When trust is not enough : Bank resolution, SPE, Ring-fencing and group support

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Mathias Dewatripont
Université Libre de Bruxelles - ECARES and ECGI

Marie Montigny
National Bank of Belgium

Gregory Nguyen
National Bank of Belgium

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Keywords: Bank resolution, SPE, Banking crisis, bail-in, bankruptcy

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Mathias Dewatripont*
Professor of Economics,
Solvay Brussels School of Economics & Management,
Université Libre de Bruxelles
Avenue Franklin Roosevelt 42,
1050 Bruxelles, Belgium
e-mail: Mathias.Dewatripont@ulb.be

Marie Montigny
National Bank of Belgium
Boulevard de Berlaimont 14
B-1000 Brussels, 1000, Belgium
e-mail: marie.montigny@diplobel.fed.be

Gregory Nguyen
National Bank of Belgium
Boulevard de Berlaimont 15
B-1000 Brussels, 1000, Belgium
e-mail: Gregory.Nguyen@nbb.be

*Corresponding Author

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* Solvay Brussels School and ECARES, Université Libre de Bruxelles.
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1. Introduction

The BRRD2[1], approved by the European legislator in 2019, introduces a totally new concept in European law, namely the concept of resolution group. A resolution group is a group or subgroup composed out of a parent entity and its subsidiaries for which a group resolution is considered to be appropriate, should an entity of the group be failing. Under a group resolution approach, resolution actions[2] – for example bail-in - are coordinated and implemented centrally, through a single entity – the so-called resolution entity - and the structure of the resolution group is preserved throughout the resolution process.

There was a need to introduce the concept of resolution group under EU law to facilitate the implementation of the so-called Single Point of Entry resolution strategy (SPE). This resolution strategy, defined by the Financial Stability Board (2013), was developed to address the resolution of highly integrated banking groups. Facing highly integrated groups, the resolution authority plans to apply its resolution tools on a single entity within the group – usually the parent company – to restore the financial situation of all the entities belonging to the resolution group.

One of the innovative features of the SPE strategy, and its objective, is to preserve the legal structure of the resolution group throughout the resolution process. Thereby, one could argue that the resolution group concept introduces in the European legal framework new legal effects to some groups of legal entities, between the legal forms that are already existing, i.e. the subsidiary (usually characterised by the limited liability of the parent company vis-à-vis the commitments of its subsidiaries) and the model of the single company with branches (which are part of the single legal entity). Indeed, a subsidiary belonging to a SPE resolution group is not supposed to be resolved on a stand-alone basis and thus, in theory, will benefit from the support of its parent company above its limited liability through the resolution undertaken at a higher level. Yet, the estate and creditors of the parent company and of its subsidiary remain distinct in contrast with a branch structure.

Given the SPE resolution strategy aims at ensuring a group approach in resolution - the legal structure of the group is supposed to be maintained in resolution - the European Commission has proposed, in parallel, to reflect this group approach in the prudential framework and to remove some safeguards aiming at preserving the corporate interests of subsidiaries at individual level. In its initial proposal[3], the European Commission envisioned a large regime of waivers for subsidiaries, e.g. of capital, liquidity or internal MREL requirements. Removing these safeguards, which are sometimes referred to as "ring-fencing" measures, would allow increasing the integration of the banking industry across Europe, which is one of the objectives of the Banking Union, next to e.g. an increased financial stability in all Member States.

The benefits of increased integration of the banking industry have been extensively assessed (see e.g. Claessens, 2017 or Schoenmaker and Wagner, 2011 for a review of the literature). A higher integration may for instance contribute to decrease the probability of default of

[1] 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

[2] The possible resolution actions include the use of the bail-in tool, the sale of business tool, the creation of a bridge institution or the asset separation tool, also referred to as a bad bank.

[3] It is worth noting that the approach proposed by the European Commission faced resistance by the European Council and Parliament and was eventually rejected in the final version of BRRD2. This paper aims at contributing to this debate which is still ongoing.

banking groups which have the possibility to better diversify their activities and investments. Thanks to this presumably more efficient capital allocation and risk sharing, banking groups may be less exposed to idiosyncratic shocks and risks affecting their domestic economy. In parallel, more integration leads to increased competition with associated benefits in terms of efficiency of banks and banks financing, and eventually economic growth.[4]

In recent speeches, several European officials have warned against the risk of refragmentation of the banking industry in the European Union (see e.g. de Guindos, 2019 or Enria, 2018). It is true that the European banking market remains quite fragmented. The share of banking assets held by foreign controlled subsidiaries and branches remains extremely low in several large Member States.[5] There are in addition empirical evidences of a decrease in the integration of the banking industry in Europe, subsequent to the Global Financial Crisis of 2007-2009. However, these evidences deserve a nuanced analysis. For instance, Claessens (2017) differentiates four forms of cross-border activities in financial services, i.e. (i) cross-border claims and flows (e.g. lending and deposit-taking), (ii) consumption abroad, (iii) financial foreign direct investments (e.g. through foreign banks subsidiaries and branches) and (iv) cross-border supply of services. He focuses on the most important ones, being cross-border claims and flows and financial foreign direct investments. He notices that fragmentation of cross-border claims increased after the Global Financial Crisis and observes that this was especially due to a decrease of cross-border capital flows at the level of European banks. He attributes this refragmentation of cross-border claims and flows to both a reduced demand for external financing abroad and a reduced supply resulting from, on the one hand, market and regulatory pressures to restore balance sheets and profitability and, on the other hand, from more demanding regulatory requirements or restrictions on the free movement of capitals due to some forms of home bias. In a similar vein, McCauley et al. (2017) confirms that the decreased international integration that followed the Global Financial Crisis was mainly attributable to a decrease of cross-border lending by European banks, necessary to restore their capital ratios. In particular, they interpret this trend as a "cyclical deleveraging of unsustainably risky bank balance sheets [rather than as] a secular deglobalisation trend." As far as foreign bank presence is concerned, Claessens (2017) concludes that the number of new foreign entrants has tended to decrease after the Global Financial Crisis, but given the number of domestic banks was also decreasing during the same period of time, the market share of foreign banks increased, even in OECD countries, where it reached nearly 25%.

Despite the multifaceted nature of cross-border integration, and the inconclusive observations in terms of a possible refragmentation trend, ring-fencing measures seem to have drawn the attention of several European policy makers (see e.g. Enria, 2018 or König, 2019), and this despite many other factors may constitute barriers to cross-border consolidation (such as e.g. differences in tax, labour or insolvency laws, as well as differences in Member States industrial policies). Interestingly, this was less the case in the

4 Note that cross-border banking integration also brings about some potential costs and risks (see e.g. Allen et al, 2011). In particular, there may be some risks in terms of financial stability, including e.g. the fact that some banks may become "too big to fail" or "too interconnected to fail". Besides, excessively fostering the cross-border integration of banking groups may lead to the risk of overbidding, often referred to as the "winner's curse" (see e.g. the battle around the acquisition of ABN AMRO in 2007. Santander, RBS and Fortis together launched one of the biggest take-over in order to acquire the Dutch lender. However, two of the acquirors, RBS and Fortis, eventually required a bail-out less than a year after the acquisition).

5 See e.g. European Central Bank (2020). The share of banking assets controlled by foreign-controlled subsidiaries and branches ranges between 5% and 10% of the total banking assets of the country in Member States like France, Germany, Greece, Italy, the Netherlands, or Spain. In other Member States, this fraction can reach almost 50% (Belgium, Ireland, Malta or Slovenia), or even substantially exceed that level (such as e.g. in Estonia, Latvia, Lithuania, Luxembourg, or Slovakia).

US, where US officials more easily recognise the legitimacy of and need for well-calibrated ring-fencing measures (see e.g. Quarles, 2019 or Tarullo, 2015).

Ring-fencing measures could be defined as measures aimed at preserving the individual economic substance and the specific corporate interest[6] of each of the different legal entities composing a group. Interestingly, the ring-fencing concept was also used in a purely national context, in the UK, by the Vickers Commission[7]. The Vickers Commission proposed to ring-fence or insulate retail activities from other banking activities. One of the objectives of the reform was to ensure that the ring-fenced activities could be easily separated from the non-ring-fenced activities in case non-ring-fenced activities would have engaged in excessive risk taking.

Often, the debate around the legitimacy of ring-fencing measures has focused on measures implemented at subsidiary level, such as e.g. capital requirements imposed on subsidiaries, restriction on liquidity flows from a subsidiary to the other entities of the group, requirement to have intragroup transactions carried out on an arm's length basis, limits to intragroup exposures, or even internal TLAC/MREL. These barriers to the free allocation of capital and funding within a group may impede its functioning and lead to sub-optimal results, even though they may not be the most important source of refragmentation. Ervin (2017) presents ring-fencing as a prisoner's dilemma where ring-fencing one legal entity may be beneficial for that entity if the other entities are not ring-fenced. However, when all legal entities within a given group are ring-fenced, no common pool of resources may be created, and all legal entities end up with a higher probability of default.

However, as explained by D'Hulster and Otker-Robe (2018), ring-fencing measures actually prove to be bidirectional where both the subsidiaries and the parent company protect their own individual corporate interests. Given the resources of the different legal entities are not fungible within a group this also implies that the support that the subsidiaries can expect from their parent company – or from a presumed pool of resources - could also be limited. The parent undertaking keeps an option to limit its support to each of its subsidiaries. This option is even reflected in the rating of the different legal entities (see e.g. Moody's affiliate support or the Fitch Bank Support Rating). Admittedly, activating this option would not be without cost for the parent company and its other subsidiaries, as this could severely affect the reputation of the group. The strike price of this option is important but when stakes are high, when different entities are striving for their survival, the option may actually be in the money. Interestingly, the reputation price to pay may also decrease if the subsidiary is affected by a purely domestic crisis which could not be attributed to a mismanagement of the group.[8]

This paper focuses precisely on those cases where stakes are high, i.e. resolution. Within the Banking Union, there is a general expectation that the introduction of the SPE strategy supported by a robust resolution regime and a single resolution authority tasked to administer resolution proceedings, would largely solve potential conflicts between the interests of the

6 The Board of directors of a company must use its powers and must take actions for the commercial benefit of the company and the interest of its shareholders and other relevant stakeholders. The important aspect here is that corporate interest refers to the legal entities taken individually and not the group.

7 See Independent Commission on Banking (2011).

8 For instance, Tschoegl (2005) discusses the cases of Crédit Agricole, Scotiabank and MBK Mercobank during the Argentinean crisis. In each of these three cases, the foreign parent company refused to recapitalise its failed subsidiary located in Argentina, and requested the intervention of the Argentinean government. Note that Scotiabank, nevertheless, did reimburse 20 p.c. of the value of the marketable security issued by its subsidiary, probably in an attempt to salvage its reputation. See also the examples of the European subsidiaries of Lehman Brothers or of the Greek subsidiary of Credit Agricole as noted by Ahmad Fontán et al. (2019).

different entities composing a group, and eventually between home and host authorities, (see e.g. König, 2018). As a consequence, ring-fencing measures would no longer be needed.

However, soft mechanisms relying on trust do not solve this issue. The set-up of a single resolution authority within the Banking Union was a necessary step to ensure a coordinated action. Yet, eventually, the resolution authority will face legal and financial impediments which constrain its action. And at the end of the resolution process, the single resolution authority may have to make some political judgement calls because the interests of different entities of the group, their stakeholders and the different national authorities are not perfectly aligned in resolution.

This misalignment of interests is even more important in a context of incomplete Banking Union, where deposit guarantee schemes remain national and where there is no fiscal backstop (see e.g. Enria, 2020). The absence of formal burden sharing agreement will be a sufficient reason for both home and host authorities to care about the geographical distribution of losses (see e.g. Garicano, 2019).

This paper argues that, given the bidirectional nature of ring-fencing, authorities of subsidiaries have a legitimate incentive to maintain measures to safeguard the corporate interest of subsidiaries as long as the support to be expected by the parent company remains uncertain. The introduction of the SPE strategy within the European legal framework is a first step, but insufficiently robust to ensure the support of the parent company under any crisis circumstances. Fortunately, while in the Banking Union, the SPE strategy has been preserved in past resolution cases, it may not be guaranteed, especially in situations where the resolution depends on an external acquiror, who may decide it is better to only acquire part of the resolution group and leave away some subsidiaries.

The support mechanism needs therefore to be reinforced to receive a statutory recognition in order to become undisputable. In the current legal framework, while a consolidated approach in going concern makes perfect sense, such an approach does not reflect the reality of the gone concern situation.

This paper then proposes two measures that could be further explored to mitigate possible concerns and misalignment of interests. They consist in (i) the formalisation of the nature of the parent support through a burden sharing agreement and (ii) the introduction of a hierarchy of creditors within groups, which would be aligned on the implicit hierarchy of creditors prevailing under the SPE strategy.

The paper is structured as follows. Section 2 explains how the SPE strategy would work and defines at the same time its boundaries. Section 3 proposes two avenues which could be further explored to make SPE models more robust. Section 4 concludes.

2. The SPE theory and practice

2.1. Concepts

A resolution strategy establishes a specific presumptive path determining how a given banking group would be resolved should it reach its point of failure. The resolution strategy defines in particular which resolution actions would be implemented and at which level within the group, i.e. on which legal entities resolution tools would be applied. The resolution strategy is determined within the context of the resolution planning process whose ultimate objective is to make a banking group resolvable.

The Financial Stability Board (2013) distinguishes two stylized resolution strategies: the Single Point of Entry (SPE) and the Multiple Point of Entry (MPE) resolution strategies. The main difference between the two strategies is the level at which the resolution authority expects to implement resolution actions. In a SPE strategy, resolution actions are expected to be implemented at a single level, the so-called resolution entity, usually the top parent undertaking or the holding company. It is then the resolution authority of the jurisdiction responsible for consolidated supervision who is responsible for the execution of resolution actions. In an MPE strategy, resolution actions are applied to different legal entities belonging to a group, usually where losses originate. When there is more than one resolution authority, they try to act in a coordinated way. In theory, SPE and MPE resolution strategies are neutral in terms of resolution actions. For the sake of simplicity, and because this is the case most often encountered in resolution planning, this paper focuses on the use of the bail-in tool. The conclusions of this paper remain applicable when implementing alternative resolution actions (e.g. transfer instruments).

While the ambition of the SPE strategy is to preserve the legal structure of the group, the MPE resolution strategy is expected to result in the break-up of the group in two or more separate parts. This is because, when implementing bail-in on the liabilities of a subsidiary, the parent company (i.e. the shareholder) and the external creditors of the subsidiary are first written down and part of the liabilities held by the external creditors are subsequently converted into equity. Thereby, external creditors acquire property rights on the subsidiary, which is thus disconnected from its former shareholder.

A key condition identified by the Financial Stability Board (2013) to implement the SPE strategy is therefore that the group should implement a mechanism allowing to pass on losses incurred by the subsidiaries to the resolution entity. The losses are then transferred, in resolution, to the resolution entity and then absorbed by its shareholders and external creditors, for instance through a recourse to the bail-in tool. This mechanism, often referred to as the loss upstream and capital downstream mechanism, necessitates to create an exposure of the parent company on its subsidiaries, junior enough to absorb losses before the operational and other external creditors of the subsidiary. Provided that sufficient loss-absorbing capacity is available at the top parent or holding level, subsidiaries should be able to continue operating on a going concern basis without entering into resolution.

The choice of the resolution strategy should essentially be determined by the features of the group and the legal frameworks in place. Which strategy is most likely to be the most suitable to resolve a group depends upon a range of factors, including the localisation of bail-inable debts, the level of interconnectedness between the different legal entities and the resulting capacity of the different subsidiaries to operate on a stand-alone basis. When the loss-absorbing capacity is centralised at the parent company, and when there is a reliable mechanism to pass on losses to that entity, the SPE strategy is a natural candidate for a resolution strategy. When the different subsidiaries are relatively independent and self-sufficient, also in terms of funding, then the MPE strategy may be preferred.[9] However, many banking groups today do not fully satisfy these conditions, and it is the responsibility of resolution authorities to ensure that their structure, funding or operations are adjusted so that at least one of the resolution strategy can be implemented if needed.

The choice of a resolution strategy is thus more than just the choice of the competent resolution authority. It requires to adjust the structure of the banking group to ensure that at least one strategy can be implemented. For cross-border banking groups, ensuring a coordinated action of resolution authorities is a necessary condition for the swift and efficient implementation of the resolution strategy. The Banking Union offers a mechanism that ensures such a cross-border coordination among participating resolution authorities. The SRB adopts a resolution scheme that is implemented by national resolution authorities. However, as will also be explained in the following sub-sections, while ensuring such a coordination is a necessary condition to execute a cross-border resolution, it is surely not a sufficient one.

2.2. Burden sharing in SPE, MPE and under normal insolvency proceedings.

In practice, the SPE resolution strategy defines an ex ante burden sharing between the different stakeholders of a banking group. The shareholders and creditors of the resolution entity are expected to absorb losses first and before the external creditors of its subsidiaries. This is a necessary condition to preserve the group structure. This means that, in resolution, they are, by construction, structurally subordinated to the external creditors of the subsidiaries, even the most junior ones.

Because the resolution regime derogates from the rules of law normally applicable to insolvency proceedings, resolution actions, in the European Union, can only be implemented as an exception, when this is justified in the public interest[10]. When the public interest criterion is not satisfied, the failing bank should be liquidated under normal insolvency proceedings.

In this context, it is necessary to examine how the burden sharing in the SPE strategy compares with the burden sharing that would be applicable in normal insolvency proceedings.

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9 In this context, Conlon and Cotter (2019) find that cross-border subsidiaries in the European Union are generally sufficiently funded to allow for an MPE strategy, and this contrary to domestic subsidiaries which lend themselves more to the SPE strategy.

10 The public interest is defined in article 32.5 of 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) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council ("the BRRD"). A resolution action is in the public interest if this action is necessary for the achievement of and is proportionate to one or more of the five resolution objectives and a liquidation under normal insolvency proceedings would not meet those resolution objectives to the same extent. The resolution objectives are (i) the continuity of critical functions, (ii) the avoidance of significant effects of the financial system, (iii) the minimisation of state aid, (iv) the protection of depositors covered by the deposit guarantee scheme and by investors benefitting from an investor protection scheme, and (v) the protection of client funds and assets.

The burden sharing in normal insolvency proceedings actually depends on the legal structure that has been adopted, which traditionally is either branches or subsidiaries[11]. A branch is not a separate legal entity. Its assets and liabilities are an integral part of the estate of the company. In the European Union, the liquidation of a branch of a credit institution must obey certain principles, which are defined in the so-called bank winding up directive[12]. In particular, a single procedure is applied to liquidate the company and its branches. This implies that the branch cannot be subject to a separate bankruptcy procedure. A branch cannot be failing if the bank is not itself failing. Vice-versa the liquidation of a bank under normal insolvency proceedings automatically triggers the liquidation of its branches under the same insolvency proceedings. The estate of a company and of its branches are one and the same, both in going concern, in resolution and in normal insolvency proceedings. The same is true with regards to the respective liabilities of a bank and of its branches. The winding up directive introduces a principle of equal treatment between creditors. Creditors of branches are treated in the same way as the other creditors of the bank, because, legally, they are creditors of the bank. They benefit from the same ranking as equivalent creditors of the company. The depositors of the branch are even covered by the deposit guarantee scheme of the bank. The bank winding up directive therefore irreversibly links the fate of the company to the fate of its branches. Translated in terms of support, one could conclude that the bank will unconditionally support its branch(es) to the full extent of its own capacity.

The burden sharing in a group structured with subsidiaries is different. A subsidiary is a separate legal entity. The liability of the parent company is usually limited, as is its support[13]. The normal insolvency regime foresees a separate liquidation of each legal entity. Several insolvency procedures have to be opened for the parent company and for each of its subsidiaries. This implies that each entity has to individually satisfy the conditions for its bankruptcy. In a group, it is likely that not all the legal entities composing the group will simultaneously satisfy the bankruptcy conditions (first, because some legal entities within the group may remain sound and second, taking into account the fact that for cross-border groups, normal insolvency proceedings have not been harmonised across Member States). It is even conceivable to have a situation where some legal entities within the group remain totally sound, while the parent undertaking is itself satisfying the bankruptcy conditions. This was, for instance, one of the objectives of the ring-fencing measures proposed by the Vickers Commission in the UK, whereby retail activities within a group would be shielded from the risks arising from market activities.

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11 Note that there exist additional models which could influence the burden sharing. They include for instance the model of cooperative networks, where a solidarity mechanism may modify the allocation of losses between the participants to the solidarity mechanism. This is, however, a specific model which given its features cannot be adopted by all banking groups. These specific mechanisms are not assessed in this paper.

12 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions

13 Note that the BRRD introduced a new mechanism of intragroup support: the intra group financial support agreement. It is an agreement between the parent company and its subsidiaries to provide support in case one of the parties experiences financial difficulties. The agreement may be limited to some subsidiaries and should not necessarily cover the full group. The agreement is not necessarily reciprocal. The support is provided at arm's length and against remuneration. This agreement, entered into in normal times, is activated in crisis times. Yet, the support may only be provided if there is a reasonable prospect (i) that the support will be successful and will effectively contribute to redress the situation of the receiving entity and (ii) that the support will be reimbursed. In addition, providing the support should be in the interest of the entity which provides the support, for instance because it contributes to stabilise the group as a whole. It should not threaten its own financial situation or the financial stability of its Member State. Finally, any provision of support is subject to a prior agreement of the supervisory authority. This instrument has eventually received little interest from the industry. However, it is a formal recognition that support between the parent company and its subsidiaries is indeed limited both prior to a crisis and in going concern.

The bankruptcy estate of the different legal entities is distributed to the different creditors of the respective entities, in accordance with the prevailing hierarchy of claims in the Member State in which the entity is incorporated. The creditors of the subsidiary do not have a claim on the bankruptcy estate of the parent company or other entities within the group. It is the allocation of the losses between the different entities and their respective liability structure which will determine the eventual burden sharing.

Consequently, when a group is failing or likely to fail, four different outcomes are possible. First, the different entities composing the group may be liquidated under normal insolvency proceedings, which is the default option. If the public interest justifies it, for instance because it would be necessary to limit financial instability, the group can be resolved. Each group can be liquidated or resolved on the basis of its legal entities. Alternatively, a group treatment could also be envisaged, either through a SPE resolution or because the group operates with branches. Table 1 summarises these different outcomes.

Table 1. Possible outcomes when addressing the failure of a group

	Legal entity based	**Group based**
Normal insolvency proceedings	Liquidation of subsidiaries	Liquidation of branches
Resolution	MPE	SPE

It is important to note that, as far as subsidiaries are concerned, the burden sharing in a SPE resolution is significantly different from the burden sharing following from a liquidation under normal insolvency proceedings. In the former, the creditors of subsidiaries are, in theory, shielded from losses. All the losses are transferred to the parent company through the loss upstream mechanism. By definition, if creditors of subsidiaries have to absorb losses, the SPE strategy collapses, together with the idea of preserving the group structure. In the latter, however, they become fully exposed to losses.

The stylised example below shows that in certain ranges of losses, the burden sharing resulting from the SPE model is similar to the burden sharing under a branch model. In the example, there is a parent undertaking with total assets of 1000. Its liabilities are composed of own funds (100), subordinated debt subscribed by external investors (50), senior unsecured creditors, for instance corporate deposits (300) and covered deposits (550). On the asset sides, it owns a stake in a subsidiary together with other assets. The liability structure of the subsidiary is similar to the liability structure of the parent undertaking with own funds (20), senior unsecured (100) and covered deposits (200). The subsidiary, however, does not hold any subordinated debt.

Assume a symmetric shock which would generate losses equal to 8% of the assets. In a liquidation under normal insolvency proceedings, the losses of the subsidiary amount to 25.6 (i.e. 8% of 320), 20 of which are absorbed by the parent undertaking through the own funds of the subsidiary and 5.6 are absorbed by the senior unsecured creditors of the subsidiary. The parent undertaking losses amount to 98.4 (a loss of 8% on its own assets 980 - i.e. 78.4 - plus a loss of 20 resulting from the write down of its stake in its subsidiary). These losses are entirely absorbed by the shareholders of the parent undertaking. In total, the losses absorbed by the external counterparties of the group amount to 104.

Table 2. Liquidation of the parent undertaking and its subsidiary

Parent undertaking (before losses)				Loss allocation
Stake in subsidiary	20	Own funds	100	98.4
Other assets	980	Subordinated debt	50	0
		Senior unsecured	300	0
		Covered deposits	550	0
Total	***1000***	***Total***	***1000***	***98.4***

Subsidiary (before losses)				Loss allocation
Assets	320	Own funds held by the parent	20	20
		Senior unsecured	100	5.6
		Covered deposits	200	
Total	***320***	***Total***	***320***	***25.6***

Assume now that the group turns its subsidiary into a branch. In this case, the total assets, after the elimination of intragroup positions, amount to 1 300. The 8% losses amount to 104 (which is equivalent to the losses absorbed by external counterparties in the first example). However, these losses are absorbed by the parent undertaking shareholders which are entirely written down and for an amount of 4 by the subordinated debtholders. The move from a group structure organised with subsidiaries to a group structure organised with branches results in a reallocation of the losses which, in the first example, were absorbed by the senior unsecured creditors of the subsidiary. These losses are now absorbed by the shareholders of the group and by its subordinated debtholders. The senior unsecured creditors do no longer absorb losses.

Table 3. Liquidation of the group after branchification of the subsidiary

Parent undertaking (before losses)				Loss allocation
Assets	1300	Own funds	100	100
		Subordinated debt	50	4
		Senior unsecured	400	
		Covered deposits	750	
Total	***1300***	***Total***	***1300***	***104***

Interestingly, the burden sharing that would result from the SPE structure is, in this example, the same as the burden sharing with a branch structure.[14] We assume that besides the own funds, the parent undertaking subscribes to subordinated debt issued by the subsidiary for an amount of 10. This amount is considered to be sufficient to satisfy the internal MREL requirement set by the resolution authority. We assume in this example that the parent

[14] Note that for the simplicity of the example, we only consider loss absorption and do not address recapitalisation. This would, however, not affect the conclusions.

undertaking finances this internal subscription by an increase of 10 of its covered deposits. Simultaneously, the subsidiary reduces its own covered deposits as it does no longer need so much funding (other forms of adjustments could be considered without affecting the results. This could be for instance an intragroup transfer of assets from the parent undertaking to its subsidiary for an amount of 10, or a re-upstream of the funding received by the subsidiary to the parent company. In these two cases the total assets of the subsidiary would increase by 10 to reach 330). The losses that have to be absorbed at the subsidiary level still amount to 25.6 (8% of 320) and these losses are entirely up-streamed to the parent undertaking by way of a write down of the own funds and the subordinated debt subscribed by the parent undertaking. Therefore, the total losses that should be subsequently absorbed by the shareholders and external creditors of the parent amount to 104 (25.6 plus 8% of 980) and these losses are absorbed by the shareholders and the subordinated debtholders as is the case with the branch structure and despite the fact that some losses were originated in the subsidiary.

Table 4. SPE strategy

Parent undertaking (before losses)				Loss allocation
Stake in subsidiary	30	Own funds	100	100
Other assets	980	Subordinated debt	50	4
		Senior unsecured	300	
		Covered deposits	560	
Total	***1010***	***Total***	***1010***	***104***

Subsidiary (before losses)				Loss allocation
Assets	320	Own funds	20	20
		Subordinated debt subscribed by the parent (internal MREL)	10	5.6
		Senior unsecured	100	
		Covered deposits	190	
Total	***320***	***Total***	***320***	***25.6***

Finally, the burden sharing that would result from the MPE situation is similar to the burden sharing of the table 2, i.e. the burden sharing of a liquidation of legal entities under normal insolvency proceedings.[15]

[15] The extent to which the burden sharing might be slightly different depends on the nature of the unsecured debts issued by the subsidiary. If those unsecured debts are eligible to meet the MREL requirement set at the level of the subsidiary to support the MPE strategy, then the burden sharing is exactly the same as the burden sharing of the liquidation of legal entities (table 2). If the composition of the MREL is such that the subsidiary should issue additional subordinated instruments to satisfy its MREL requirement, then the burden sharing between the different creditors of the subsidiary may be modified (because the subordinated debt externally issued by the subsidiary will absorb losses before its unsecured creditors). However, the sharing of the losses between the parent undertaking and its subsidiary will remain unchanged, i.e. a loss of 98.4 for the parent undertaking and 25.6 for its subsidiary.

2.3. Deconstructing the SPE : nature and robustness of the commitment to support in SPE strategies

As illustrated above, the sole execution of the bail-in at the level of the resolution entity does not restore by itself the viability of all the legal entities within the group. Such a bail-in is a necessary first step to create enough loss absorbing capacity at the level of the resolution entity to meet the needs of the group and to provide the resolution authority with a sufficient buffer to channel the losses out of the group. However, implementing the SPE resolution strategy requires to complement this bail-in with a mechanism to upstream losses from the failing subsidiary to the resolution entity, and to downstream enough resources to recapitalize the subsidiary.

The Financial Stability Board (2013) suggests basing this upstream and downstream mechanism on the subscription by the resolution entity of subordinated debt issued by the subsidiary which could be written-down or converted if needed, namely the internal Total Loss Absorbing Capacity (internal TLAC). The Financial Stability Board (2017) goes one step further and defines guiding principles on this internal TLAC for global systemically important banks (G-SIBs). It defines both its calibration (75% - 90% of the external Minimum TLAC requirement that would apply to the subsidiary if it were itself a resolution group) and its composition.

In the European Union, the BRRD2 introduced a similar mechanism for all SPE groups (and not solely dedicated to GSIBs), called internal MREL, where the resolution entity must subscribe own funds and subordinated liabilities issued by its subsidiaries. In parallel, article 59 of the BRRD, as modified by the BRRD2, extends the power of resolution authorities to write-down and convert capital instruments to all the internal MREL instruments. This allows to activate internal MREL instruments without triggering the need for the subsidiary to formally enter into resolution.

The SPE strategy, both as devised by the Financial Stability Board (2013) and (2017) and as introduced in the European legal framework by the BRRD2, relies on a mechanism of limited support. Indeed, the pre-commitment of the resolution entity to absorb the losses of its subsidiaries is limited to the own funds and subordinated liabilities that it has subscribed. Should the losses of one subsidiary exceed this amount, there would be no obligation for the resolution entity to further support its subsidiary. More fundamentally, the resolution entity may be legally obliged to limit the support it offers to its subsidiaries.[16] The enforcement of the SPE strategy beyond the pre-positioned instruments would conflict with one of the overarching principles of the BRRD, which was also affirmed by the Financial Stability Board (2013), namely that no creditors should be worse off than in a liquidation under normal insolvency proceedings. Consequently, transferring additional losses to the parent company, above and beyond the pre-funded instruments, could be legally disputable, as these losses would then need to be absorbed by the creditors of the resolution entity. Given that, as explained in section 2.2., in a liquidation under normal insolvency proceedings the creditors of the resolution entity would not be liable for these extra-losses, they could challenge the resolution authority and claim that they would be better off if the subsidiary was liquidated under normal insolvency proceedings.

In the example above, the losses of the subsidiary were limited to 8% of total assets and the internal MREL was sufficient to absorb these losses. If we assume that losses, instead of

[16] Note in this context that the Financial Stability Board (2013) explicitly recognises that ring-fencing at parent level may threaten the implementation of the SPE strategy: “Regulatory large exposure limits at the top of the group on intra-group funding may be an impediment to SPE resolution strategies”.

being equal to 8% of total assets, reach 12.5% of total assets, we see that the implementation of the SPE strategy is more complicated. Indeed, if the resolution authority wants to maintain the SPE approach, it will be forced to transfer losses to the parent company, above and beyond the internal MREL. In table 5, we see that normally, in absence of a SPE (through a MPE or a liquidation), the senior unsecured creditors of the subsidiary would have to absorb losses for an amount of 10 compared to 2.5 for the senior unsecured creditors of the parent undertaking.

Table 5. SPE strategy beyond prepositioning – SPE is not maintained

Parent undertaking (before losses)				Loss allocation
Stake in subsidiary	30	Own funds	100	100
Other assets	980	Subordinated debt	50	50
		Senior unsecured	300	2.5
		Covered deposits	560	
Total	***1010***	***Total***	***1010***	***152.5***

Subsidiary				Loss allocation
Assets	320	Own funds	20	20
		Subordinated debt subscribed by the parent (internal MREL)	10	10
		Senior unsecured	100	10
		Covered deposits	190	
Total	***320***	***Total***	***320***	***40***

Table 6 shows that if resolution authorities want to maintain their SPE strategy, they need to reallocate losses borne by the senior unsecured creditors of the subsidiary to the parent undertaking. This can be done, for instance, through the subscription of additional own funds or subordinated debt for an amount of 10, which would be immediately written-off. Such an operation, that the parent undertaking is not legally obliged to do, would be done at the expense of the senior unsecured creditors of the parent undertaking, which would obviously be worse off than in liquidation.

Table 6. SPE strategy beyond prepositioning – SPE is maintained

Parent undertaking				Loss allocation
Stake in subsidiary	30	Own funds	100	100
Other assets	980	Subordinated debt	50	50
		Senior unsecured	300	12.5
		Covered deposits	560	
Total	***1010***	***Total***	***1010***	***162.5***

Subsidiary				Loss allocation
Assets	320	Own funds	20	20 + 10
		Subordinated debt subscribed by the parent (internal MREL)	10	10
		Senior unsecured	100	
		Covered deposits	190	
Total	***320***	***Total***	***320***	***40***

This means that, while the SPE strategy is a presumptive path, there remain cases where, as a second-line of defence, resolution actions may need to be eventually implemented on subsidiaries instead of on the resolution entity. When resolution actions are implemented on subsidiaries, i.e. when the SPE strategy cannot be implemented and there are multiple points of entry (MPE), the burden sharing is similar to the outcome characterising the liquidation as presented in Table 2.

This also means that the frontiers between the SPE and the MPE strategy are more blurred than what could be expected at first sight. Some SPE scenarios may prove inadequate at the time of resolution, because the losses originated at subsidiary level are too important to be upstreamed to the parent company. These cases may require direct intervention at the level of subsidiaries, despite the pre-agreed resolution strategy. Vice-versa, one could easily imagine cases where a MPE group is resolved from the top, especially if the shock affecting the group remains limited and does not require a substantial intervention at the level of its subsidiaries. Actually, as also argued by Ahmad Fontán et al. (2019), the SPE and MPE strategy form a continuum whose inflexion point is determined by the level of internal loss absorption capacity that has been prepositioned at subsidiary level (i.e. internal TLAC or internal MREL). The feasibility of the SPE strategy is thus endogenously determined by the level of internal TLAC or MREL pre-positioned. The lower the level of internal pre-positioning, the higher the risk that the strategy cannot be implemented without breaching the NCWO principle.[17] That is why waivers of internal MREL need to be extremely limited and, according to the BRRD2, can only be given when very strict conditions are satisfied.

Considering this, one can conclude that SPE and MPE resolution strategies are two sides of the same coin where the calibration of pre-positioning defines the extent of the parent support and, from there, the probability that one or the other option will be implemented. The choice

[17] This problem is not purely European, but is also present in the US. Norton (2013), a FDIC Board member explains that "without sufficient intra-company debt to recapitalize a failed subsidiary, the desired orderliness of a Title II [SPOE] approach might not be achievable. In order to effectuate an SPE resolution, policymakers might need to consider requiring that the debt be apportioned, or pre-positioned, in a particular way among subsidiaries." (quoted in Kupiec and Wallisson, 2015).

between the SPE and MPE resolution strategy is therefore more an issue of calibration (i.e. answering the question of up to which level of losses it is preferable to maintain the group structure unchanged) rather than a binary choice between two radically different distinct models of resolution. The SPE strategy defines an interval of losses over which there is a certainty that the losses will be upstreamed to the parent company. If losses exceed this predetermined level, no one can exclude an MPE-type of resolution in a second step.

In this context, the Financial Stability Board (2013) encourages authorities to consider fall-back options to address the cases in which the preferred resolution strategy could not be implemented and refers explicitly to situations where the resolution strategy cannot be implemented because of "the extent of losses suffered across different parts of the firm". Another case envisaged by the Financial Stability Board (2013) where a deviation from the SPE strategy may be necessary is the case in which the losses experienced by one or several operating companies exceed the loss absorption capacity at the top parent or holding company. In such a case, a resolution at the subsidiary level may be necessary.[18]

Surprisingly, the BRRD2 approach does not necessarily leave this flexibility in resolution planning. While there is eventually no obligation to apply the chosen preferred resolution strategy, the framework set by the BRRD2 does not seem to offer the possibility to plan simultaneously the SPE and MPE resolution strategies. However, while resolution authorities within the European Union have to select the SPE or the MPE resolution strategy, their choice only has a limited impact on the level of MREL at each level of the group. Indeed, in the current framework, the European legislator, recognising that there is a continuum between SPE and MPE strategy, has deliberately chosen to closely align the calibration of internal MREL on the calibration of external MREL.

2.4. SPE implementation risks

Kupiec and Wallison (2015) identify a series of risks to the implementation of the SPE resolution strategy in the US, casting doubts on its feasibility.[19] While their analysis is based on the US legal framework, many of the issues they identify are relevant in a European Union context as well. These additional sources of implementation difficulties reinforce the conclusion that the choice of a particular strategy when planning for resolution establishes a presumptive path and only gives an indication of the eventual strategy that could be applied at the time of an effective resolution.

These difficulties essentially concern the impediments to the activation of the loss-upstream and capital down-stream mechanism that is at the core of the SPE strategy. As a consequence, there is no certainty that centrally available loss absorbing capacity will effectively be available to resolve ailing subsidiaries. While these resources are available at the resolution entity level, there is an asymmetry in the possibility to access them.

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[18] This is also acknowledged in the joint paper of the Federal Deposit Insurance Corporation and the Bank of England (2012) : "in cases where the losses on assets in a particular operating subsidiary were potentially so great that they could not be absorbed by bailing in at group level or where the business had incurred such significant losses and was so weighed down by toxic assets that the capital needs in resolution were too difficult to estimate credibly, resolution at the level of one or more operating subsidiaries may be more appropriate. In this situation, the application of resolution tools to operating subsidiaries would be easier if the subsidiaries providing critical economic services were operationally and financially ringfenced from the rest of the group. This is one of the advantages of the ringfence introduced in the UK".

[19] They conclude as follows: "SPOE may be a groundbreaking theoretical resolution idea, but our analysis suggests that it is unlikely to be a successful legal strategy for resolving the largest banks. When we take the [Dodd-Frank Act] language at face value and examine whether SPOE is a resolution option for a large failing subsidiary bank, we find many problematic issues."

a) Incapacity to upstream losses

A first legal difficulty to note in the European Union legal framework is the impossibility that the resolution authority will have to implement an SPE strategy if the parent entity is not itself failing or likely to fail.[20] Pursuant to article 32 BRRD, a resolution action can only be taken in relation to a particular legal entity if this entity is failing or likely to fail, no alternative private sector or supervisory measures could prevent this failure within a reasonable timeframe and the resolution action is necessary in the public interest. If the legal entity is not failing or likely to fail, no resolution action can be taken. This means that in a situation where a subsidiary would be failing or likely to fail but its parent company would not, the resolution must necessarily be implemented at the subsidiary level, and this, despite any predetermined strategy. As noted above, the exposure of the parent may be strictly limited to the level of prepositioned internal MREL. A full loss of the internal MREL prepositioned in a subsidiary may not be sufficient to trigger the failure of the parent company. For instance, Kupiec and Wallison (2015) study the 15 largest bank holding companies in the US and observe that for 11 of them, a loss that would deplete the entire equity capital of the subsidiary would not be large enough to deplete or substantially deplete the equity capital of the holding company. If the failure of the subsidiary is not triggering the failure of the parent company, the resolution authority is not in a capacity to implement its SPE strategy and is forced to conduct its resolution at the level of the subsidiary.

Of course, the parent company keeps the option to voluntarily recapitalise its subsidiary in such a situation. In addition, it will most likely be encouraged to do so by its supervisor in the Banking Union. However, basing the success of the SPE strategy on a voluntary mechanism would remain rather weak, as there would be no guarantee that the SPE strategy could eventually be enforced. There may be tail cases in which it may not be in the fiduciary interest of the parent company to support its subsidiary and absorb losses above the prepositioned internal MREL. A parent company may have little incentive to do so, for instance if the shock on the subsidiary is due to an idiosyncratic issue (such as e.g. an AML issue or a sovereign crisis in the State in which the subsidiary is incorporated), especially if the parent company is already experiencing difficulties, and granting such support would make the failure of the parent company itself more likely. These cases may seem to be remote scenarios but the cost to exert the 'no-support option' will decrease if the economic substance of a subsidiary has not been sufficiently preserved, for instance in absence of safeguards measures.

In such a case, the MPE would constitute the only legally available option in resolution. In addition, for the resolution authority, it would be easier to separate the subsidiary from its parent company and address operational interconnections over the resolution week-end than to create legally shaky and challengeable loss absorption mechanisms. The crisis experience

[20] We assume here that the legal entities are subject to a single resolution legal framework or should be resolved by a single resolution authority. The case where the parent company and its subsidiary are incorporated in different countries and fall within the remit of different resolution authorities is likely to present even more obstacles. See e.g. Bolton and Oehmke (2018) who assess the ex ante and ex post incentive compatibility of resolution strategies. They determine the optimal resolution strategy on the basis of two elements: the cost of separation and the geographical dispersion of the loss-absorbing capacity. When the separation cost is low and the loss-absorbing capacity is geographically dispersed (i.e. requires to be transferred across jurisdictions in resolution), the MPE strategy seems to be more robust.

at Fortis in 2008 has demonstrated that separating entities which are interconnected is probably easier than to address the question of the burden sharing.[21]

b) Trades-off in loss upstreaming

Even in a situation where the resolution authority has the power to initiate the resolution at the parent level, it would face several trade-offs. In the Banking Union, these trade-offs would need to be solved by a single resolution authority, i.e. the Single Resolution Board. First it would have to make a balancing act between bailing-in the loss absorbing capacity of the parent company and bailing-in the loss absorbing capacity of its subsidiaries. This is because there is no obligation in the European Union for the resolution entity to be a holding company (HoldCo). An operational company (OpCo), i.e. a credit institution, can perfectly be the point of entry of a SPE resolution strategy. This makes the implementation of the SPE strategy even more complicated, compared for instance to the US, where the SPE is applied to an empty HoldCo (see e.g. Kupiec and Wallison, 2015). Considering that, in the European Union, the MREL is not necessarily fully subordinated (or in certain cases not subordinated at all), and taking into account that, for instance, corporate deposits are not excluded from the scope of bail in, the resolution authority might have to make a choice between either bailing-in the corporate deposits of the parent company to solve a problem at a subsidiary level or to directly bailing-in the corporate deposits of the subsidiary, as it is illustrated in Table 5 and 6 above.

Depending on the importance of the banking group, this balancing act could also entail the choice between putting a whole G-SIB in resolution – possibly triggering serious disturbances and contagion effects - vs initiating a resolution at one of its subsidiary, in a more local environment. If the resolution authority wants to minimise possible disruptions[22], it may have to act at the local level instead of implementing an SPE strategy.

Another type of trade-off which may need to be arbitrated by the resolution authority is a situation where a potential acquiror is ready to take over part of an SPE group. For instance, the acquiror is ready to acquire the parent undertaking but not some of its important subsidiaries. In such a situation, the resolution authority could have to make a difficult choice between, on the one hand, applying the bail-in, preserve the SPE strategy but take more legal and financial risks and potentially create more contagion, and, on the other hand, transferring part of the group to an acquiror and resolving the remaining part on a stand-alone basis. Fortunately, the Single Resolution Board has not been confronted with such a situation in past resolution cases, but one could wonder how the Single Resolution Board would have solved such a situation if it had occurred and more importantly, no one can exclude that it could happen in the future.

[21] In particular, the break-up of the group resulted from difficulties to reach an agreement on burden sharing between the Belgian and Dutch governments, the two main countries where the group was active. The Dutch government took over the Dutch activities of the group, including its stake in ABN AMRO, while Fortis Bank Belgium was taken over by the Belgian government and subsequently acquired by BNP Paribas. While determining the burden sharing was a key concern of authorities, the separability issue has never seemed to be a blocking factor, despite the high level of integration of the banking group.

[22] Note that in the European Union, minimising disruptions may be considered as one of the objectives of the resolution authority. Indeed, article 31 BRRD lists the different resolution objectives, one of which being « to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline » and another being « to ensure the continuity of critical functions ».

The existence of a single authority thus improves trust and coordination among national authorities. Yet, it does not say anything about how different trade-offs will be solved. As observed by Tarullo (2015), "a global regulator (…) would at least in theory take the interests of all jurisdictions into account in regulating, supervising, and resolving a global bank. Of course, how to balance those interests – particularly in the face of unanticipated circumstances – would be a difficult, and almost invariably political judgement. This reality raises the thorny issue of the accountability of a global regulator".[23]

c) Loss downstreaming mechanisms

The difficulty to implement the SPE strategy may also arise from mechanisms which lead to a downstreaming of losses to subsidiaries. For instance, in the original version of the BRRD, intragroup exposures of subsidiaries on their resolution entity were eligible to bail-in. This implied that when applying the bail-in on the resolution entity, the resolution authority was obliged to also bail-in the exposures of subsidiaries, such as e.g. intragroup deposits, on their resolution entity. The consequence of such a bail in would have been to downstream the losses of the parent company to its different subsidiaries, totally neutralising any loss upstream mechanism that could have been devised and even threatening the viability of sound subsidiaries. Fortunately, this mechanism has been rectified in BRRD2 and intragroup exposures between a subsidiary and its resolution entity are no longer eligible to bail-in. This may however not be the case in all the jurisdictions outside the European Union.

Note also that in a liquidation under normal insolvency proceedings, these exposures are not immune against losses and so may be a decisive factor in the eventual loss allocation should the group be liquidated instead of resolved. This difference in treatment may further complicate the execution of the SPE strategy given the No Creditor Worse Off (NCWO) principle. Indeed, the fact that intragroup funding, which may potentially constitute an important share of the funding of the parent undertaking, would absorb losses in liquidation but would remain immune from losses in resolution may give rise to a NCWO issue as well as to a need for compensation by the resolution fund.

d) Lack of sufficient external loss absorbing capacity

An additional issue which may complicate the implementation of the SPE strategy is the potential lack of sufficient loss absorbing capacity at the resolution entity level. This would leave no other choice to the resolution authority than to mobilise the external loss absorbing capacity that is available at subsidiaries level, in other words to switch from an SPE to an MPE strategy. This calls for prudence in the calibration of the external TLAC/MREL which should be sufficient to sustain the implementation of the SPE strategy. In the European Union, this might also call for introducing some bottom-up features or test when calibrating the external MREL.[24]

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[23] In this context, in the Banking union, the Single Resolution Mechanism foresees for instance that in the absence of consensus, resolution actions may be adopted by a simple majority of the permanent members of the Single Resolution Board. The fact that the vote of national resolution authorities is not required in the absence of consensus might not offer sufficient comfort to national resolution authorities, be they home or host, that their interests and national sensitivities will be sufficiently taken into account in the overall balance of interests.

[24] The European Commission, in its BRRD2 proposal, initially proposed a rule by which the sum of the internal MREL should be lower than the external MREL requirement. This constraint was ambiguous as it could have been understood as a pure bottom-up approach but also as a pure top down cap on the internal MREL. This constraint was eventually removed from the final text.

However, this does not imply to set a strict equivalence between the sum of internal MREL and the external MREL. This is because the nature of internal and of external MREL are profoundly different. The external MREL allows transferring losses to external counterparties. The internal MREL, however, can be compared to a conduit allowing to shuffle losses at the point where they have to be absorbed, i.e. to the resolution entity. Contrary to the external MREL, on a consolidated basis, the internal MREL disappears and is thus not loss absorbing. A larger conduit allows to more easily upstream losses, a thinner one will act as a constraint on the upstream of losses. Yet, it is not because the conduit is larger that it will necessarily be used up to its full capacity. In addition, the shocks on the different subsidiaries may not be perfectly correlated. This means that not all the conduits would be used to their full capacity simultaneously.

2.5. SPE and ring-fencing.

The SPE strategy has never been tested and is not without risks. The SPE strategy tries to fix an important shortcoming, namely that groups become collections of legal entities in death (see e.g. Huertas, 2009). Given the difficulty to implement SPE strategies, authorities should, however, be ready to fall back on an MPE approach to resolution. This means that authorities should remain in capacity to resolve subsidiaries on a stand-alone basis if necessary.

Ring-fencing (or "safeguard") measures implemented at subsidiary level aim at maintaining this possibility. Totally removing all ring-fencing measures would have important consequences on the nature of a subsidiary both in going and gone-concern. Pushed to its extreme, this would virtually mean that a subsidiary would operate, in going concern, without any prudential requirements, including no capital requirements. In addition, in absence of liquidity requirements or limits to large intragroup exposures, the parent undertaking would have the possibility to freely transfer all the liquid assets from its subsidiaries. The parent company could also place risky assets at or originate risky assets in a subsidiary without being obliged to internally allocate enough capital reflecting the locally present economic risks. Just before the gone-concern, in absence of ring-fencing measures, the parent company could have the possibility to reallocate part of the losses between the different legal entities and thereby partially determine which creditors of the group have to absorb losses first.

Such potential abuses could be limited if the SPE was more than a presumptive path and became really enforceable in all circumstances. Reinforcing the SPE model to make it impossible to deviate from it would contribute to limit the risks of abuses and would thereby reduce the need and the incentives for ring-fencing measures. In addition, deviations from the group approach through a liquidation of legal entities under normal insolvency proceedings should also be limited and recognising the group dimension in normal insolvency proceedings is also necessary. The following section proposes two avenues to explore in order to reinforce the SPE model.

3. From a weak SPE model to a robust regime of group support

The introduction of the bank winding up directive in the European Union was justified, back in 2001, by the need to have a single insolvency procedure for a credit institution and its branches. This need resulted from the consolidated supervision exerted on the credit institution and its branches by a single supervisory authority. This is largely explained in recitals 3 and 4 of the directive:

> *"(3) This Directive forms part of the Community legislative framework set up by Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions. It follows therefrom that, while they are in operation, a credit institution and its branches form a single entity subject to the supervision of the competent authorities of the State where authorisation valid throughout the Community was granted.*
>
> *(4) It would be particularly undesirable to relinquish such unity between an institution and its branches where it is necessary to adopt reorganisation measures or open winding-up proceedings."*

We argue that developing a similar approach is also necessary for SPE groups. If we want to address the ring-fencing issue, we need to ensure that the unity between the legal entities constituting the SPE does not disappear in resolution or when the legal entities are liquidated under normal insolvency proceedings. This, however, does not imply that a harmonised and comprehensive winding-up regime should be introduced for SPE groups. Yet, some of its elements need to be considered to move from a soft weak SPE regime to a robust model of group support. These elements include (i) the introduction of a statutory recognition of support within the SPE group which would ex ante prescribe the applicable burden-sharing among the creditors on a group wide basis ; and (ii) the definition of a single bankruptcy estate for the SPE group, together with the determination of a group hierarchy of creditors in insolvency.

3.1.Statutory regime of support and burden sharing

From a conceptual standpoint, the support of the parent undertaking should be commensurate to its capacity to use the resources of its subsidiaries. Given that, in absence of any ring-fencing measures, all the resources of the subsidiary would be freely available to the parent company, it should, in theory, offer a support to its subsidiary which is (i) unlimited; (ii) unconditional, and (iii) independent from the chosen course of action (liquidation / resolution).

First, in absence of ring-fencing measures, limiting the support would indeed offer an option to the parent undertaking to benefit from the resources of its subsidiary while capping its potential liability. For instance, a support limited to a particular level, say X, might introduce perverse incentives. While the liability of the parent company would be capped to the level X, it could nonetheless draw on the resources of the subsidiary above and beyond that level.

Second, the support that a parent company offers to its subsidiary could not be subject to any condition. Subjecting the support of the parent to the satisfaction of one or several conditions would offer a way for the parent undertaking to renege on its commitment.

Finally, the support of the parent company should not depend, or be conditional on, the course of action, be it a liquidation under normal insolvency proceedings or a partial or full resolution. In practice, considering the SPE strategy remains a presumptive path, one may not exclude that it may be optimal to take resolution actions that might prevent a parent undertaking from honouring its commitment towards its subsidiaries. It might be for instance optimal for resolution authorities to resolve the group through an asset deal at the level of the parent company, where the support mechanism to the benefit of the subsidiaries would not be part of the asset deal. The commitment would indeed be left within the residual parent company which would be liquidated under normal insolvency proceedings. Considering this residual entity would be a bad bank or an empty shell, there would not be any possibility for subsidiaries to enforce the mechanism of parental support.

The current EU framework does not provide any instrument which would meet these three conditions. The solidarity between the parent undertaking and its subsidiary within a SPE currently rests on very weak instruments, such as the internal TLAC or internal MREL, which, as explained above, are exposed to legal constraints, or such as a declaration of guarantee which could lose its substance or be ineffective[25]. Yet, eliminating ring-fencing measures at the level of the subsidiary would legitimately require eliminating ring-fencing measures at the parent company level as well, in a symmetric way.

In absence of a mechanism of support, one indirect avenue to contribute enforcing the support of the parent company is to ex ante define the allocation of losses between the shareholders, the different creditors of the group and possible additional stakeholders. As explained above, the burden sharing between the different stakeholders of the group currently heavily depends on the course of action that is chosen (liquidation, SPE resolution or MPE resolution) and on the structure of the group (subsidiary or branch). Establishing a burden sharing mechanism which would not depend on the particular situation of the individual legal entities within the group at the moment of its resolution or liquidation under normal insolvency proceedings would contribute to increase certainty for all stakeholders. This burden-sharing mechanism, because it might derogate from some principles applicable in normal insolvency proceedings, should be enshrined in a specific regulation. It would define a group approach to the allocation of losses between the different creditors of the group.

The practicalities of this group burden sharing mechanism would need to be further worked out such as its legal nature, the trigger for its activation, its scope, its link with the resolution strategy, its interconnection with DGSs or its governance. However, one may already identify some general principles that would apply:

- First, the burden sharing would need to be determined on a resolution group basis. This means that the loss allocation should be determined independently of the specific situation of the different legal entities at the time of the crisis. Indeed, in absence of ring-fencing measures, the specific situation of the different legal entities of the resolution group would be the direct result of the capital and liquidity management policies implemented by the parent company. These policy choices, made by the parent company, should be irrelevant for the determination of the burden sharing, especially if these choices are not constrained.

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25 For instance, Art 7.1. of the Regulation (EU) No 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) No 648/2012 (“CRR”) allows the supervisor to waive a subsidiary of the application of its individual prudential requirements, provided certain conditions are satisfied. One of these conditions is that the parent undertaking has declared that it guarantees the commitments of its subsidiary. Such a support mechanism is however extremely weak given it may not only be difficult to enforce, but the support declaration could also be declared void.

- Second, the group loss allocation resulting from the burden sharing mechanism would need to be transparent to the group shareholders and to the creditors of its different legal entities, including to the national depositor guarantee scheme (DGS). Shareholders and creditors should be informed of their rank in the hierarchy of creditors resulting from the group burden sharing mechanism and they should be in a position to predict how losses would affect them.

- Third, the burden sharing mechanism would need to be consistent with the resolution strategy. As explained in section 2, the extent to which the loss allocation is predictable also depends on the consistency between the treatment of shareholders and creditors in resolution and their treatment in liquidation. The burden sharing mechanism should address both situations and define a loss allocation which would be similar in resolution and liquidation. If the loss allocation in resolution is significantly different from the loss allocation in liquidation, the loss allocation would not be predictable as it would depend on the choice of the resolution authority to initiate or not a resolution procedure. As a corollary, a subsidiary that is part of a resolution group should never be allowed to fail or to be resolved on a stand-alone basis if it is part of a resolution group in which ring-fencing measures would have been lifted.

- Finally, the loss allocation resulting from the burden sharing mechanism should be sufficiently fair to be accepted by all stakeholders. A fair burden sharing mechanism should acknowledge, for instance, the primary responsibility of the parent company. This means that the shareholders of the parent company and its most junior creditors should be the first to absorb losses. Furthermore, the burden sharing should be such that legal entities which are a priori less risky but become riskier because of the capital and liquidity management policies of the parent company, should absorb less losses. Their creditors, including their DGS, should therefore be less exposed in the burden sharing mechanism. In addition, it should be expected that creditors of subsidiaries (including DGSs) should not absorb more losses than equally ranked creditors at the level of the parent company[26].

A burden sharing mechanism as described above would in a sense formalise in a European context the source of strength doctrine that has been promulgated in the US. The source of strength doctrine requires that a bank holding company uses the resources in its banking and non-banking subsidiaries to support a distressed subsidiary bank (see e.g. Ashcraft, 2004).[27]

It is nonetheless important to note that a burden sharing mechanism will only be convincing and sufficiently robust in a European context provided it goes beyond the ex-ante allocation of losses among the creditors of the group. A burden sharing mechanism should also determine the burden sharing rules between national DGSs that are involved in the resolution group and should also cater for the provision of liquidity needs in resolution. In Europe, the creation of a European deposit guarantee scheme and a framework for the provision of liquidity in resolution would contribute to strengthening a comprehensive burden sharing arrangement.

Finally, the burden sharing should also address the question of the mutualisation of State aid, in the sense that, even in resolution, State aid may be needed.

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[26] This principle is already recognised for own funds instruments in EU law under article 59.7 BRRD which states that “A relevant capital instrument issued by a subsidiary shall not be written down to a greater extent or converted on worse terms […] than equally ranked capital instruments at the level of the parent undertaking which have been written down or converted.”

[27] Note that even in the US, applying the source of strength doctrine has proven difficult (see e.g. Bliss, 2005 or Kupiec and Wallison, 2015).

3.2. Group hierarchy of creditors

The burden sharing mechanism would normally be activated before the subsidiary is failing or likely to fail. However, one cannot exclude that both the parent company and the subsidiary are simultaneously experiencing difficulties. In such a case, the mechanism will materialise either in resolution or, should both entities be liquidated along normal insolvency proceedings, in liquidation.

Introducing such a mechanism of burden sharing for groups under a SPE strategy would modify the creditor hierarchy within the group, given the losses of the subsidiary would be first assumed by the parent company (i.e. its shareholders and where needed, its creditors). To avoid any problems of no creditor worse off, and to present a clean and consistent framework, it would be needed to also adapt the normal insolvency framework to take into account this new instrument of burden sharing.

Currently, the insolvency framework is still based on legal entities. That is why the SPE strategy can be enforced only within certain boundaries. In order to fully reflect the outcome of the SPE strategy and to ensure a unity of treatment in resolution and liquidation, the insolvency framework should be adapted in two ways. First the group hierarchy of creditors should be clarified. The SPE strategy assumes that the losses will be first absorbed by the shareholders and creditors of the parent company. In a sense, the new instrument of burden sharing also rests on the same assumption, which facilitates the implementation of the SPE strategy. The new group insolvency framework should clearly establish a hierarchy of creditors, which would recognise the reality of the SPE strategy and be based on the principle that, also in liquidation along normal insolvency proceedings, the creditors at the point of entry absorb losses before the creditors of the subsidiaries of the point of entry.

Establishing such a hierarchy of creditors should not be an issue when the group is structured with a HoldCo. However, when the top company is an OpCo, it introduces a difference of treatment between the creditors of the parent company and the creditors of a similar rank of its subsidiaries which could be considered too favourable for the creditors of subsidiaries. Two solutions could be envisaged to address this issue. First, a generalisation of the HoldCo model could be envisaged for SPE strategies. This would seem to be the easiest way to address this issue and this would in parallel contribute to facilitate a swifter implementation of SPE strategies. Alternatively, if the generalisation of HoldCo model is not possible, another group hierarchy of creditors could then be envisioned, where creditors of a similar rank would be treated in a similar way, independently of the legal entity which is their debtor. However, following such an avenue would require to also modify the intrinsic mechanics of the SPE so as to ensure that the burden sharing in resolution is not different than the burden sharing in normal insolvency proceedings, and this in order to minimise the risk of NCWO and of arbitrages between resolution and normal insolvency proceedings. It would require to fundamentally alter the principles currently governing the SPE strategy and to revise the resolution framework.

In parallel to the introduction of a group hierarchy of creditors, there would be a need to establish a single bankruptcy estate, composed of the assets of the parent company and of its subsidiaries. Having a single bankruptcy estate would allow to be consistent when addressing the question of the corporate interest. Given there would be a single bankruptcy estate, the corporate interest of the companies forming the group would be more easily aligned than if they each had a separate estate.

4. Conclusion

This paper analyses the two resolution strategies, i.e. the SPE and MPE models. These models have been introduced in the European Union legislative framework in 2019. Resolution authorities are obliged to define a resolution group, which forms the basis for resolution. The resolution group covers one or several legal entities that are assumed to stay together in resolution. This resolution model allows in theory to maintain the group after its failure, i.e. to give substance to the group concept in resolution.

The paper shows the potential limits of the SPE strategy and in particular that beyond a certain point, there is no certainty at all that the group structure will be maintained. In other words, there is a non-negligible probability that resolution is eventually executed at a legal entity level on an MPE basis, rather than at the resolution group level, or that legal entities composing the resolution group are liquidated along normal insolvency proceedings, i.e. on a legal entity basis.

This is not a major issue if legal entities keep their individual economic substance which individual safeguards help to preserve. However, as soon as groups interests are privileged over the interest of legal entities, this becomes a major issue, as this will determine how losses are allocated between the different entities, i.e. the burden sharing.

The paper argues that, if the European legislator has the ambition to remove ring-fencing, it should simultaneously clarify what happens when the breaking points of the SPE resolution strategy are reached (for instance, when losses at local level exceed the prepositioning), and this, especially in those cases where subsidiaries are not presumed to be separable.

This comes down to clarify the support that a subsidiary can expect from its parent company or the burden sharing. We argue that, in order to be consistent there is a need to reinforce the concept of resolution group in resolution and to recognise its existence also in normal insolvency proceedings. This would require to introduce two new elements in the European Union legislation : (i) a formal statutory instrument of support based on a burden sharing mechanism and (ii) a group hierarchy of creditors, at resolution group level.

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