforts to place not just capital but also subordinated (by contract) term debt on the balance sheets of the different subsidiaries of a large bank is highly unlikely to lead to smooth resolution in a crisis. One host grabbing more TLAC than it strictly needs to resolve a failed subsidiary within its jurisdiction (meaning other subsidiaries of the banking group are now less secure), one court

[27] The exemption is limited in substance as follows: it does not apply to liabilities arising from a participation in certain payment systems (with a remaining maturity of less than seven days) and to liabilities to other credit institutions or investment firms (with an original maturity of less than seven days). The objective is to 'reduce risk of systemic contagion' (Recital 70).
[28] FSB (n 15) s 18.

(mis)interpreting the complex subordinated provisions of a bond issuance—these are sufficient to inject uncertainty that will destabilize the entire system.

The traditional European approach to resolution is commonly referred to a Multiple Points of Entry (MPE), a phrase that pastes a calm description on a process that will at best be ad hoc and at worst chaotic. 'We take each financial firm as we find it' is the exact opposite of the administrative predictability and maintenance of consistent expectations that becomes increasingly important as market conditions themselves become more stressed and less predictable. The contrast is Single Point of Entry (SPE), a strategy employed by the FDIC that is designed to minimize value destructivity during the resolution process. The difference between SPE and MPE is precisely structural: because the public parent, a top level holding company, owns and supports the operating subsidiaries, the resolution fire-power and the TLAC bail-in liabilities can be concentrated on a single target.

To return to the insurance analogy: the capital and the subordinated term debt that constitute TLAC should be understood as self-insurance for the credit claims that cannot be allowed to default, namely deposits and other short-term credit claims. Avoiding default on such claims is a matter of practical necessity, not morality, because otherwise during times of financial distress, such default risk will produce runs, fire sales, and the negative spiral that transmutes distress into a financial crisis that damages the real economy. Governments are simply not in a position to provide such insurance both because of financial constraints at the single country level and, as the fierce resistance of Germany demonstrated, the inability to supply credible transnational support within the European Union. MPE, which looks to identify failing subsidiaries or affiliates within a banking group, will require prepositioning of TLAC throughout the group. This is bound to be highly inefficient and will lead to destabilizing forbearance on how TLAC will be provided. Think of an industrial concern with multiple plants, each one of which is required to carry separate fire insurance sufficient to rebuild the plant—and the size (and value) of any particular plant will vary over time, given that the plant's business activities may decline or increase depending on the business environment. Yet not all the plants will catch fire at the same time. The excess costs of this scheme if complied with literally are likely to lead to underinsurance at the individual plant level—noncompliance—and/or some sort of transferrable insurance rights or guarantees within the group that will lead to haggling and shortfalls at crunch time. So it is likely to be with prepositioned TLAC throughout a complex banking group, except that the consequences will be more dire.

Put otherwise, MPE may be a successful strategy for banking groups that operate in distinct functional or regional units, with little integration among the units, so that it is genuinely possible to address these units separately even in the heat of a crisis.[29] As described by the Financial Stability Board, MPE is 'suitable for firms with a decentralized structure and greater financial, legal and operational separation along national or regional lines, with sub-groups of relatively independent, capitalized and separately funded subsidiaries'.[30] This description obviously does not mean to fit the case of European banks. European banks operate in the Single Market, with the goal of achieving capital mobility and financial integration in the European Union, much as industrial or commercial firms operate throughout the EU. Indeed, the EBU project is equally about affirming the internal market in banking as it is about breaking the ties between sovereigns and the systemically important banks. A structural organizational change to the holding company form that enables SPE is a commitment to 'European banking' as well as a mechanism that will facilitate credible resolution.

In sum, the SPE approach to resolution at the holding company level has a number of distinct advantages.[31] First, it makes resolution more transparent and credible, as the 'bail-in-able' debt at the holding company level is earmarked and effectively available for

[29] See Paul Tucker, 'The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations', 3 July 2014 (available online at <http://www.cepr.org/sites/default/files/events/papers/6708_TUCKER%20Essay.pdf>).

[30] FSB, 'Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies', 16 July 2013 (available online at <http://www.fsb.org/wp-content/uploads/r_130716b.pdf?page_moved=1>).

[31] In many policy initiatives, SPE is given preference over MPE. See, eg, Finma, 'Resolution of Global Systemically Important Banks—FINMA Position Paper', 7 August 2013; FDIC, 'Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy—Notice and Request for Comments' (2013) 78 Federal Register 76614, 76615; Martin J Gruenberg, FDIC Chairman, 'Comments to the Volcker Alliance Program', Washington DC, 13 October 2013 (available online at <https://www.fdic.gov/news/news/speeches/archives/2013/spoct1313.html>); FDIC and Bank of England, 'Resolving Globally Active, Systemically Important, Financial Institutions', 10 December 2012 (available online at <http://www.fdic.gov/about/srac/2012/gsifi.pdf>); European Parliament, Directorate General for Internal Policies, 'Single Resolution Mechanism—Note', February 2013. For a helpful overview, see Scope Ratings, 'Holding Companies: The Right Vehicle for European Bank's SPE Resolution?', 11 September 2014 (available online at <http://www.scoperatings.com/study/download?id=c2da6224-fa08-491c-aed2-93fa2de5eebe&q=1>). For a recent academic analysis, see Patrick Bolton and Martin Oehmke, 'Bank Resolution and the Structure of Global Banks', CEPR discussion paper 13032/2018.

regulatory activation. Unlike the current situation, the bank, market participants, and the regulator would be aware of the liabilities available for bail-in, which would enhance transparency and foreseeability of resolution effects; besides, their specific separation for resolution purposes would make assets across the banking group more valuable for their specific purposes.[32] Secondly, SPE works much better in *cross-border situations*, facilitating an effective regulatory solution by one resolution authority and bundling the responsibility in one center of control. Indeed, one of the main points of critique of an MPE approach is that it would empower several regulators in various jurisdictions and thus create co-ordination problems, frictions, and a race to grab assets for the purpose of protecting national creditors.[33] Finally, and most importantly, the SPE approach ensures that the operating subsidiaries can carry on their business and thus avoids fatal disruptions, destructive runs that can produce fire sale liquidations, negative asset valuation spirals and other knock-on effects. The double advantage of this last point is that because of the large savings anticipated by an SPE regulatory framework, the overall creditor losses associated with the resolution will be much less than in an unco-ordinated resolution, let alone ordinary bankruptcy proceedings. This in turn will reduce the level TLAC required to achieve systemic stability.

This chapter now proceeds to sketch out the SPE approach and the happenstance history in which large US financial firms came to have holding company structures. It then builds out the case for adoption of this structural innovation in the EU as the missing element of EBU.

III. The Path to Single Point of Entry Resolution in the US

Single Point of Entry evolved as the way to apply the authority granted to the FDIC in the Dodd-Frank Act to resolve a systemically important financial institution. The FDIC's 1930s vintage resolution authority extended only to banks, which did not easily extend to address solvency problems for financial holding companies that included not just a large bank but also other substantial non-bank financial subsidiaries providing financial

[32] This may be part of the explanation for why the rating of the holding company wouldn't normally be much different from the rating of an integrated banking structure. See Scope Ratings (n 31) 2.
[33] See European Parliament (n 31) 13.

services.[34] Nor did such resolution authority cover the problem of investment banks and other financial firms that had no link to the regulated banking sector. These problems manifested themselves in the necessarily ad hoc rescues of Bear Stearns, an investment bank; AIG, an insurance company; and Citigroup, a financial holding company with a large bank at its core. And of course the FDIC had no authority to avoid the disorderly failure of Lehman Brothers once the Federal Reserve and the Treasury decided that their respective capacities had run out.[35] The problem with the ad hoc approach was not just that it might omit important cases (for example, Lehman Brothers) but that the strategies to avoid bankruptcy would necessarily protect all creditors. Bankruptcy or bail-out is not an appealing set of options.

Title II of the Dodd-Frank Act gave new authority to the FDIC, 'Orderly Liquidation Authority', which despite the nomenclature, provided broad capability to reorganize a systemically important financial firm and considerable discretion in the treatment of unsecured credit claims of nominally equal priority, so long as the claimants received at least what they would have received in bankruptcy. The FDIC quickly realized that the most important feature of a successful resolution is to minimize the knock-on risks associated with the resolution itself. Broader systemic distress would reduce asset values at the failed firm and make it harder to reorganize successfully. But broader distress could also lead to insolvency at other firms, potentially engulfing the financial sector, with a sharp negative impact for the real economy. Lehman Brothers, the disorderly resolution of which resulted in losses to unsecured third party creditors of nearly 80%,[36] not to mention global financial distress, was the example of all to avoid.

The Dodd-Frank Act addressed some of this directly. Lehman's failure had involved such extensive losses in part because the firm was entangled in a web of 900,000 derivatives trades, most of which terminated by reason of the filing of the bankruptcy petition. The Act defined a category of 'qualified financial contacts' and both abrogated application of

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[34] For a fuller account of the FDIC's authority and bank resolution practices before the financial crisis, see Gordon and Ringe (n 20).

[35] The FDIC's (and Fed's) authority with respect to these rescues (and non-rescues) is discussed in Jeffrey N Gordon and Christopher Muller, 'Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund' (2011) 28 Yale Journal on Regulation 185.

[36] For a detailed analysis of the Lehman Bankruptcy, see Michael Fleming and Asani Sarkar, 'The Failure Resolution of Lehman Brothers', Economic Policy Review, 3 April 2014 (available online at <http://libertystreeteconomics.newyorkfed.org/2014/04/the-failure-resolution-of-lehman-brothers-.html>).

various immediate default triggers and permitted the FDIC to transfer such contracts (appropriately bundled) to a successor financial firm.[37] But a major additional concern for systemic stability is the run risk of diverse forms of short-term credit, which include various money market instruments, conventional deposits above the insured amount, and 'repo', short-term borrowing often secured by long-term assets of uncertain value.[38] Failure to protect such short-term credit claims in a resolution would have severe spillover effects, since creditors of other institutions not (yet) in resolution would see advantages in withdrawing their funds. This would put immediate strain on liquidity-pressed financial firms and could lead to fire sale asset dispositions to raise cash, which would damage balance sheets throughout the financial sector, raising solvency concerns and leading to liquidity hording. Dodd-Frank granted the FDIC authority to vary payouts within a class of similarly situated unsecured creditors, if necessary to maximize asset values or to facilitate the receivership or the transfers to a bridge bank, so long as the discriminated-against party received at least the bankruptcy liquidation amount.[39] Against resistance, the FDIC has produced regulations with a 'short-term creditors first' *credo*.[40] Nevertheless the FDIC's intention is not necessarily binding in a particular case because of statutory provisions that seem to require recourse to creditor payouts before assessing other financial institutions for repayment of Treasury funds used in the resolution.[41] The possibility of *ex post* litigation (however unlikely) by assessed financial institutions seeking to claw-back payments to short-term creditors not covered by deposit insurance would add to run risk. Thus in planning for its exercise of Orderly Liquidation Authority the FDIC has to bridge two quite different goals. On the one hand, the over-arching purpose of the resolution provisions of the Dodd-Frank Act is to protect the US economy from financial distress; this justifies a special administrative procedure rather than bankruptcy. Yet the Act not only empowers the FDIC to impose losses on creditors but

[37] Dodd-Frank Act, §§210(c)(8), (9), and (13).
[38] See Gary Gorton and Andrew Metrick, 'Securitized Banking and the Run on Repo' (2012) 104 Journal of Financial Economics 425.
[39] Ibid, §210(c)(4).
[40] See 12 CFR, §380.27; see Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed Reg 64,173, 64,181 (proposed 12 October 2010) (proposing 12 CFR, pt 380.2); Interim Final Rule, 76 Fed Reg 4207 (adopted 19 January 2011) (requiring FDIC board action for such a preference).
[41] Dodd-Frank Act, §§204, 210(n)(9), (o).

insists that taxpayers come ahead of creditors and, at several turns, wants to avoid bail-outs.

An additional source of potential spill-over distress from a resolution under Dodd-Frank is with respect to the foreign subsidiaries of US financial firms. Although the FDIC has authority to impose its receivership on subsidiaries that are 'in default or in danger of default', its resolution authority apparently does not extend to foreign subsidiaries of US financial firms.[42] This means that a failed foreign subsidiary, for example, UK Lehman Brothers, would be subject to the bankruptcy (or other resolution regime) of the host country, with the consequence of destabilizing uncertainty.

SPE was devised as the way to square these several circles. SPE takes advantage of the characteristic organizational form of the largest financial firms in the US, especially ones that own a bank: the financial holding company. In such a structure, the holding company, 'HoldCo', is a public entity the principal assets of which are shares in various operating financial subsidiaries—such as a large commercial bank, a broker-dealer, an insurance company, and an asset manager—including various foreign subsidiaries in these diverse financial services areas. The subsidiaries are likely to have complex financial arrangements with one another, entailing the intra-organizational transfer of funds and collateral subject to various regulatory limits. The subsidiaries will face different short-term credit claimants with immediate liquidity rights, whether depositors or brokerage customers, and will have different counterparty relationships with set-off and liquidation of collateral provisions.

Paul Tucker, the former Deputy Governor of the Bank of England and head of the FSB during the period when the international consensus on resolution emerged, describes the SPE process as follows:

> *The first step involves transferring losses exceeding a subsidiary's equity to its parent [HoldCo]. In essence, the solution is for key subsidiaries—overseas and domestic—to issue super-subordinated debt (or extra equity) to [HoldCo] . . . The subsidiary's 'excess' losses are covered and its solvency is restored by writing down and converting into equity as much as is needed of the intragroup debt. Thus, the subsidiary is recapitalized without going into default itself. That will at*

[42] ibid §210(a)(1)(E)(i).

last make a reality of the long-standing doctrine—underpinning all consolidated supervision but without binding substance up to now—that groups should be a source of strength for their component parts.

Losses having being transferred up to [HoldCo], the second step is to ensure that [HoldCo] can in turn be resolved in an orderly way if it is mortally wounded. This requires that [HoldCo] maintain a critical mass of bonds that can be 'bailed-in' to cover losses and recapitalize the group to the required equity level. The holders of those bonds become the new owners. (The previous owners lose their investment.)

Through those two steps, a group-wide, global resolution can be executed without operations across the planet going into local liquidation or resolution. Compared with [dismembering the bank through 'purchase and assumption'] it is liability reconstruction rather than an assets reconstruction.[43]

Because the Dodd-Frank Act speaks in terms of 'orderly liquidation' rather than 'orderly resolution', the US variant of SPE has a twist: the FDIC will impose a receivership on the failed systematically important financial institution (SIFI) (HoldCo) and then transfer its assets to a successor bridge bank, 'BridgeCo'. HoldCo will disappear into the FDIC's receivership while BridgeCo continues. HoldCo's shareholders will almost surely be wiped out. (Perhaps an equity stub remains, depending on the initial level of capital.) Based on the FDIC's estimate of losses, HoldCo's unsecured debt will be partly written off (to cover losses in the transferred subsidiaries not already covered by the write-down of HoldCo's capital) and partly converted into equity in a fully recapitalized BridgeCo.[44]

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[43] Tucker (n 29), 2–3.

[44] See Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed Reg 76614 (18 December 2013). One important element clarified in the Dodd-Frank Act is the obligation of HoldCo to cover losses in its operating subsidiaries, even where such losses would exceed HoldCo's equity in those subsidiaries, the so-called 'source of strength' doctrine by which a bank holding company is obliged to support its subsidiaries. Although it has been contested in the past, see Herring and Carmassi (n 23), Dodd-Frank, §616 mandates that the Fed 'shall require' the bank holding company 'to serve as a source of financial strength' for a bank subsidiary, which is defined as 'the ability . . . to provide financial assistance . . . in the event of the financial distress of the insured depository institution.' Presumably this means that HoldCo will be required to enter into the undertakings deemed necessary to assure that subsidiary liabilities can be upstreamed to the HoldCo parent and that HoldCo's support can be downstreamed, as necessary to make SPE effective.

The Fed adopted a TLAC implementation rule 15 December 2016; see 82 Fed Reg 8266 (24 January 2017) (adopting 12 CFR §252.60); see also 12 CFR §252.160. Compliance is required by 1

As this process is unfolding, the FDIC can supply liquidity to BridgeCo, either through a direct cash infusion from the 'Orderly Liquidation Fund', generated through a drawdown on a Treasury line of credit, or through the guarantee of new debt obligations issued by BridgeCo, full faith and credit obligations of the US. Logically such liquidity support could be provided by the Fed as a lender of last resort, but in line with criticism of the Fed's role in the rescue of Bear-Stearns and AIG, the Dodd-Frank Act restricted single company loans that might be counted as a bail-out.[45]

The upshot of this approach is that the shareholders and debtholders of HoldCo bear the losses of the operating subsidiaries. In effect, the TLAC of HoldCo, its capital and its unsecured term debt, is used to cover losses throughout the group and to re-equitize the BridgeCo successor. This approach should reassure depositors, other short-term credit suppliers, and counterparties of the operating subsidiaries (the bank or broker-dealer, for example) as to the financial stability of the relevant stressed subsidiaries and thus should avoid a run.[46] The long-term creditors and shareholders of HoldCo cannot run in the face of impending financial distress because of the nature of their commitment. Because the subsidiaries' businesses are not disrupted—because the systemic shock is contained—the ultimate creditor losses will be much less. This the FDIC regards as the lesson of Lehman Brothers. The losses were far greater than the intrinsic asset write-downs. Rather, most of the losses occurred because of value destructivity in the disorderly bankruptcy: fire sale liquidations and lost going concern and franchise value. To be sure, the SPE strategy depends upon a layer of unsecured debt in the liability structure of HoldCo, but the claim is that in expectation of a well-managed resolution process, losses can be contained to the point so that a reasonable level of unsecured debt (plus capital) can cover the losses.

An additional powerful feature of the SPE is the way it can solve the multiple resolution regime problem for firms that have operations in different jurisdictions. If only HoldCo is put into resolution, if BridgeCo can re-equitize the within-group obligations of foreign 'SubCo' as necessary to preserve SubCo's solvency, and if the FDIC (or another lender

January 2019. The Fed estimated that banks will need to raise an addition $70bn in long-term debt to comply with the final rule.

45 Dodd-Frank Act, §1101 (restrictions to the Fed's emergency lending authority).

46 It will also reassure longer-term creditors of the operating subsidiaries who might otherwise be concerned of disfavored treatment relative to short-term creditors.

of last resort) can flow liquidity support through BridgeCo to foreign SubCo, then Subco remains a solvent and functional entity throughout the resolution of the SIFI of which it is apart. This approach and its advantages are described in a joint FDIC-Bank of England paper that contemplates co-operation among two major regulators in the resolution of cross-border firms in their jurisdictions:

The strategies remove the need to commence foreign insolvency proceedings or enforce legal powers over foreign assets . . . Liquidity should continue to be downstreamed from the holding company to foreign subsidiaries and branches. Given minimal disruption to operating entities, resolution authorities, directors, and creditors of foreign subsidiaries and branches should have little incentive to take action other than to co-operate with the implementation of the group resolution. In particular, host stakeholders should not have an incentive to ringfence assets or petition for a preemptive insolvency—preemptive actions that would otherwise destroy value and may disrupt markets at home and abroad.[47]

To use the Lehman example, in an SPE world, Lehman UK would never have faced UK insolvency proceedings, because the FDIC would have assured its solvency and liquidity.[48] The Clearing House Association organized and conducted a comprehensive and sophisticated simulation exercise of the operability of SPE per the FDIC's model in November 2012.[49] This important test for the new system confirmed that SPE can be a viable mechanism for resolution of even large and complex SIFIs. The outcome of this exercise gave a boost to the credibility of the approach and supported its consideration in other jurisdictions. As we said earlier, the FDIC projected that in the case of Lehman Brothers, an OLA resolution would have resulted in losses of only 3% (approximately) versus disorderly bankruptcy losses of 79%.[50] Even with the change in US

[47] FDIC and Bank of England, 'Resolving Globally Active, Systemically Important, Financial Institutions', 10 December 2012, para 49 (available online at <www.fdic.gov/about/srac/2012/gsifi.pdf>). The claims in the paragraph are made subject to the proviso that the resolving administrator has power 'necessary to write down or convert debt [claims] at the top of the group that are subject to foreign law'. This power could be obtained by specific contractual provision in the debt instrument.
[48] This is at least the hope. We cannot exclude the possibility that the FDIC in practice would be subject to practical considerations and political pressure that would taint its unilateral perspective and approach.
[49] The Clearing House, 'Report on the Orderly Liquidation Authority Resolution Symposium and Simulation', January 2013 (available online at <www.theclearinghouse.org>).
[50] See FDIC Press Release, 'FDIC Report Examines How An Orderly Resolution of Lehman Brothers Could Have Been Structured Under the Dodd-Frank Act' (available online at

administrations, the FDIC has signaled its recognition of the importance of advance planning and high-level cross-border co-operation among financial regulators.[51] The US Treasury, in its presidentially-mandated review of Orderly Liquidation Authority, has endorsed those efforts.[52]

IV. The US Path to Holding Companies

A critical institutional feature for the success of SPE is a top level holding company whose assets consist primarily of equity and intra-company debt claims in its operating subsidiaries and whose liabilities consist principally of non-runnable term debt. Large bank-centred financial companies in the US are invariably organized in the holding company form, indeed, as bank holding companies ('BHCs'). This result derives from regulatory path dependence rather than a prior view about the optimal form of financial firm organization.[53] Until approximately twenty-five years ago, the US financial sector was highly balkanized. Bank expansion was limited by highly restrictive branching laws that limited interstate banking, even intrastate banking.[54] The 'business of banking' was narrowly defined to exclude banks from the provision of many financial services[55] and commercial banks were famously barred from engaging in securities underwriting and

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<www.fdic.gov/news/news/press/2011/pr11076.html>). The main reason is that the main losses in the failure of a large financial institution will derive from disorderly failure; these losses can be avoided through an effective resolution process.

[51] Jelena McWilliams, FDIC Chairman, 'Preparing for Cross-border Resolution Together,' Single Board Resolution Conference (Brussels), 15 October 2018 (observing 'strong foundation' of prior planning for co-operation); Martin J Gruenberg (then FDIC Chairman), 'Progress on Cross-Border Resolution Cooperation,' Single Resolution Board Conference (Brussels), 29 September 2017.

[52] US Treasury, Orderly Liquidation Authority and Bankruptcy Reform: Report to the President (21 February 2018) 20–23.

[53] The following text draws from many sources, including Saule T Omarova and Margaret Tahyar, 'That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States' (2011) 31 Review of Banking and Financial Law 113; Arthur E Wilmarth, Jr, 'The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risk' [2002] University of Illinois Law Review 215; Charles C Calomiris, *Bank Deregulation in Historical Perspective* (Cambridge University Press 2000); Charles C Calomiris and Stephen H Haber, *Fragile By Design* (Princeton University Press 2014); Richard S Carnell, Jonathan R Macey, and Geoffrey P Miller, *The Law of Banking and Financial Institutions* (4th edn, Wolters Kluwer 2009). For some quantification, see Dafna Avraham et al, 'A Structural View of U.S. Bank Holding Companies', *Federal Reserve Bank of New York Economic Policy Review*, July 2012, 65–81. See also Jeffrey N Gordon and Kathryn Judge, 'The Origins of Capital Market Union in the U.S.' in Franklin Allen et al. (eds), *Capital Market Union and Beyond* (MIT Press, 2019) 89.

[54] See, eg, the McFadden Act of 1933, 12 USC §36.

[55] See 12 USC §23(7).

other investment bank activity by the Glass-Steagall Act.[56] The result was a relatively small number of 'money center' banks, thousands of 'unit banks', and many thousands of different financial service providers.[57]

One way that banks attempted to navigate through these regulatory barriers was through the creation of holding companies. Although a bank could not branch, a parent holding company could acquire banks in a particular geographic area and the sibling subsidiary banks could form a network that could provide many of the functional equivalents of branch banking. Although a bank might be unable to provide a particular financial service directly or through a direct subsidiary, a sibling subsidiary of the holding company could.[58] In 1956 the holding company structure was both legitimated and regulated through the Bank Holding Company Act which limited (for a time) geographic expansion and which specified that the permitted subsidiaries of the BHC must be 'closely related to banking'.[59] When Glass-Steagall finally fell in 1999, the holding company structure was nevertheless the vehicle through which financial services expansion took place. Banks remained barred from securities underwriting and related investment banking activities. However, banks could *affiliate* through the holding company structure with investment banks and full service broker dealers. Moreover, large, well-capitalized bank holding companies could become 'financial holding companies', which were permitted to engage in a broader set of activities that were 'financial in nature', or 'incidental' or 'complementary' to such activity, and that could include both insurance underwriting and merchant banking activity.[60] All of these activities were to occur through subsidiaries of the bank holding company. Pre-existing rules limited extent to which the affiliated bank could provide financial support to these sibling subsidiaries.[61]

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[56] See §§16, 20, 21 and 32, Banking Act of 1933, codified respectively at 12 USC §§24 (Seventh), 377, 378, 78; *Inv. Co. Instit. v Camp*, 401 US 617 (1971) (providing capacious reading of Glass-Steagall).
[57] See Omarova and Tahyar (n 54) 131–2.
[58] Compare 12 USC §24 (Seventh). See generally Carnell, Macey, and Miller (n 49), 485–94.
[59] Bank Holding Company Act of 1956, 12 USC §1841. See also Carl A Sax and Marcus H Sloan III, 'The Bank Holding Company Act Amendments of 1970' (1970) 39 George Washington Review 1200.
[60] See, generally, The Gramm-Leach-Bliley Act of 1999, Public Law 106–02 and, specifically, 12 USC §§843(k)(4)(H) and (I).
[61] See §§23A, 23B of the Federal Reserve Act of 1913. See Saule Omarova, 'Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act' (2011) 89 North Carolina Law Review 1683.

The point is this: the evolution of the US banking system has proceeded in such a way that the largest banking groups are organized as bank holding companies. In general a public parent, HoldCo, sits astride a cluster of financial subsidiaries. Such a structure vastly facilitates a resolution strategy like SPE. We now explore how the EU banking framework could be turned in this direction.

V. SPE for Europe: The Structural Reform Project

eturning to Europe, we can think of several ways of achieving the holding company structure that would facilitate SPE resolution of G-SIBs. There are three possible mechanisms: first, supervisors could insist on such a structure for individual banks in the course of the 'recovery and resolution planning' exercise under the Bank Recovery and Resolution Directive ('BRRD').[62] Secondly, incentives could be given by charging capital surcharges for non-holding company banking groups pursuant to the supervisory assessment of the systemic risks of particular G-SIBS, as contemplated by Basel III (as implemented in the Capital Requirements Regulation and Directive CRR/CRD IV).[63] This is similar to the approach Swiss authorities have used to nudge UBS and Credit Suisse into holding company structures.[64] Thirdly, supervisory assessment of extra capital charges for a firm without a holding company structure could be a result of the ECB's stress tests, another incentives-based approach. Nevertheless, concerns for the stability of the system as a whole—macroprudential considerations—would argue for a more prescriptive approach and an adoption of an organizational structure for systemically important financial firms that would minimize a resolution shock. Precisely because the resolution of any systemically important financial firm carries risk of a systemic shock and high externalities, G-SIBs should not have the option of persisting in an organizational form that increases such risks. There is a better structural alternative: a public HoldCo parent for the operating subsidiaries of the banking group, set up so that the assets of HoldCo consist of shares in its subsidiaries, and that its liabilities are

[62] See n 4. On this concept, see Jens Hinrich Binder, 'Resolution Planning and Structural Bank Reform within the Banking Union' in Juan Castañeda and others (eds), *European Banking Union. Prospects and Challenges* (Routledge 2018).
[63] See n 63.
[64] James Shotter, 'Credit Suisse to Overhaul Structure' *Financial Times* (London, 21 November 2013).

confined to unsecured term debt. This is the missing piece for a credible Single Resolution Mechanism in the Banking Union.

Structural reform has been an important element in the financial crisis reform agenda, although the particular structural proposals have varied. One variant has been a version of Glass-Steagall, the exclusion of some element of financial activity from banking. Perhaps the most notable version of this is the Volcker Rule,[65] which prohibits a banking group either directly, or through an affiliate, from engaging in 'proprietary trading' or owning a significant interest in a hedge fund or private equity fund. The rationales are various: to divorce banks from especially risky activity (although proprietary trading losses were not a significant factor in the run-up to the financial crisis); to prevent banks from using insured deposits and other funding sources subsidized by the social safety net to engage in speculative activity; or to keep banks away from the risk-taking culture associated with proprietary trading (Paul Volcker's preferred rationale).

A second structural reform, associated initially with the Vickers Report in the UK in 2011, is a within-banking group separation: between retail banking activities—deposit-taking, payments, and lending to households and small- and medium-sized enterprise—and investment banking activities.[66] In the UK model, 'core' banking activities are to be housed in a separately capitalized, separately governed ring-fenced bank; all the rest must be held in an affiliated but legally separate investment banking arm. The retail bank is not permitted to engage in proprietary trading and merchant banking activities, but such activity is permitted in the investment banking affiliate.

EU-level proposals for structural regulation of the banking sector began with the so-called 'Liikanen Report' (named after the committee's chair) in 2012.[67] Part of what spurred the European Commission to initiate the Liikanen process was the adoption of different versions of ring-fencing and functional separation by other Member States, including France and Germany, which would add complexity and regulatory

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[65] Dodd-Frank Act, §619.

[66] For elaboration on the various structural reform proposals in the EU and US, see John Armour and others, *Principles of Financial Regulation* (Oxford University Press 2016) ch 22; Financial Stability Board, 'Structural Banking Reforms—Cross-Border Consistencies and Global Financial Stability Implications: Report to the G20 Leaders for the November 2014 Summit', 27 October 2014.

[67] Liikanen Report (n 17).

fragmentation to cross-border banking within the EU.[68] The initial Liikanen proposals gave Volcker a spin: virtually the only activities for which separation from the deposit bank was required were proprietary and other trading activity, and hedge fund and private equity relationships; these activities need be housed in a separately capitalized subsidiary but could remain in the banking group. The Liikanen proposals would have permitted the location of sophisticated banking services in either the deposit bank or the investment (trading) bank.

In January 2014 the European Commission proposed a Bank Structural Measures Regulation that took more direct inspiration from the Volcker Rule.[69] Following the initial Liikanen proposal, the proposed Regulation would require separation of the bank's trading activities from the deposit bank. However, for the largest banking groups, principally the European G-SIBs, proprietary trading and investing in hedge funds would be banned. The Commission endorsed the 'risky activity' rationale.[70]

The Commission's proposal was controversially discussed in the EU lawmaking process. In June 2015, the Council reached agreement on its position at first reading (known as 'general approach') on the draft regulation.[71] However, different approaches became apparent in the ensuing debates in the European Parliament, which failed to come to a common position on the text. In 2018, after no progress for a long time, the Commission decided to withdraw the proposal, stating as main reasons the lack of progress and foreseeable agreement on the project. However, interestingly, the Commission claims that the main objectives of the proposed regulation have already been addressed by other

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[68] For an overview of national measures, see Chen Chen Hu, *The Regulation and Supervision of Banks: The Post Crisis Regulatory Responses of the EU* (2018) ch 3.2.

[69] Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, COM(2014) 43 final, 29 January 2014.

[70] 'These are generally highly risky speculative activities, alien to the traditional role of banks as intermediaries between borrowers and capital suppliers. Proprietary trading today represents only a limited part of banks' activities/revenues but it was significant prior to the crisis. This proposal would prevent a reversal of this process in the future, when market conditions improve': European Commission, 'Structural Measures to Improve the Resilience of EU Credit Institutions—Frequently Asked Questions', 29 January 2014 (available online at <http://europa.eu/rapid/press-release_MEMO-14-63_en.htm?locale=en>).

[71] Council of the European Union, 'Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions – General Approach' (Document number 10150/15), 19 June 2015, available online at <http://data.consilium.europa.eu/doc/document/ST-10150-2015-INIT/en/pdf>.

regulatory measures in the banking sector, most notably with the entry into force of the Banking Union's supervisory and resolution arms.[72]

The proposed regulation was far from perfect. Its problem was that it was, in a fundamental way, backwards looking. It contemplated that: (i) investment banking activity is the major threat to the stability of a banking group; (ii) that the deposit bank at the centre of the group will receive state support, 'the social safety net', which ought not be shared with the investment bank; and (iii) that resolution, perhaps bankruptcy, of the investment bank will have only limited impact on the real economy so long as the deposit bank is protected. Propositions one and three seem false as a factual matter. Banking groups generally fail the old fashioned way: because of 'bad' assets on the bank balance sheet, whether defaulting real estate loans or debt securities that are falling in value. As recent research has confirmed, Eurozone banking groups continue to be hampered by bad loans carried on the bank balance sheet, not investment bank trading losses.[73] The failure of a separate investment banking subsidiary may seem to matter less in the EU than in the US, but that is only because of the much larger fraction of credit intermediation currently performed within European banks than in capital markets. But public issuance of debt securities by non-financial corporations in the Eurozone has increased, in absolute terms as well as a percentage of debt.[74] Credit rationing by European banks may have stimulated this trend, but it is likely to grow over time, which means that the investment banks will become an increasingly important credit intermediation channel.

But the key anachronism of the proposed Structural Measures Regulation was the backwards look to governments as the source of strength for G-SIBs as opposed to the self-insurance of TLAC. The point of the Banking Union, the point of the SRM, is to take governments out of the bail-out role for the largest banking groups. This is not just to control moral hazard by private actors but also to protect governments from providing

[72] European Commission, 'Annex to the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Commission Work Programme 2018: An agenda for a more united, stronger and more democratic Europe', COM(2017) 650 final (24 October 2017) 2, available online at <https://ec.europa.eu/info/sites/info/files/cwp_2018_annex_iv_en.pdf>.

[73] ECB (Banking Supervision), 'Guidance to banks on non-performing loans', March 2017 (available online at <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf>).

[74] ECB, 'Report on financial structures', October 2017 (available online at <https://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201710.en.pdf>).

guarantees and other forms of state support that they cannot sustain. Resolution will be credible only if resolution can, in prospect, resolve a large banking group, without sparking an own-firm run or a run elsewhere in the financial system. As we have explained previously, this means firstly, minimizing the disruption to the financial businesses within the group and, secondly, that TLAC must be perceived as sufficient to protect short-term credit suppliers throughout the banking group against loss. A holding company structure that permits an SPE style resolution offers greatest promise for these pro-resolvability criteria. If only the public parent goes through the resolution procedure, business relations with the operating subsidiaries will be minimally disturbed. This mitigates adverse counterparty reactions and can minimize cross-border conflicts among regulators. If the unsecured term debt is issued by the public HoldCo entity, then putting only HoldCo through resolution will result in structural subordination of HoldCo debt to debt elsewhere in the group. Otherwise, subordination of TLAC debt will be a matter of contract and thus susceptible to contract interpretation. As explained by Paul Tucker, former Deputy Governor of the Bank of England, in arguing for bonds issued by HoldCo on the SPE model:

It is a device to achieve *structural subordination* of bondholders, putting beyond doubt that they absorb losses after group equity holders but *before* anyone else. Everybody else would be a creditor of one or other of the various operating subsidiaries. They would have a prior claim on the cash flows generated by the underlying businesses. Equivalently, they would be bailed-in only if the holdco didn't have sufficient bonds in issue to cover the group's losses, so that ailing subsidiaries ended up going into resolution too.[75]

TLAC at the HoldCo level also maximizes its deployability throughout the group, avoiding the problem that, in effect, the insurance is at the 'wrong' subsidiary, and, because of contractual limitations, cannot be used to provide bail-in coverage for a subsidiary whose problems exceed its own TLAC.

In sum, the decision to withdraw the Structural Measures Regulation may not be a disaster after all. It is certainly deplorable that the banking structure remains largely unaddressed on the European level. True, many of the larger EU Member States have

[75] See Tucker (n 11).

meanwhile adopted their national versions of structural regulation,[76] and the EU is on course to implementing the TLAC principles.[77] But Elke König, head of the SRB, recently spoke out against mandating bank holding companies in Europe, preferring a 'clean-up' of group structures along functional lines to ensure separability, rather than imposing a holding company structure.[78]

Nevertheless some momentum may be on the way. A number of national lawmakers have taken the initiative and have started to set incentives for structural conversion. Most importantly, Swiss rules on banking capital requirements lower those requirements for banks that adjust their organizational structure to make the bank more easily resolvable. This move has prompted the two Swiss SIFIs (UBS and Credit Suisse) to change their structure in a way that is very similar to the United States' holding company structure.[79] Once the new structure is in place, Credit Suisse plans to issue ample bail-in-able debt from its group holding company, in order to facilitate the SPE approach.[80] Following new regulation in the United Kingdom, British banks are also beginning to issue debt at the holding company level.[81] And more recently, the Italian banking group Unicredit as well as Irish banks (Bank of Ireland and Allied Irish Banks) have announced plans to

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[76] See n 69.
[77] Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC, [2019] OJ L150/296, which is to be implemented by Member States by the end of 2020.
[78] Cecile Sourbes, 'Q&A: SRB's Elke König on resolution regimes', Risk.net (1 July 2015): '[Y]ou might want to have these critical functions isolated in one or, at least, in a small number of companies, and not spread around the group. This does not call for the setting up of a holding structure, but a clean-up of the organisational structure – so functions are aligned with legal entities that can be easily separated' (available at online <https://www.risk.net/risk-management/2414515/qa-srbs-elke-konig-resolution-regimes>.
[79] James Shotter, 'Credit Suisse to Overhaul Structure' *Financial Times* (London, 21 November 2013), available online at <http://www.ft.com/intl/cms/s/0/45d5a706-527d-11e3-8586-00144feabdc0.html>; James Shotter, 'Swiss Bank Creditors Face Bail-in Risk' *Financial Times* (London, 8 August 2013), available online at <http://www.ft.com/intl/cms/s/0/48ab28a0-ff6e-11e2-919a-00144feab7de.html>. According to rating agency Fitch, it is likely that other European banks are under pressure to follow this example. See Shotter, ibid; see also James Shotter, 'UBS Plans Dividend as Part of Overhaul to Ease a Crisis Break-up' *Financial Times* (London, 6 May 2014), available online at <http://www.ft.com/intl/cms/s/0/7c5ffa50-d4d8-11e3-8f77-00144feabdc0.html> ('UBS is to overhaul its legal structure to make it easier to break up the bank in a crisis, in a move designed to lower its capital requirements and enable it to pay a special dividend.').
[80] Shotter, 'Credit Suisse' (n 80).
[81] Sam Fleming, 'Banks Address "Too Big to Fail" Question with Debt Shift' *Financial Times* (London, 26 December 2013), available online at <http://www.ft.com/cms/s/0/df877896-6c7e-11e3-ad36-00144feabdc0.html>.

reorganize their operations in a holding structure more amenable to resolution.[82] At least in the case of the Bank of Ireland, this move was apparently requested by the SRB, in order to provide for a more effective framework for the bail-in of bondholders in the event of another financial crisis.[83] All of these efforts may however be undermined by efforts in some key EU Member States, notably France and Spain, to continue issuing new forms of senior debt out of their operating companies rather than switching to a holding company structure, as endorsed by the European Commission.[84]

VI. Conclusion

Our conclusion is this: Bank resolution in the European regulatory framework is missing one crucial element: consideration for the *structure* of European banks. Requirements or, at least, irresistible incentives for banks to operate in a holding company structure would greatly enhance the operability of the resolution framework, would make it more credible, and would reduce the likelihood of another taxpayer bail-out. As a by-product, it would also facilitate transatlantic co-ordination of resolution policies.

No co-ordinated EU action appears forthcoming. The potential reform vehicle, the Structural Measures Regulation, has been withdrawn.[85] Hence, the EU must find other ways of tackling the problem. Legal and functional separation of the various financial activities in a G-SIB is important principally because of the impact on the resolvability of such a financial institution in the event of financial distress. A critical structural element is the separation of public equity and bail-in-able debt from the operating financial subsidiaries. Because it facilitates resolution, the holding company structure adds credibility to the supervisory mechanism and serves the Banking Union's most important goal, to break the link between sovereigns and the EU banking system.

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[82] Fitch Ratings, 'New UniCredit Structure Would Simplify A Resolution' (20 November 2015), <https://www.fitchratings.com/site/fitch-home/pressrelease?id=994472>; Joe Brennan, 'Banks advance bond 'bail-in' plans under new European rules' *The Irish Times* (Dublin, 3 February 2017), available online at <http://www.irishtimes.com/business/financial-services/banks-advance-bond-bail-in-plans-under-new-european-rules-1.2962210>.

[83] Ciarán Hancock, 'Bank of Ireland gets court approval to set up new holding company', *The Irish Times* (Dublin, 23 June 2017), <https://www.irishtimes.com/business/financial-services/bank-of-ireland-gets-court-approval-to-set-up-new-holding-company-1.3131510>.

[84] RTE, 'Bank of Ireland and AIB set off down "holding company" road' *RTE* (3 February 2017), available online at <https://www.rte.ie/news/business/2017/0203/849801-bank-of-ireland/>.

[85] European Commission (n 72).

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