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Financial Stability Board

- by email -

New York/Copenhagen, February 2nd, 2015

Dear Sir or Madam,

This letter is submitted by Jeffrey N. Gordon and W. Georg Ringe in connection with the request for comments by the Financial Stability Board (FSB) in connection with its Consultation on Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution ("the TLAC Proposal"). Gordon is the Richard Paul Richman Professor at Columbia Law School and, among other responsibilities, co-director of the Millstein Center for Global Markets and Corporate Ownership. Ringe is Professor of International Commercial Law at the Copenhagen Business School. Neither of us represents clients and or has done consulting that would be affected by the outcome of the FBS's consultation. We would like to submit two forthcoming papers that discuss aspects of the FSB's TLAC Proposal. One paper, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take*, will be published in the June 2015 issue of the COLUMBIA LAW REVIEW. Another, *Bank Resolution in Europe: the Unfinished Agenda of Structural Reform*, will be a chapter in Danny Busch & Guido Ferrarini, eds., EUROPEAN BANKING UNION (Oxford University Press 2015). Both papers are attached to this letter. They are both highly relevant to the FSB's proposal and this letter may quote from them without specific further attribution.

The TLAC proposal is part of the core message of Basel III and the general FSB program: Banks should not look to sovereigns for rescue. At one level this is a response to taxpayer outrage at "bail-outs." But even more importantly, Basel III/TLAC is shaped for a global financial environment in which no sovereign (except for the United States, as issuer of the world's reserve currency) can credibly stand behind its banking system. Many banks, especially in Europe (or any other bank-dominated economy), 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." TLAC is a response to this dilemma, and a welcome and useful addition to the framework for a global resolution standard. On top of a balance sheet structured to reduce the risk of failure -- the capital and liquidity requirements specified in Basel III – a global systemically important bank (G-SIB) must carry a level of bailin-able term debt sufficient to recapitalize the bank even after the equity cushion is fully wiped out by losses. The previous mechanism of providing systemic stability through a crisis, namely, deposit insurance – a scheme by which banks pool risks in a mutual insurance scheme run by a particular government and receive backstopping by the government as a "reinsurer" – plays no front-line role in this regulatory plan. The point is to take sovereigns out of the picture and, through bail-in, to require banks to self-insure.

This set up 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. For this reason, we think the FSB should come down more firmly on the side of a mandatory holding company structure for G-SIBs as part of the TLAC proposal, which should be coupled with a "single point of entry" (SPOE) approach to resolution. Together, these two elements would facilitate efficient resolution. Where the banking group is organized in a holding company structure, the losses of a bank operating subsidiary can be upstreamed. If the equity layer is insufficient after the resulting write-down, a regulatory authority can trigger a resolution proceeding for the parent only, in which the layer of unsecured term debt can provide additional loss absorbency. Crucially, this avoids putting an operating bank or some other operating financial entity through a resolution procedure that 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.

In our view, the SPOE approach to resolution at the holding company level has at least two additional advantages. First, it makes resolution more transparent and credible, as the bailin-able debt at the holding company level is earmarked and effectively available for regulatory activation. Different from the situation at present, both bank and 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 respective purposes. And secondly, SPOE 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 the rival "multiple point of entry" approach is that it would empower several regulators in various jurisdictions and thus create coordination problems, frictions, and a race to grab assets for the purpose of protecting national creditors. As a by-product, the proposed TLAC for material subsidiaries ("internal TLAC") would thus become redundant.

Finally, resolution through conversion of TLAC in a holding company structure minimizes the risk of destructive runs and may thus reduce the importance of deposit insurance. Under national deposit guarantee schemes, the protection of short term credit providers is incomplete. For example, deposit insurance is usually capped, at EUR 100,000 or USD 250,000. Yet banks are commonly funded through deposits over the insurance cap and other short term credit issuances. 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 rollover 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. Resolution run through a holding company offers such short term credit providers the protection of a structurally subordinated debt layer. This is the argument for a thick enough layer to provide assurance, if not insurance, of loss-protection. The other side of the argument is this: for a given level of TLAC, the holding company structure, because it facilitates efficient resolution, will provide greater systemic stability. If TLAC is costly, then increasing its systemic potency is cost-justified. Putting it differently: if all global SIBs were to use a holding company structure, the TLAC required as a worldwide standard would be significantly lower.

The superiority of the holding company approach to resolution becomes apparent in the TLAC consultative document itself, in which 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 to address home/host problems, so as to assure that "TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution." Such efforts to place not just capital but also subordinated (by contract) term debt on the balance sheet 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 interpreting the complex subordinated provisions of a bond issuance – these are sufficient to inject uncertainty that will destabilize the entire system.

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. Some governments are simply not in a position to provide such insurance, both because of financial constraints at the single country level, and, as recent debates in the European Union have demonstrated, the challenges of credible transnational support. An approach that looks to resolve particular 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 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, efficient resolution might be consistent with a banking group structured through multiple intermediate holding companies, but only 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. For banks that operate in a "single market" or find value as a world-wide integrated financial institution, a holding company structure, in which TLAC is located at the holding company level, offers the greatest chance for efficient resolution. Efficient resolution also means greater stability at a given level of TLAC.

Very truly yours,

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Bank Resolution in Europe: the Unfinished Agenda of Structural Reform

Law Working Paper N° 282/2015

January 2015

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ECGI Working Paper Series in Law

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We are grateful for very helpful comments on prior presentations of this work by participants at the European Banking Union conference that preceded this book, the ESSET seminar in Gerzensee, and the EU Financial Architecture session at the World Bank Law, Justice and Development Week Conference, and various EU and governmental officials who have given us informal reactions.

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Abstract

This chapter argues that the work of the European Banking Union 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. A holding company structure in which the public parent holds unsecured term debt sufficient to cover losses at an operating financial subsidiary would facilitate a "Single Point of Entry" resolution procedure that would minimize knock-on effects from the failure of a systemically important financial institution. Resolution through such a structure would minimize run risk from short term creditors and minimize destructive ringfencing by national regulators. Although structural reform in the EU could be achieved by supervisory implementation of the "living wills" requirement for effective resolution or irresistible incentives through capital charges, it would be best obtained through addition to the EU's Proposed Structural Measures Regulation now under consideration.

Keywords: bank resolution, bank structural regulation, single point of entry, bank holding company

JEL Classifications: G21, G33, K20

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Electronic copy available at: http://ssrn.com/abstract=2548251

Draft January 11, 2015

Bank Resolution in Europe: the Unfinished Agenda of Structural Reform

[forthcoming in Danny Busch & Guido Ferrarini, eds., EUROPEAN BANKING UNION (Oxford University Press, 2015)]

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Abstract

This chapter argues that the work of the European Banking Union 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. A holding company structure in which the public parent holds unsecured term debt sufficient to cover losses at an operating financial subsidiary would facilitate a "Single Point of Entry" resolution procedure that would minimize knock-on effects from the failure of a systemically important financial institution. Resolution through such a structure would minimize run risk from short term creditors and minimize destructive ring-fencing by national regulators. Although structural reform in the EU could be achieved by supervisory implementation of the "living wills" requirement for effective resolution or irresistible incentives through capital charges, it would be best obtained through addition to the EU's Proposed Structural Measures Regulation now under consideration.

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We are grateful for very helpful comments on prior presentations of this work by participants at the European Banking Union conference that preceded this book, the ESSET seminar in Gerzensee, and the EU Financial Architecture session at the World Bank Law, Justice and Development Week Conference, and various EU and governmental officials who have given us informal reactions.

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Introduction

This chapter argues that the work of the European Banking Union 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 European Banking Union, 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: First, 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. Second, 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." 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]

The EU currently has a Proposed Structural Measures Regulation under deliberation, which chiefly considers whether to adopt a form of the U.S. "Volcker Rule" to limit proprietary trading by large credit institutions and to require a separately capitalized subsidiary for trading activities that remain permissible.[2] 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

[1] US Gov't Accountability Office, Large Bank Holding Companies – Expectations of Government Support (GAO-14-621) July 2014. See generally on the connection between a credible resolution system and banks' risk-taking, Magdalena Ignatowski & Josef Korte, *Wishful thinking or effective threat? Tightening bank resolution regimes and bank risk-taking*, 15 J. FIN. STABILITY 264 (2014).

[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 (Jan. 29, 2014).

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(BRRD)[3] as the supervisor comes to decide that a holding company is essential for "feasibility of resolution" of a particular firm; through capital requirements under the Capital Requirements Regulation and Directive (CRR/CRD IV)[4]; 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 or the European Banking Authority, or a structurally-sensitive systemic risk assessment on a "G-SIB" (a Global Systemically Important Bank), as contemplated by Basel III. Concerns for the stability of the system as a whole – macro-prudential considerations – would argue for prescriptive 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. 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 is the missing piece of the Proposed Structural Measures Regulation and a missing piece for a credible Single Resolution Mechanism in the European Banking Union.

The Regulatory Aftermath of 2007/08 and the Emergence of EU Bank Resolution

The financial crisis that began in 2007 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 catalyzed an unprecedented regulatory outpouring. Shortly after the financial crisis exploded in September 2008 with the bankruptcy of Lehman Brothers, President Bush convened a meeting of the leaders of the 20 most significant global economic players, both developed and emerging market countries, the so-called G-20.[5] 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 coordination in the following decade. But the financial crisis showed the value of global financial coordinating

[3] 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, [2014] OJ L173/190.

[4] Capital Requirements Regulation and Directive: Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV); Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR).

[5] See Colin I. Bradford, Johannes F. Linn & Paul Martin, Global Governance Breakthrough: The G20 Summit and the Future Agenda Brooking Policy Brief No. 168 (Dec. 2008), available at www.brookings.edu/research/papers/2008/12/g20-summit-bradford-linn.

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

Beginning with the November 2008 Leaders' Summit, and continuing through eight successive summits over six 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," tasked with a major agenda-setting role.[6] The Basel Committee on Banking Stability, the international standard setting body of central bankers that had labored for six years to produce the Basel II accords,[7] 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. By the end of 2018, all global banks will 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 3%, 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."[8]

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.[9] The Financial Stability Board produced a guidance document, "Key Attributes of Effective Resolution Regimes for Financial Institutions," in October 2011, reflecting and shaping this consensus.[10] This influential guidance contemplated an administrative receiver with significant discretionary authority, modeled on the U.S. Federal Deposit Insurance

[6] See James R. Barth et al., *Systemically Important Banks (SIBs) in the Post-Crisis Era: 'The' Global Response, Reponses Around the Globe for 135 Countries*, in Allen N. Berger, Philip Molyneux & John O.S. Wilson, eds., THE OXFORD HANDBOOK OF BANKING (Oxford University Press, 2nd edition 2014), chapter 26 (describing G20-FSB interaction and initiatives); Daniel E. Nolle, *Who's in Charge of Fixing the World's Financial System? The Un[?]der-Appreciated Lead Role of the G20 and the FSB*, in 24 FINANCIAL MARKETS, INSTITUTIONS & INSTRUMENTS 1 (2015).

[7] Daniel K. Tarullo, BANKING ON BASEL (2008).

[8] For a general summary see Mark Carney, *The Future of Financial Reform* (Bank of England, Nov. 17, 2014), www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf; Paul Tucker, *Regulatory Reform, Stability, and Central Banking* (Brooking W.P. Jan. 16, 2914), www.brookings.edu/~/media/Research/Files/Papers/2014/01/16%20regulatory%20reform%20stability%20central%20banking%20tucker/16%20regulatory%20reform%20stability%20central%20banking%20tucker.pdf; Jaime Caruana, *Building a Resilient Financial System* (Bank for International Settlements, Feb. 7, 2012), www.bis.org/speeches/sp120208.pdf.

[9] 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." Tucker, *supra* note 8, at 6.

[10] At www.financialstabilityboard.org/wp-content/uploads/r_111104cc.pdf?page_moved=1 (updated as of October 2014). See also Financial Stability Board, Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies (July 16, 2013), www.financialstabilityboard.org/wp-content/uploads/r_130716b.pdf.

Corporation. It also contemplated advance planning by large financial institutions that would facilitate an orderly resolution process, so-called "living wills," modeled after comparable provisions of the U.S. Dodd-Frank Act.[11] The companion element of this consensus, so-called "bail-in," is now reflected in the Financial Stability Board's proposal at the November 2014 G-20 Leaders Summit for "Total Loss Absorbency Capacity" ("TLAC") (roughly, equity plus subordinated term debt) scaled to a least twice the amount of required equity capital on both risk-weighted and leverage measures.[12] 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.[13] 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.

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 European Banking Union. In the effort to mitigate the threat to European banks as the global financial crisis unfolded in fall 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.[14] 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.[15] 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

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[11] Dodd-Frank Act, § 165(d).

[12] Financial Stability Board, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution – Consultative Document (Nov. 10, 2014), www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

[13] Id., at 13. The threshold limits were based on calculation of losses during the recent financial crisis in an earlier consultation document. See Financial Stability Board, Issues for Consideration in the Development of a Proposal on Adequacy of Loss Absorbing Capacity in Resolution (memo to Steering Committee, SC/2013/45, Dec. 18, 2013).

[14] The European Commission has recently estimated the level of State aid as EU 4.9 trillion (39% of EU GDP), of which EU 1.7 trillion (13.5% of EU GDP) was actually deployed. Guarantees and liquidity support maxed out in 2009 at EU 906 billion, (7.7% of EU GDP). See also High-level Expert Group on Reforming the Structure of the EU Banking Sector (the "Liikanen Report) 20-25, http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.
The Liikanen Report also provides a useful account of the Eurozone crisis of 2010-2012. Id., at 8-11.

[15] See Alberto Gallo and others, The Revolver – European banks: Still too big to fail, RBS Macro Credit Research, January 23, 2014, available at <http://cfa.wpengine.netdna-cdn.com/marketintegrity/files/2014/03/Alberto_Gallo_The_Revolver.pdf>.

weighting for OECD sovereign debt (which permitted banks to earn a "risky" spread on purportedly risk-free assets[16]) 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 2010-12 period, an on-going 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 IMF and the EU and liquidity support from the ECB, in exchange for an austerity program 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 bailout/haircut terms were protracted, a grueling six months over the October 2011-March 2012 period.

This was the crucible within which the European Banking Union was formed.[17] Its creation has been described as a "revolution" and the "most ambitious project since the creation of the euro."[18] What does "Banking Union" entail? In critical part it means a "Single Supervisory Mechanism" through which the European Central Bank organizes the supervision of all "significant" banks in the Eurozone, and a "Single Resolution Mechanism" ("SRM") that

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[16] See Viral V. Archarya & Sascha Steffen, The "Greatest" Carry Trade Ever? Understanding Eurozone Bank Risks, NBER Working Paper 19039 (May 2013); Daniel Gros, Banking Union with a Sovereign Virus: The Self-serving Treatment of Sovereign Debt, Intereconomics 2/2013, p. 94.

[17] The relevant history with supporting footnotes and more detail is described in Jeffrey N. Gordon & Wolf-Georg Ringe, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take*, forthcoming 2015 COLUMBIA LAW REVIEW. The following paragraphs draws from that paper.

[18] Commissioner Michel Barnier, *The EU and US: leading partners in financial reform*, Speech at the Peterson Institute for International Economics, Washington DC, June 13, 2014, available at <http://europa.eu/rapid/press-release_SPEECH-14-465_en.htm?locale=en>.

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 Single Resolution Mechanism was a highly controversial element of Banking Union. This was for two reasons. First, the SRM would put the fate of a national champion bank in the hands of 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, for example, concessionary loans that do not appear on the public balance sheet, or public finance, a guaranteed purchaser of government debt. Second, the SRM came packaged with a funding mechanism, the Single Bank Resolution Fund, which contemplated at least EU 55 billion (ultimately1 percent 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 signoff 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.[19] 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 European Banking Union 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 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.

[19] 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 EZ member states, which controls allocations from the Fund.

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 "bailout" 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 United States, 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 bailin-able term debt sufficient to recapitalize the bank even after the equity cushion is fully wiped out by losses.[20] 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 in this regulatory plan. The point is to take sovereigns out of the picture and, through bail-in, to require banks to self-insure.

This set up 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,"[21] have a complex organizational structure in which various financial services are provided by divisions of the bank or through subsidiaries of the bank.[22] Putting an operating bank or some other operating financial entity through a resolution procedure

[20] 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").

[21] See Jordi Canals, UNIVERSAL BANKING (1997).

[22] See James R. Barth, Daniel E. Nolle & Apanard Prabha, *Banking Structure, Regulation, and Supervision in 1993 and 2013: Comparisons Across Countries and Overtime*, 13 J. INT'L. BUS. & L. 231 (2014) (Table 4); World Bank Bank Regulation and Supervision Survey (2011), http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html; James R. Barth et al. Commercial Banking Structure, Regulation and Performance: An International Comparison Office of the Comptroller of the Currency, E&PA Working Paper 97-6, March 1997, www.occ.gov/publications/publications-by-type/economics-working-papers/1999-1993/working-paper-1997-6.html. (Tables 5, 6a, 6b). Richard J. Herring & Anthony M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 J. FIN. RES. SERVICES 471, 481-489(1990); Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety and Soundness*, in A. Berger, P. Molyneux, and J. Wilson, eds., THE OXFORD HANDBOOK OF BANKING (2010).

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.

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," EUR 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. 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 rollover 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 consultative document itself, in which 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 to address home/host problems, so as to assure that "TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution."[23] Such efforts to place not just capital but also subordinated (by contract) term debt on the balance sheet 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 interpreting the complex subordinated provisions of a bond issuance – these are sufficient to inject uncertainty that will destabilize the entire system.

The European approach to resolution is commonly referred to a "Multiple Points of Entry" ("MPOE"), 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 ("SPOE"), a strategy employed by the FDIC that is designed to minimize value destructivity during the resolution process. The difference between SPOE and MPOE is precisely structural: because the public parent, a top level holding

[23] See *supra* note 12.

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. MPOE, 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 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, MPOE 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.[24] As described by the Financial Stability Board, MPOE is "suitable for firms with a decentralised structure and greater financial, legal and operational separation along national or regional lines, with sub-groups of relatively independent, capitalised and separately funded subsidiaries."[25] 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 European Banking Union 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

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

[25] Financial Stability Board, Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies (July 16, 2013), www.financialstabilityboard.org/wp-content/uploads/r_130716b.pdf.

organizational change to the holding company form that enables SPOE is a commitment to "European banking" as well as a mechanism that will facilitate credible resolution.

In sum, the SPOE approach to resolution at the holding company level has a number of distinct advantages.[26] First, it makes resolution more transparent and credible, as the bailin-able debt at the holding company level is earmarked and effectively available for 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.[27] Secondly, SPOE 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 MPOE approach is that it would empower several regulators in various jurisdictions and thus create coordination problems, frictions, and a race to grab assets for the purpose of protecting national creditors.[28] Finally, and most importantly, the SPOE 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 SPOE regulatory framework, the overall creditor losses associated with the resolution will be much less than in an uncoordinated 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 SPOE 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 EU as the missing element of European Banking Union.

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[26] In most recent policy initiatives, SPOE is given preference over MPOE. See, e.g. Finma, *Resolution of global systemically important banks – FINMA position paper*, August 7, 2013; Martin J. Gruenberg, FDIC Chairman, Comments to the Volcker Alliance Program Washington, D.C. (October 13, 2013), available at <https://www.fdic.gov/news/news/speeches/archives/2013/spoct1313.html>; FDIC and Bank of England, RESOLVING GLOBALLY ACTIVE, SYSTEMICALLY IMPORTANT, FINANCIAL INSTITUTIONS (December 10, 2012), available 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?* (September 11, 2014), available at <http://www.scoperatings.com/study/download?id=c2da6224-fa08-491c-aed2-93fa2de5eebe&q=1>.

[27] 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, *id.*, at p. 2.

[28] See European Parliament, Directorate General for Internal Policies, SINGLE RESOLUTION MECHANISM – NOTE (February 2013), at p. 13.

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 Federal Deposit Insurance Corporation ("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 services.[29] 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.[30] The problem with the ad hoc approach was not just that it might omit important cases (e.g., 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 lead to insolvency at other firms, potentially engulfing the financial sector, with 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%,[31] 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 various

[29] For a fuller account of the FDIC's authority and bank resolution practices before the financial crisis, see Gordon & Ringe, *supra* note 17.
[30] The FDIC's (and Fed's) authority) with respect to these rescues (and non-rescues) is discussed in Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. REG. 185-190 (2011).
[31] For a detailed analysis of the Lehman Bankruptcy, see Michael Fleming & Asani Sarkar, The Failure Resolution of Lehman Brothers, Fed. Res. Bank NY, 20 Econ. Policy Rev. March 2014, available at <http://www.newyorkfed.org/research/epr/2014/1403flem.pdf>.

immediate default triggers and permitted the FDIC to transfer such contracts (appropriately bundled) to a successor financial firm.[32] 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 longterm assets of uncertain value.[33] 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.[34] The FDIC has produced regulations with a "short term creditors first" credo.[35] 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.[36] 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 different 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 insists that taxpayers come ahead of creditors, and, at several turns, wants to avoid "bailouts."

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.[37] This means that a failed foreign subsidiary, for example, UK Lehman Brothers, would be subject

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[32] Dodd Frank Act, §§ 210(c)(8),(9),(13).
[33] See Adam Copeland et al, *Key Mechanics of the U.S. Tri-Party Repo Market*, FRBNY ECON. POLICY REV. (Nov. 2012) 17-28.
[34] Id., § 210(c)(4).
[35] 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 Oct. 12,2010) (proposing 12 C.F.R, pt. 380.2).
[36] Id., §§ 204, 210(n)(9), (o).
[37] Id., § 210 (a)(1)(E)(i).

to the bankruptcy (or other resolution regime) of the host country, with the consequence of destabilizing uncertainty.

SPOE was devised as the way to square these several circles. SPOE takes advantage of the characteristic organizational form of the largest financial firms in the United States, 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 Financial Stability Board during the period when the international consensus on resolution emerged, describes the SPOE 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 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.[38]

Because the Dodd-Frank Act speaks in terms of "orderly liquidation" rather than "orderly resolution, the US variant of SPOE has a twist: the FDIC will impose a receivership on the failed SIFI (HoldCo) and then transfer its assets to a successor bridge bank, "BridgeCo." HoldCo will

[38] Tucker, *supra* note 24, at 2-3.

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.[39] 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 U.S.[40] 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."[41]

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. 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 SPOE 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.

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[39] 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 & Carmassi, *supra* note 22, 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 SPOE effective.

[40] Some material in this paragraph and the next several follow Gordon & Ringe, *supra* note 17.

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

An additional powerful feature of the SPOE 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 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 cooperation 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 cooperate 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."[42]

To use the Lehman example, in an SPOE world, Lehman UK would never have faced U.K. insolvency proceedings, because the FDIC would have assured its solvency and liquidity.[43] The Clearing House Association L.L.C. organized and conducted a comprehensive and sophisticated simulation exercise of the operability of SPOE per the FDIC's model in November 2012.[44] This important test for the new system confirmed that SPOE 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 above, 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%.[45] These figures and test results are so compelling that the U.S. is currently negotiating agreements

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[42] FDIC and Bank of England, Resolving Globally Active, Systemically Important, Financial Institutions Par. 49 (December 10, 2012), 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.

[43] This is at least the hope. We can't 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.

[44] The Clearing House, Report on the Orderly Liquidation Authority Resolution Symposium and Simulation, January 2013, available via www.theclearinghouse.org.

[45] See FDIC Press Release describing the Lehman OLA report, 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.

with other countries – including Germany and Switzerland – with a view to reach similar agreements to the one in place with the UK.[46]

The US Path to Holding Companies

A critical institutional feature for the success of SPOE is a top level holding company whose assets consist primary of equity and intra-company debt claims in its operating subsidiaries and whose liabilities consist principally of non-runnable term debt. Large bank-centered financial companies in the United States are invariably organized in the holding company form, indeed, as "bank holding companies" (BHC). This result derives from regulatory path dependence rather than a prior view about the optimal form of financial firm organization.[47] Until approximately twenty years ago, the U.S. financial sector was highly balkanized. Bank expansion was limited by highly restrictive branching laws that limited interstate banking, even intrastate banking.[48] The "business of banking" was narrowly defined to exclude banks from the provision of many financial services.[49] And commercial banks were famously barred from engaging in securities underwriting and other investment bank activity by the Glass-Steagall Act.[50] The result was a relatively small number of "money center" banks, thousands of "unit banks," and many thousands of different financial service providers.[51]

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.[52] In 1956 the holding

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[46] FDIC Chairman Martin J. Gruenberg at the Clearing House Annual Conference in New York, November 21, 2013, www.bloomberg.com/video/fdic-s-gruenberg-on-resolution-strategy-for-banks-g5YN2PiESFyCrIsIuANWJQ.html.

[47] The following text draws from many sources, including Saule T. Omarova & Margaret Tahyar, *That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States*, 31 REV. BANKING & FIN. L. 113 (2011); Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risk*, 2002 UNIV. ILL. L. REV. 215 (2002); Charles C. Calomiris, BANK DEREGULATION IN HISTORICAL PERSPECTIVE (2000); Charles C. Calomiris & Stephen H. Haber, FRAGILE BY DESIGN (2014); Richard S. Carnell, Jonathan R. Macey & Geoffrey P. Miller, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS (4th ed. 2009). From some quantification, see Dafna Avraham et al., *A Structural View of U.S. Bank Holding Companies*, FRBNY ECONOMIC POLICY REVIEW (July 2012) 65-81.

[48] See, e.g., the McFadden Act of 1933, 12 U.S.C. § 36.

[49] See 12 U.S.C § 23(7).

[50] See §§ 16, 20, 21, 32, Banking Act of 1933, codified respectively at 12 U.S.C §§ 24 (Seventh),377, 378, 78; Inv. Co. Instit. v. Camp, 401 U.S. 617 (1971) (providing capacious reading of Glass Steagall).

[51] See Omarova & Tahyar, *supra* note 47, at 10.

[52] Compare 12 U.S.C. § 24 (Seventh). See generally Carnell et al., *supra* note 47, at 485-494.

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."[53] 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 broaden 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.[54] 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.[55]

The point is this: the evolution of the U.S. 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 SPOE. We now explore how the E.U.'s bank structural reform project, the so-called "Liikanen process," could be turned in this direction.

SPOE for Europe: the Structural Reform Project

Returning to Europe, we can think of several ways of achieving the holding company structure that would facilitate SPOE 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)[56]. 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).[57] This is similar to the approach Swiss authorities have

[53] Bank Holding Company Act of 1956, 12 U.S.C. § 1841. See also Carl A. Sax & Marcus H. Sloan III, *The Bank Holding Company Act Amendments of 1970*, 39 GEO. WASH. L. REV. 1200 (1970).
[54] See generally, The Graham-Leach-Bliley Act of 1999, Pub. L. 106-102. Specifically, 12 U.S.C §§ 843(k) (4)(H), (I).
[55] See §§ 23A, 23B, 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*, 89 N.C. L. REV. 1683 (2011).
[56] See *supra* note 3. On this concept, see Jens Hinricht Binder, *Resolution Planning and Structural Bank Reform within the Banking Union*, in: Juan Castaneda et al., eds., EUROPEAN BANKING UNION. PROSPECTS AND CHALLENGES (forthcoming 2015).
[57] See *supra* note 4.

used to nudge UBS and Credit Suisse into holding company structures.[58] Third, 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 – macro-prudential 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 confined to unsecured term debt. This is the missing piece of the Proposed Structural Measures Regulation and a missing piece for a credible Single Resolution Mechanism in the European 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,[59] 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 enterprise -- and investment banking activities.[60] In the UK model, "core" banking activities will be housed in a separately capitalized, separately governed ring-fenced bank; all the rest will be housed 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.

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[58] James Shotter, *Credit Suisse to overhaul structure*, FINANCIAL TIMES, Nov. 21, 2013.
[59] Dodd-Frank Act § 619.
[60] For elaboration on the various structural reform proposals in the EU and US, see John Armour et al, PRINCIPLES OF FINANCIAL REGULATION, ch. 22 (forthcoming 2015); Financial Stability Board, STRUCTURAL BANKING REFORMS – CROSS-BORDER CONSISTENCIES AND GLOBAL FINANCIAL STABILITY IMPLICATIONS: REPORT TO THE G20 LEADERS FOR THE NOVEMBER 2014 SUMMIT (October 27, 2014).

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.[61] 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 fragmentation to cross-border banking within the EU. 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.[62] 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.[63]

The problem with the proposed Structural Measures Regulation is that it is, in a fundamental way, backwards looking. It contemplates that (i) investment banking activity is the major threat to the stability of a banking group, (ii) that the deposit bank at the center 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 the write-downs in connection with the recent Asset Quality Review demonstrated, Eurozone banking groups continue to be hampered by bad loans carried on the bank balance sheet, not investment bank trading losses.[64] The failure of a separate

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[61] High-level Expert Group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen, FINAL REPORT (2012), available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

[62] 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 (Jan. 29, 2014).

[63] "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." Structural Measures to Improve the Resilience of EU Credit Institutions – Frequently Asked Questions, Jan. 29, 2014, http://europa.eu/rapid/press-release_MEMO-14-63_en.htm?locale=en.

[64] www.ecb.europa.eu/press/pr/date/2014/html/pr141026.en.html

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 Euro area has increased, in absolute terms as well as a percentage of debt.[65] 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 is 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 Single Resolution Mechanism, 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 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 first, minimizing the disruption to the financial businesses within the group, and second, 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 SPOE 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 SPOE 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 [H]oldco didn't have sufficient bonds in issue to cover the group's losses, so that ailing subsidiaries ended up going into resolution too.[66]

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

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[65] European Central Bank, BANKING STRUCTURES REPORT, Nov. 2013, 31, Chart A.6, www.ecb.europa.eu/pub/pdf/other/bankingstructuresreport201311en.pdf
[66] See Tucker, *supra* note 24.

limitations, cannot be used to provide bail-in coverage for a subsidiary whose problems exceed its own TLAC.

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 reduce the likelihood of another taxpayer bailout. As a by-product, it would also facilitate transatlantic coordination of resolution policies.

The flipside of our argument is that structural reform in EU banking regulation has aimed at the wrong target. The proposed Structural Measures Regulation should be revised. 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 bailin-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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Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take

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Draft of January 31, 2015

Forthcoming June 2015 COLUMBIA LAW REVIEW

Abstract: The project of creating a Banking Union is designed to overcome the fatal link between sovereigns and their banks in the Eurozone. As part of this project, political agreement for a common supervision framework and a common resolution scheme has been reached with difficulty. However, the resolution framework is weak, underfunded and exhibits some serious flaws. Further, Member States' disagreements appear to rule out a federalized deposit insurance scheme, commonly regarded as the necessary third pillar of a successful Banking Union.

This paper argues for an organizational and capital structure substitute for these two shortcomings that can minimize the systemic distress costs of the failure of a large financial institution. We borrow from the approach the Federal Deposit Insurance Corporation (FDIC) has devised in the implementation of the "Orderly Liquidation Authority" under the Dodd-Frank Act. The FDIC's experience teaches us three important lessons: first, systemically important financial institutions need to have in their liability structure sufficient unsecured (or otherwise subordinated) term debt so that in the event of bank failure, the conversion of debt into equity will be sufficient to absorb asset losses without impairing deposits and other short term credit; second, the organizational structure of the financial institution needs to permit such a debt conversion without putting core financial constituents through a bankruptcy or other resolution process, and third, a federal funding mechanism deployable at the discretion of the resolution authority must be available to supply liquidity to a reorganizing bank. On these conditions, a viable and realistic Banking Union would be within reach—and the resolution of global financial institutions would be greatly facilitated, not least in a transatlantic perspective.

Keywords: banking resolution, banking union, deposit guarantee, bail-in, centralization, political economy

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Jeffrey N. Gordon* **& Wolf-Georg Ringe****

INTRODUCTION

The European Union is currently assembling the components of a Banking Union, mostly in order to break the close link between banks and their sovereigns, which proved almost deadly during the 2007--2009 Global Financial Crisis. The creation of the Banking Union has been described as a "revolution" and the "most ambitious project since the creation of the euro".[1] Yet the project is fraught with difficulties, and initial enthusiasm is long gone. Although the prevailing view holds that an effective Banking Union requires three pillars---supervision, resolution, and deposit guarantee---the current political situation suggests that all three pillars are unlikely to be achieved. Agreement for a common supervision framework has been reached with some difficulty, but agreement on a centralized bank resolution mechanism was much more complicated than anticipated. In particular, the funding of the resolution mechanism proved to be very controversial, and the outcome jeopardizes the credibility of its operation. Further, some E.U. Member States have made it clear that they are not at all willing to support calls for a joint deposit guarantee scheme, and the third pillar has now been dropped accordingly.[2]

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We are grateful for very helpful comments by Barry Adler, Ido Baum, Jens-Hinrich Binder, Simon Gleeson, Thomas Huertas, Kate Judge, Jan Pieter Krahnen, Maria Nieto, Thomas Ordeberg, Katharina Pistor, Emiliano Tornese, Eddy Wymeersch, Finn Østrup, as well as participants of workshops and seminars at Oxford University, ETH/NYU, Columbia Law School, Study Center Gerzensee, University of Amsterdam, the LMU Center for Advanced Studies, Radboud University, the Frankfurt House of Finance and Tübingen University.
[1] Commissioner Michel Barnier, *The EU and US: leading partners in financial reform*, Speech at the Peterson Institute for International Economics, Washington DC, June 13, 2014, available at http://europa.eu/rapid/press-release_SPEECH-14-465_en.htm?locale=en.
[2] John O'Donnell & Tom Körkemeier, Europe strikes deal to complete banking union, Reuters (March 20, 2014, 1:57 P.M.) http://www.reuters.com/article/2014/03/20/eu-bankingunion-idUSL6N0MH1ZM20140320 ("Neither will there be any joint protection of deposits.").

This Essay uses a transatlantic perspective on bank resolution, drawing from the peculiar U.S. financial history, legislation, and administrative experience of the Federal Deposit Insurance Corporation (FDIC), to suggest a way to make resolution in the European Banking Union credible. The key insight this Essay contributes to the debate is to suggest an approach to resolution that is similar to the FDIC's implementation strategy under the Dodd-Frank Act. This strategy has two main ingredients: first, applying a single-point-of-entry approach (SPOE) to large financial institutions organized in holding company form, and second, to combine this with the authority to subject unsecured term debt at the holding company level to bail-in powers. If one of the operating subsidiaries runs into serious trouble, the losses can be moved upstream to the holding company, where existing equity is written down and remaining losses are imposed on debt holders, in a bail-in process that avoids a taxpayer bailout.

This approach would have three major advantages over the current state of play.

(1) First, this proposal would advance the overall objective of the Banking Union by making the resolution pillar credible even where the sovereign is weak. In essence, what we are proposing is mandatory *self-insurance* for systemically important financial institutions (SIFIs) instead of recourse to limited state resources. If a SIFI has in its liability structure sufficient subordinated term debt, in the event of bank failure the conversion of debt into equity will be sufficient to absorb asset losses without impairing deposits and other short-term credit. The advantage of targeting resolution at the holding company level is that the operating subsidiaries of the banking group can carry on and will not be disrupted.

(2) The second advantage is that a banking resolution pillar strengthened in this way would make the Banking Union operational without need to rely on the third pillar, deposit guarantee. That is, our concept of *self-insurance* would make the Banking Union altogether less dependent on *state insurance*. As we noted previously, the current political situation in Europe means that a full-fledged Banking Union with all three pillars is extremely unlikely, in particular due to resistance from Germany. Furthermore, recent policy documents no longer refer to the deposit guarantee pillar. In this political deadlock, a self-insurance resolution mechanism would overcome the sensitive issue of mutualization of debt.[3] From a political economy perspective, a proposal that requires SIFIs to self-insure against failure should also be much easier to achieve than an expensive state-financed resolution process, let alone a bailout program.

(3) Finally, a self-insured SIFI resolution mechanism along the lines we suggest should make it possible for financial institutions to be resolved successfully even *on a global stage*. The SPOE approach concentrates the resolution mechanism at the parent company level, avoiding the

[3] A deposit insurance fund pools the risk of bank failure and covers depositor losses at a failed bank by premiums contributed by other banks. Risk is thus "mutualized." Some think of this as a form of cross-subsidy. Unsecured term debt at the holding company level protects depositors of a failed subsidiary bank through a form of self-insurance.

need for resolution of diverse national subsidiaries and thus avoiding the disruptive disintegration of a cross-border financial institution. Regulators worldwide have confirmed that they prefer the SPOE strategy over its post-crisis competitor, the Multiple Point of Entry approach (MPOE). The Swiss banking watchdog Finma has recently stated its preference is for the SPOE system,[4] as have the German BaFin[5] and the Bank of England and the FDIC in a joint statement.[6] The alternative MPOE approach would require cooperation and joint action of several regulators, which would create information problems and follow-up costs: Essentially, the SIFI would fragment during a resolution process. If regulators worldwide could agree on the SPOE as a global standard, the current pressure by U.S. regulators for foreign banks to operate in the U.S. through intermediate holding companies might well be relaxed.[7]

This paper is organized as follows. Part I describes the current efforts in Europe to create a Banking Union and demonstrates the politically uncertain future of all three pillars. Policymakers face the critical questions of whether the newly adopted resolution mechanism can credibly introduce market discipline and whether a two-pillar Banking Union—consisting only of common supervision and resolution but not deposit guarantee—can operate satisfactorily in practice.

Part II then turns to the U.S. developments to suggest an institutional alternative. We explain the rise of deposit insurance as the resolution backstop for SIFIs and the way its limits were exposed by the financial crisis. The consequence was the adoption of Title II of the Dodd-Frank Act, which put in place "Orderly Liquidation Authority" (OLA), a resolution mechanism for SIFIs administered by the FDIC. OLA transcended deposit insurance in two important ways. First, Title II covers non-depository institutions as well as banks. Second, an explicit legislative goal was to force *creditors* to realize losses in resolving the particular failed institution, rather than mutualizing such losses through use of a deposit insurance fund.

Part III explains how the FDIC in its implementation of OLA has planned an implicit bail-in strategy that imposes losses on unsecured term creditors while protecting depositors and all other short term credit providers without recourse to the deposit insurance fund. The FDIC

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[4] FINMA, Resolution of Global Systemically Important Banks: FINMA Position Paper on Resolution of G-SIBS 3 (2013), available at http://www.finma.ch/e/finma/publikationen/Documents/pos-sanierung-abwicklung-20130807-e.pdf.
[5] See Martin J. Gruenberg, FDIC Chairman, Remarks to the Volcker Alliance Program Washington, D.C. (Oct. 13, 2013), available at https://www.fdic.gov/news/news/speeches/archives/2013/spoct1313.html (noting BaFin's approval).
[6] FDIC & Bank of England, Resolving Globally Active, Systemically Important, Financial Institutions 1 (2012), available at http://www.fdic.gov/about/srac/2012/gsifi.pdf.
[7] See Federal Reserve System, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17240, 17242 (March 27, 2014) (codified in 12 CFR § 252.153.) (discussing intermediate holding company requirement for large foreign banks); Daniel K. Tarullo, Regulating Large Foreign Banking Organizations (March 27, 2014), available at http://www.federalreserve.gov/newsevents/speech/tarullo20140327a.htm (same)..

strategy is facilitated by the holding company structure that characterizes large U.S. financial institutions. Upon the imminent failure of a SIFI, the FDIC would initiate an OLA proceeding through a "single point of entry," putting only the holding company ("Topco") into receivership. This makes it possible to avoid resolution or a disruptive bankruptcy for all subsidiaries, including banks and foreign affiliates. It would thus be easier to protect short-term creditors, including uninsured depositors, who typically are claimants at the operating subsidiary level. Topco (or its immediate successor, "Bridgeco") would then be recapitalized through conversion of its unsecured term debt into equity; its liquidity needs would be satisfied through advances funded by the FDIC's borrowing from the U.S. Treasury and through FDIC guarantee of obligations issued by the reorganizing entity. The effectiveness of such a resolution strategy would require prior regulation of the holding company balance sheet, to assure a sufficiently thick layer of unsecured term debt.

This structure has a double genius: First, a large financial institution can be resolved in a way that minimizes own-firm losses as well as other-firm contagion deriving from the resolution itself. This is because the structure mitigates run-risk that leads to fire sale asset dispositions and avoids operating subsidiary disruption that erodes franchise value. Second, with this structure in place, a large financial institution can be resolved, and depositors protected, without recourse to the deposit insurance fund. This is because deposits will be senior to the subordinated term debt, the conversion of which into equity will absorb losses. Note that anticipated minimization of own-firm losses will reduce the thickness of the term debt cushion necessary to make the resolution successful. In short, the U.S. experience teaches that deposit insurance is neither sufficient nor necessary for successful resolution of a large financial firm.

Part IV briefly explores the history of U.S. banking organization; specifically it explores how the holding company structure of significant financial institutions became the common pattern. Evolution of European financial firms to a similar pattern would enable use of the FDIC SPOE approach.

The paper subsequently returns to Europe and applies the insights from the U.S. context. Part V briefly describes the strategies that have been employed by E.U. Member States to address failing banks, including the newly-adopted E.U. directive on bank resolution[8] and, for systemically important banks, the newly-created set-up for a Single Resolution Mechanism (SRM).[9] These proposals and plans are then evaluated against a proposal modeled on the FDIC's approach under OLA.

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[8] This is the Bank Recovery and Resolution Directive, 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, [2014] OJ L173/190.

[9] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework

Part VI applies the fruit of our comparative focus to propose how the SRM can become more effective operationally, which would make "resolution" a more credible disciplinary device and thus strengthen the Banking Union.. Drawing on the U.S. experience, this Essay argues for (i) a capital structure for European SIFIs that includes sufficient unsecured term debt so that a "bail-in" resolution can provide a form of self-insurance of bank deposits and (ii) reorganization of systemic important European financial firms into holding companies that would facilitate SPOE resolution strategies. These elements are complementary, because the reorganization proposal facilitates effective use of the bail-in resolution strategy. We then chart a path through the existing European institutional framework that would make this approach possible.

I. The Plans for Creating a European Banking Union

This Part describes the establishment of a "European Banking Union," initially comprising three pillars—supervision, resolution and deposit guarantee. This remarkable project can be understood only by appreciating the problems European banks faced during the Global Financial Crisis of 2007-09 and then the follow-on Eurozone sovereign debt and banking crisis of 2010-2013.

The failure of Lehman Brothers in the Fall of 2008 triggered the acute phase of what is commonly regarded as the worse financial crisis since the Great Depression. Lehman's bankruptcy led to a multi-faceted run that quickly froze credit markets. Banks faced large losses, realized and unrealized, across diverse asset classes, especially real estate. The crisis imperiled financial institutions worldwide, especially in the U.S. and the E.U., whose financial sectors were most closely linked. In most cases, the response of governments was to bail out their banks with taxpayers' money, bowing to a well-placed fear of generalized financial sector collapse that would debilitate the real economy. In the U.S., for example, Congress anted up $700 billion through the Trouble Assets Relief Program; the FDIC provided loan guarantees to financial institutions of up to $1.5 trillion; the U.S. Treasury guaranteed money market funds of with outstanding obligations of $3.5 trillion; and the Federal Reserve created multiple liquidity facilities (with generous collateral conditions) with potential commitments of up to $7 trillion. Upon the U.S. Treasury's successful implementation of credible bank stress tests, the financial crisis ended in the United States in March 2009.[10]

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of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, [2014] OJ L225/1.

[10] For a general account, see Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: The Case for a Systemic Emergency Insurance Fund, 28 Yale J. Reg. 151, 164 & n.25, 192 n.32 (2011). For an insider's account of the U.S. Government's response, see generally Timothy Geithner, Stress Test: Reflections on Financial Crises (2014).

The European response to the crisis has been a play in two acts.[11] Act One was the immediate post-Lehman rescue of national banks by Member States. Act Two is the ongoing sovereign debt/banking crisis that particularly affects the Eurozone. Throughout, the E.U. has faced two distinct problems that interact. First, credit intermediation in Europe is heavily bank-based; a consequence is that banking assets (by country) are a multiple of national GDP, so that rescuing the banking sector through national guarantees seemed likely to exceed the fiscal capacity for some Member States.[12] Second, zero risk-weighting under the Basel rules for OECD sovereign debt and implicit sovereign debt guarantees associated with the European Monetary Union encouraged banks prior to the financial crisis to add sovereign assets.[13] As the crisis unfolded, mounting evidence of bad (private) assets on bank balance sheets made it more likely that explicit and implicit state guarantees would be called upon, which eroded the safety of sovereign debt.[14] In turn, increasing sovereign default risk eroded the quality of bank balance sheets, heavily-laden with sovereign debt, raising the specter of bank insolvency. Banks pulled back from lending to fortify their balance sheets; the resulting credit rationing fed economic contraction, which damaged national fiscal stability because of reductions of tax receipts and increases in stabilizing transfer payments. Such fiscal imbalances heightened sovereign credit risk. Banks and sovereigns in the E.U. were linked in a destructive spiral. The establishment of the European Banking Union was a desperate effort to sever that link.[15]

Ever since the initial wave of state interventions in Fall 2008, academics, regulators, and policymakers have deplored the lack of alternatives to the bail-out programs, pressing for the adoption of restructuring tools that could "resolve" a large failing bank or other financial

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[11] In Part V we describe the particulars of the European response to the financial crisis, which has moved fitfully from a series of loosely coordinated rescues at the Member State level to negotiation of the banking union.

[12] See Alberto Gallo et al., European Banks: Still Too Big to Fail, The Revolver: RBS Macro Credit Research, Jan. 23, 2014, at 9–10, available at http://static.presspeople.com/attachment/cd8316b272864aacaf2161ef83016d09 (noting European banks' assets are roughly 3.2 times GDP and "[m]any are larger than the sovereign they are based in, measured as total assets/GDP). See also High-level Expert Group on Reforming the Structure of the EU Banking Sector (the "Liikanen Report) 11-19, 39-41, 119, http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

[13] Banks are required to set aside capital for risky assets against the possibility of losses. Sovereign debt issued by OECD countries was deemed under the applicable conventions to carry "zero" risk, thus not to require a capital set-aside. Markets appreciated that such sovereign debt was risky, however, and required incremental interest. Thus banks could increase profitability by holding sovereign debt. In effect, the zero-risk weighting meant that banks could increase their leverage. See Viral V. Archarya & Sascha Steffen, The "Greatest" Carry Trade Ever? Understanding Eurozone Bank Risks, NBER Working Paper 19039, at 33–34, 39 (May 2013) (explaining this phenomenon); Daniel Gros, Banking Union with a Sovereign Virus: The Self-Serving Treatment of Sovereign Debt, Intereconomics, March/April 2013, at 94. (arguing for increase in risk weights)

[14] The most obvious case was Ireland, but the problem generalized as the crisis wore on. See European Commission, Representation in Ireland, http://ec.europa.eu/ireland/key-eu-policy-areas/economy/index_en.htm

[15] For an account of the European Financial crisis, see Liikanen Report, supra note 12, at 4-11, 21-22, 24-31. See also European Commission, The Financial and Economic Crisis (successive links), http://ec.europa.eu/economy_finance/explained/the_financial_and_economic_crisis/why_did_the_crisis_happen/index_en.htm.

institution without wreaking havoc across the financial sector. [16]Additionally, the collapse of Lehman Brothers U.K. after the failure of Lehman Brothers U.S. and the failure of Fortis Bank underscored the need to create cross-border resolution options.[17] As we will elaborate below, the U.S. Dodd-Frank Act has given the FDIC powers for orderly resolution of systemically important financial institutions; in turn, the FDIC has devised an approach that may address cross-border problems as well.

In Europe, the first round of activity took place at the national level, reflected most prominently in new bank resolution regimes adopted in the U.K. and Germany.[18] After an extended period of deliberation, the E.U. has now agreed on a common instrument for recovery and resolution of banks, effectively harmonizing the (*national*) resolution powers across E.U. Member States, the "Bank Recovery and Resolution Directive" (BRRD).[19] This instrument introduces mandatory standards for all existing resolution mechanism throughout the E.U. Member States, but leaves resolution authority and funding in the hands of the Member States.

Under pressure of the Eurozone's on-going sovereign debt/bank crisis, in June 2012 the E.U. Member States and institutions agreed in principle to create a Eurozone Banking Union.[20] The agreement opened up an entirely new dimension for cross-border banking resolution, as the second element of the three pillars of the proposed Banking Union—joint supervision, resolution, and deposit insurance—would create federal resolution powers to be wielded by a new E.U. resolution authority given access to a new federal rescue fund. Under its current design, the Banking Union is primarily a framework for the Eurozone, but is open for all other E.U. Member States as well. The key rationale for federalizing these powers is to strengthen an unbiased, neutral approach to bank oversight and resolution, thus mitigating forbearance and moral hazard, and to break the fatal link between sovereigns and their banks. [21]

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[16] A prominent proponent was Ben Bernanke, then Chairman of the Federal Reserve. See Testimony on AIG, U.S. House Committee on Financial Services, March 24, 2009 ("AIG highlights the urgent need for new resolution procedures for systemically important nonbank financial firms"), http://www.federalreserve.gov/newsevents/testimony/bernanke20090324a.htm.

[17] Fortis Bank had operations in Belgium, Luxembourg and the Netherlands. The problems that arose from the inconsistent objectives of the national regulators are described in Zdenek Kudrna, Cross-Border Resolution of Failed Banks in the European Union After the Crisis: Business As Usual, 50 J. Comm. Mkt Stud. 283, 288-290 (2012). See also *infra* note 119. Some can claim prescience in seeing urgency for new resolution regimes. See Robert R. Bliss, Resolving Large Complex Financial Institutions, *in* Market Discipline in Banking: Theory And Evidence (George G. Kaufman, ed., Elsevier, Oxford: 2003), at p. 3.

[18] For an overview of various policy responses until 2011, see Basel Committee on Banking Supervision, Resolution policies and frameworks – progress so far, July 2011, available at http://www.bis.org/publ/bcbs200.pdf.

[19] 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, [2014] OJ L173/190.

[20] Council of the European Union, Summit conclusions of June 28/29, 2012, EUCO76/12.

[21] See European Commission, Proposal for a Single Resolution Mechanism, COM(2013) 520 final, 10.7.2013; Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform

The first step has been the creation of a Single Supervisory Mechanism (SSM) for Eurozone banks, in which the European Central Bank has been given the additional mandate of supervising all “significant” Eurozone banks.[22] Vivid demonstration of both the novelty and the urgency of the Banking Union project is reflected by the timeline for approval and implementation of the SSM. Banking Union was agreed to in June 2012; the European Commission’s initial proposal on SSM came in September 2012;[23] the Member States reached final agreement in 2013;[24] and the ECB took up its supervisory duties in November 2014.[25]

The second pillar, the Single Resolution Mechanism, proved more controversial and uncertain. The European Commission’s initial legislative proposal for creation of the SRM came in July 2013.[26] This proposal was met with fierce political criticism, and its constitutional

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rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, [2014] OJ L225/1 (explanatory material).

[22] A bank is deemed “significant” when it meets one of the following 5 conditions: (1) The value of its assets exceeds € 30 billion; (2) the value of its assets exceeds both € 5 billion and 20% of its state GDP; (3) the bank is among the three most significant banks of the country in which it is located; (4) the bank has large cross-border activities; (5) the bank receives assistance from a Eurozone bailout fund. European Central Bank, Guide to Banking Supervision 10 (2014), available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguide-bankingsupervision201411.en.pdf. Overall, at present 130 banks are subject to ECB supervision, representing about 80% of all bank’s assets. See European Central Bank, Comprehensive Assessment, (Oct. 26, 2014) https://www.bankingsupervision.europa.eu/banking/comprehensive/html/index.en.html (noting 130 banks were subject to a comprehensive health check). The Banking Union primarily addresses the Eurozone countries, but another non-Euro E.U. Member States can sign up for it. See on the SSM the speech by Jörg Asmussen, ECB executive board member, *Building Banking Union*, Atlantic Council, London, July 9, 2013; further Nicolas Véron, *Europe’s Single Supervisory Mechanism and the Long Journey Towards Banking Union*, Bruegel Policy Contribution, October 2012.

[23] European Commission, *Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions,* COM(2012) 511 final. Alongside this, the Commission also proposed another regulation to adapt the rules governing the European Banking Authority (EBA), see COM(2012) 512 final. See also, An important step towards a real banking union in Europe: Statement by Commissioner Michel Barnier following the trilogue agreement on the creation of the Single Supervisory Mechanism for the Eurozone, Press Release of March 19, 2013, <http://europa.eu/rapid/press-release_MEMO-13-251_en.pdf>. The Council gave its final blessing in October 2013, see <http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/139012.pdf>

[24] The final package consists of two instruments: Council Regulation No 1024/2013 of October 15, 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L287/63 (the “SSM Regulation”), and Regulation (E.U.) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (E.U.) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (E.U.) No 1024/2013, [2013] OJ L287/5 .

[25] Fr detailed guidance, see European Central Bank, GUIDE TO BANKING SUPERVISION (September 2014), available at <http://www.ecb.europa.eu/pub/pdf/other/ssmguidebankingsupervision201409en.pdf

[26] European Commission, Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (E.U.) No 1093/2010 of the European Parliament and of the Council, July 10, 2013, COM(2013) 520 final.

feasibility under the current European Treaty framework was unclear for quite some time.[27] It took months of contentious negotiation before the SRM was adopted in July 2014.[28] The SRM is accompanied by an Intergovernmental Agreement (IGA) between the Member States that specifically creates a "Single Bank Resolution Fund."[29] From the perspective of this paper, the significance of the SRM lies in its fundamental departure from a parallel post-crisis enactment, the Bank Recovery and Resolution Directive. Whereas the BRRD harmonizes *national* resolution mechanisms and improves the coordination between them, the rationale of bank resolution under a Banking Union means that it becomes *centralized*. This is an essential part of the Banking Union: It endeavors to ensure impartial decision-making on how to deal with failed banks on the European level, thus reducing any possibility of national forbearance.[30] Moreover, the Union aims to better deal with cross-border bank failures.[31] The final text of the SRM Regulation will be discussed in detail below.

The third pillar, a joint deposit guarantee scheme, now seems abandoned.[32] Soon after plans for the Banking Union were announced, strenuous objections to joint deposit insurance, particularly from Germany, meant that the banking union designers were forced to give up on this element.[33] Media reports suggest that the Commission, when putting forth the proposals for the SSM, had planned to publish simultaneously a detailed roadmap to a European deposit insurance fund. But the document appeared only briefly on the Commission's website and was deleted after a few hours, due to complaints from Berlin that it was premature and unrealistic.[34] Instead, it was condensed to a short "next steps" page, which referred only vaguely to the need to develop a common bank resolution plan and barely mentioned a deposit guarantee scheme at

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[27] Quentin Peel and Alex Barker, Berlin hits at banking union plan, *Financial Times* (London, July 11, 2013), p. 2. The constitutional problems, which related to the limits on the European Commission's ability to delegate its authority to administrative bodies, appear to be mitigated by the recent ECJ decision endorsing the role of ESMA in prohibiting certain aspects of short selling: case C-270/12 *United Kingdom v Parliament and Council* ECLI:EU:C:2014:18, available at <http://curia.europa.eu/juris/document/document.jsf?text=&docid=146621&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=12829>.

[28] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, [2014] OJ L225/1.

[29] See *infra* note 195.

[30] Cf. Gary Gorton. Misunderstanding Financial Crises: Why We Don't See Them Coming 176 (2012) (noting how forbearance "typically results in even greater losses" than bank runs).

[31] Commission proposal, *supra* note 26, at pp. 3-5. See also, Opinion of the European Central Bank of November 6, 2013 on the SRM Regulation.

[32] More optimistic is Eilis Ferran, European Banking Union: Imperfect, But It Can Work, Working Paper April 2014, available at <http://ssrn.com/abstract=2426247>: "Some form of common system for deposit protection (DGS) is also intended but not immediately" (p. 3 of manuscript).

[33] Alex Barker, Germany forces Brussels to abandon bank guarantee idea, *Financial Times* (September 14, 2012) at p 4.

[34] Id.

all.[35] The episode underlines the deep-seated resistance to some of the elements of the Banking Union plans in Germany (and other countries), where a joint deposit guarantee scheme is interpreted as requiring Northern European taxpayers to underwrite the losses of Southern depositors.

The Banking Union represents a major shift in attitude towards integration for European financial regulation. The threat to the Eurozone project from the sovereign debt and banking crisis that began in 2010 overwhelmed the initial opposition from some of the economically-strong Northern European countries. What was once contested was eventually seen as necessary. The bottom line, however, is that a future Banking Union will rest on two legs at most, instead of three. Only the first leg (supervision) is comparatively solid, whereas the second leg (resolution) appears to be a weak compromise. The third leg will probably never come: Recent E.U. documents scarcely reference the deposit guarantee plan,[36] and regulators are devising plans to make the Banking Union work without deposit guarantee.[37]

The question is whether European Banking Union can stand as a one-and-a-half-legged stool. After all, various experts had asserted the necessity of a "fully-fledged" banking union with "all three pillars."[38] The next sections offer a transatlantic perspective on how a resolution authority could be improved to operate effectively, and how it could even do without a deposit guarantee scheme.

II. THE U.S. PATTERN OF RESOLUTION: DEPOSIT INSURANCE AND THE PATH TO THE "ORDERLY LIQUIDATION AUTHORITY"

[35] The *Financial Times* reports that the Commission had intended to propose a new agency, the European Deposit Insurance and Resolution Authority (Edira), which would control a new European Deposit Guarantee and Resolution Fund (Edgar). Edira would then replace national deposit guarantee arrangements. See Barker, *supra* n 33.

[36] For example, the recent SRM proposal does not mention a single deposit guarantee mechanism anymore, but refers to (harmonized) national schemes only.

[37] For example, in a recent speech, Vítor Constâncio, Vice-President of the ECB, signaled that the Banking Union would have to live without a single deposit guarantee scheme for the near future. He emphasized the strengthening of local (but harmonized) rules for deposit insurance, which "[…] should help shore up confidence in national schemes […]. This means that a single European scheme is not an essential component of Banking Union in the short term." Vítor Constâncio, The nature and significance of Banking Union, Speech at the conference "Financial Regulation: Towards a global regulatory framework?", Chatham House City Series, London, March 11, 2013. See <http://www.ecb.int/press/key/date/2013/html/sp130311.en.html>.

[38] See, for example, the speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the conference "Bank funding – markets, instruments and implications for corporate lending and the real economy", Frankfurt, October 8, 2012: "we need to construct a banking union […], an institutional framework which ultimately should have three legs: a single supervisory mechanism (SSM), a common resolution structure and a shared deposit insurance."; Nicolas Véron, Europe's Single Supervisory Mechanism and the Long Journey Towards Banking Union, Bruegel Policy Contribution, October 2012: "A fully-fledged banking union [beyond the SSM] requires an autonomous European resolution authority and a federal European deposit insurance system, both of which require some sufficient form of backstop from a European level of fiscal authority to acquire credibility."

Deposit insurance in the United States evolved from a way to protect small depositors at small banks to an integral part of a resolution process that, in the case of large banks, commonly protected—or "bailed out"—all depositors, whether or not insured. The rationales for these bailouts were, variously, that the bailouts would be self-funding, that they would minimize community impact of failed financial institutions, and ultimately, that they would mitigate systemic risk. This practice failed during the financial crisis for two somewhat distinct reasons: First, the initial source of systemic distress was the failure of non-bank institutions that were beyond the resolution authority of the FDIC. Second, depository institutions ("banks") were themselves such large, complex institutions, and so tied up with non-banking affiliates, that the losses might have swamped the Deposit Insurance Fund (DIF) had the FDIC decided via the "systemic risk" exception that it could offer protective assistance.[39]

The U.S. Government responded with the Dodd-Frank Act, which, inter alia, instituted an "Orderly Liquidation Authority" ("OLA") in order to address both of these issues. First, OLA provides a resolution mechanism for *all* SIFIs, not just banks, thereby closing gaps in coverage. Second, the OLA provisions are clear on the point that "creditors are to bear losses," thus rejecting the bailout expectancy and statutorily preventing potential exhaustion of the Deposit Insurance Fund.[40]

Thus framed, an OLA regime would not necessarily succeed in preventing systemic distress from the failure of a large financial institution. This is because a regime organized around the principle of "no more bail-outs"/"creditors bear losses" may exacerbate an important vector of systemic risk—run risk on the part of large, uninsured depositors and other providers of short term credit (such as money market mutual funds). In anticipation of the possibility of losses, uninsured depositors may withdraw funds and short-term creditors may simply refuse to roll-over maturing obligations. This will trigger the immediate need for financially stressed banks to shrink their balance sheet to match the corresponding fall off in funding, which is likely to produce "fire sale" dispositions of existing assets, "liquidity hoarding" throughout the financial sector, and credit rationing to the real economy. Thus failure at a single important financial firm rapidly can lead to systemic consequences.

Thus there are three key elements to resolution of a failing SIFI that minimizes the risk of follow-on systemic distress: first, the reliable transport of short term credit claims to a new, well-

[39] In 2009, even after injections from the Trouble Asset Relief Program (TARP) that protected all the major banks from failure, the FDIC's Deposit Insurance Fund was approximately $21 billion in the red. On the eve of the crisis, the fund balance was a record high of only $52 billion. See FDIC, Toward a Long Term Strategy for Deposit Insurance Management, 4:4 FDIC Quarterly 29, 30 (2010). When it came time to rescue Citigroup, $45 billion came directly from TARP funds but an additional $301 billion came through loss-sharing guarantees; the FDIC limited its "at risk" amount to only $10 billion. Special Inspector General for TARP, Extraordinary Financial Assistance Provided to Citigroup, Inc. 20, Table 1 (Jan. 13, 2011).

[40] Indeed, the Dodd-Frank Act states that "the authorities of the [FDIC] relating to the Deposit Insurance Fund … shall not be used to assist a covered financial company pursuant to the this title and … the Deposit Insurance Fund may not be used in manner to otherwise circumvent the purposes of this title." Dodd Frank Act § 210(n)(8)(A).

capitalized successor financial institution; second, adequate liquidity support to the successor firm while it finds its footing; and third, a way to recapitalize that successor institution that does not require taxpayer support, at a time when equity markets would be closed to such a possibility. The Dodd-Frank Act gives the FDIC the power to establish a successor firm, a "bridge bank,"[41] and to provide liquidity support either through relending the proceeds from a drawdown on a U.S. Treasury credit line or full-faith-and-credit guarantees of bridge-bank debt issuances.[42] Under the FDIC's OLA implementation procedures, the means of capitalizing the new financial institution will come through "bail-in": the conversion of long term unsecured credit claims of the failed SIFI into equity in the new institution, via administrative action under law.[43] In short, instead of deposit insurance that bailed out the depositors (and sometimes all of the creditors), the bail-in of longer term unsecured creditors will protect all the depositors and other short-term creditors. Large depositors and other short term credit providers are not "insured," in the literal sense, but the mechanism of the resolution aims to give them sufficient "reassurance" as to mitigate run risk. "Deposit insurance" becomes "deposit assurance." At least that is the theory on which the FDIC claims that its OLA procedures can successfully resolve a SIFI without taking down the financial system.[44]

A. *Resolution in the United States*

We now turn to unpacking this argument. At the outset, it is important to state the importance of "resolution," as opposed to the "bankruptcy" or "insolvency" alternative for banks and other financial institutions.[45] "Bankruptcy" entails a court-supervised process that is designed to protect the substantive and procedural rights of all creditors without particular regard for broader public interests. It entails the immediate cessation of payments to any particular class of creditors (e.g., depositors or other short-term funders). It triggers default provisions in various counterparty credit agreements that may permit the seizing of collateral and the termination of relationships. It will bring an abrupt halt to the trading in financial claims that is the life's blood of a financial firm. Because of the nature of financial assets and relationships in the financial sector, in the absence of immediate "debtor-in-possession" financing that would keep the firm afloat and guarantee its undertakings while a reorganization is negotiated, bankruptcy

[41] Dodd Frank Act § 210(h).
[42] Dodd Frank Act §§ 210(h)(2)(G)(iv); 210(n).
[43] See Federal Deposit Insurance Corporation, "Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy," 78 Fed. Reg. 76614 (December 18, 2013).
[44] See Stephen J. Lubben, OLA After Single Point of Entry: Has Anything Changed?, Roosevelt Institute Report, at 1–6 (2013) available at http://rooseveltinstitute.org/sites/all/files/Unfinished_Mission_Lubben_OLA_Has_Anything_Change.pdf (summarizing and critiquing FDIC proposal).
[45] On the difference, see David A. Skeel, Jr., Single Point of Entry and the Bankruptcy Alternative, (2014) Faculty Scholarship. Paper 949, forthcoming in ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS (Brookings Institution and Hoover Institution); available at http://scholarship.law.upenn.edu/faculty_scholarship/949; Douglas G. Baird & Edward R. Morrison, Dodd-Frank for Bankruptcy Lawyers, 19 Am Bankruptcy Inst. L. Rev. 287, 299–302 (2011).

intervention will produce severe erosion in the franchise value of a failed financial firm and will deepen the losses for creditors.[46] The financial sector conditions that produce the bankruptcy of a large firm also make it unlikely that other financial institutions could provide such large-scale financing and guarantees; instead, they will hoard liquidity. The consequence of bankruptcy, then, is likely to be "disorderly liquidation," meaning the disposition of assets at fire-sale valuations and a value-destructive disassembly of the firm's business.[47] If the firm is systemically important, particularly if the firm is highly interconnected with other financial firms, the abrupt cessation of counterparty relationships, the expectation of large losses, and the gyrations in asset values will likely produce widespread systemic distress, which will magnify the losses that would otherwise occur.[48]

By contrast, "resolution" is an administrative process in which the goal is to protect the liquidity needs of short term creditors, especially depositors, and to manage financial assets in a way that preserves their value and the franchise value of the failing institution.[49] A major objective of resolution is to avoid systemic distress in the financial sector, a social good that may not be coincident with the private objective of protecting the equal treatment or absolute priority of creditor claims.[50] One critical element of resolution, at least from a U.S. perspective, is the capacity of the administrator to offer liquidity to maintain the critical functions of the financial institution.[51] This is operationally equivalent to debtor-in-possession financing but has the advantage of assured availability in sufficient amount at a time of systemic distress. In comparing resolution under OLA with the outcome of bankruptcy, the FDIC projected that in the case of Lehman Brothers, an OLA resolution would have produced losses of only 3 cents on the dollar versus bankruptcy losses of 79 cents on the dollar.[52] In short, the major losses in the failure of a large financial institution will result from disorderly failure; these losses can be avoided through an effective resolution process.

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[46] Randall D. Guynn, Are Bailouts Inevitable?, 29 Yale J. on Reg 121, 137-140 (2012).

[47] The value loss includes significant social value, not just private value, because the assets commonly end up in the hands of parties who are not best positioned to maximize their value. For example, a loan officer with knowledge of the borrowers will be better positioned to manage the credit relationships than a hedge fund manager who has purchased a loan book. See Andrei Shleifer & Robert W. Vishny, Fire Sales in Finance and Macroeconomics, 25 J. Econ. Persp. 29, 41-43 (2011) (surveying economics literature).

[48] Heidi M. Schooner and Michael W. Taylor, *Global Bank Regulation: Principles and Policies* 243 (2010).

[49] John Armour, Making Bank Resolution Credible, in OXFORD HANDBOOK OF FINANCIAL REGULATION (Eilis Ferran, Niamh Moloney and Jennifer Payne, eds., forthcoming OUP 2015).

[50] See Guynn, supra note --, at 141. . Compare Kenneth E. Scott & John B. Taylor, eds., BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (2012).

[51] See Guynn, supra note – at 144.

[52] See FDIC Press Release describing the Lehman OLA report, <http://www.fdic.gov/news/news/press/2011/pr11076.html>. For a detailed analysis of the Lehman Bankruptcy, see Michael Fleming & Asani Sarkar, The Failure Resolution of Lehman Brothers, Fed. Res. Bank NY, 20 Econ. Policy Rev. March 2014 (forthcoming), available at <http://www.newyorkfed.org/research/epr/2014/1403flem.pdf>.

To understand the U.S. resolution regime it makes sense to start with resolution of a simple bank.[53] The Federal Deposit Insurance Act creates a special bank resolution procedure that grants the FDIC considerable discretion in addressing a bank failure.[54] One straight-forward way to resolve a failed bank is through an "insured deposit payoff," in which the FDIC pays off insured deposit claims, takes the failed bank's assets as receiver, and pays off remaining bank creditors, including uninsured deposits, from asset dispositions.[55] This is not the FDIC's preferred approach, not just because of the on-going administrative costs of the receivership, but also, perhaps more importantly, because of the loss of the franchise value of the failed institution, including the depositor and lending relationships.[56] Historically the FDIC's favored approach is a "purchase and assumption" transaction (P&A)[57], in which an acquiring bank purchases assets of the failed bank in exchange for assuming a certain share of its liabilities and receives FDIC assistance to cover the gap between the asset values and the liabilities.[58] That gap is funded by the Deposit Insurance Fund.[59] Because the entity is preserved as a going concern, the acquirer will offer a higher price (require less FDIC assistance) than on a simple asset purchase. The FDIC has the authority to decide which liabilities (beyond insured deposits) will carry over to the transferee and therefore be fully protected, but commonly all deposits—whether or not insured—are carried over, particularly for larger banks.[60] In cases where a P&A cannot be immediately arranged, the FDIC may establish a "bridge bank" and has similar authority over balance sheet composition in its creation.[61]

The P&A structure allows considerable flexibility. Not only can the FDIC allocate assets between its receivership and the acquiror, but it can transfer assets subject to a loss-sharing arrangement. Loss-sharing arrangements are particularly useful for large portfolios of troubled assets of uncertain value. Resolutions are arranged quickly to avoid a run that would erode the franchise value of the failing bank, meaning that there is often not time for extensive due diligence, which in any event could be quite difficult. Depending on market conditions, valuation of the underlying collateral may be difficult and a transferee bank may insist on a lowball price

[53] See generally Jeffrey N. Gordon & Christopher Muller, Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund, 28 Yale J. Reg. 151, 185-190 (2011) (explaining FDIC's original powers and its struggles regarding large banks).
[54] Federal Deposit Insurance Act of 1950, Pub. L. 81–797, 64 Stat. 873 (codified as amended in 12 U.S.C. § 1811–1835a (2012)).
[55] See FDIC Resolutions Handbook, Ch, 4, Deposit Payoffs, 41 (2003) https://www.fdic.gov/bank/historical/reshandbook/ch4payos.pdf (explaining payoff method).
[56] See id. at 44 (listing problems associated with deposit payoffs and noting it is usually considered a "'last resort' resolution method").
[57] See id. at 41 (noting "purchase and assumption transactions are the most common resolution method").
[58] See FDIC Resolutions Handbook, Ch. 3, Purchase and Assumption Transactions, at 19 ,<http://www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf> (last updated February 2013).
[59] The Deposit Insurance Fund maintains its reserves by assessing a premium on any bank wishing to be insured by the Fund. See 12 U.S.C. § 1815(d)(1) (2012).
[60] This is now subject to a "least cost resolution" requirement, which in turn is subject to a systemic risk exception. See ## – infra.
[61] See generally FDIC Resolutions Handbook, Ch. 3, Purchase and Assumption Transactions,<http://www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf> (last updated February 2013).

before adding risk to its balance sheet. Taking on some of this risk may permit the FDIC to realize a considerably higher price for the transferred assets and thus reduce the overall cost of the resolution to the DIF.

B. *Deposit Insurance in U.S. History*

During the last real-estate related banking crisis in the United States, the savings and loan crisis of the 1980s, the FDIC was criticized for excessive protection of uninsured creditors, particularly uninsured depositors.[62] These creditors were almost invariably protected, "bailed out," even if the failed bank attracted an acquirer.[63] As a result, a 1991 legislative change now requires the FDIC to opt for the "least costly" resolution transaction—meaning, least costly to the DIF— except where otherwise necessary to avoid a systemic distress, a judgment that requires the concurrence of the Fed and the U.S. Treasury.[64] No large banks failed in the 1991–2007 period, meaning that the FDIC had no experience in addressing "least cost resolution" issues, including whether a P&A transaction that transferred uninsured as well as insured deposits to protect franchise values would produce "least cost" resolution.[65]

Deposit insurance was controversial when it was initially adopted as part of the New Deal Banking legislation of the early 1930s.[66] At the time, the U.S. banking system was highly fragmented into relatively few large money center banks with limited branching and thousands of small local banks, often confined to a single location, so-called "unit banks." Such unit banks were exposed to shocks in the local economy, such as a drought or the closing of a large factory. Private and state-level deposit insurance schemes had failed at critical moments. The promoters of deposit insurance (for example, Congressman Henry B. Steagall of Alabama) regarded deposit insurance as necessary to protect their small bank constituents from the flow of deposits to

[62] See Alan S. Blinder, After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead 162 (2013) (describing how "Congres had been badly burned by the S&L crisis" because the FDIC had "toss[ed] money around without a compelling reason").
[63] See Timothy Curry & Lynn Shibut, The Cost of the Savings and Loan Crisis: Truth and Consequences, FDIC Banking Rev. Dec. 2000, at 26, 30–33, available at https://www.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf (discussing financial outlay from S&L crisis).
[64] Federal Deposit Insurance Improvement Act of 1991. See Blinder, supra note 62, at 162 (describing least-cost resolution requirement); Richard Scott Carnell, A Partial Antidote to Perverse Incentives: the FDIC Improvement Act of 1991, 12 Annual Rev. Banking L. 317, 325–26, 352, 363–64 (1993) (same). The "least cost" resolution requirement did result in a greater incidence of uninsured deposit losses in the event of bank failure, but the "Great Moderation" of the 1990s and early 2000s meant that the subject institutions were relatively small banks. FIDC Historical Statistics on Banking (search covering 1991-2007, showing 3 failures).

[66] See, on the history of the FDIC, Charles W. Calomiris & Eugene N. White, The Origins of Federal Deposit Insurance, in THE REGULATED ECONOMY: A HISTORICAL APPROACH TO POLITICAL ECONOMY (Claudia Goldin and Gary D. Libecap, eds., University of Chicago Press 1994) at p. 145; Roger Lowenstein, There's a Reason for Deposit Insurance, *New York Times* (March 24, 2013) at p. 3.

larger, more diversified, more resilient banks.[67] Deposit insurance was opposed by the large banks and by President Roosevelt, who asserted that the program would create moral hazard.[68] As part of the legislative compromise, the insured deposit level was capped at $2500 (approximately $45,000 in 2013 dollars), a retail level, not a wholesale level.[69]

In fact, until banking liberalization in the 1970s and 1980s, moral hazard because of deposit insurance was not much of a problem.[70] The applicable regime protected banking rents, which became a self-enforcing mechanism against excessive risk-taking. The legislative package that included deposit insurance, the Glass-Steagall Act, also contained provisions for the capping of interest rates on bank deposits, so-called "Reg Q," as well as restrictions on bank affiliation with securities firms.[71] Because banks could not bid up interest rates to compete for deposits, banks could generate profits on lower risk/lower yielding loans. The preexisting geographic restrictions that limited bank branching also protected local deposit gathering and loan-making from competitive encroachments.[72]

It is easy to see how the FDIC moved from "insured deposit protection" to "deposit protection." First, the transactions that protect all deposits, not just insured deposits, are ex post efficient, since they maximize the going concern value of the transferred entity. Among other things, imposing losses on depositors probably creates ill will that would make it hard for an acquirer simply to reopen the failed bank under a different nameplate. Indeed, preserving the going concern value by effectively bailing out all depositors often may be the FDIC's least cost resolution strategy.[73] Second, many bank failures arose out of the exposure of unit banks to local economic shocks, not mismanagement by the local owners. Use of the deposit insurance fund could efficiently allow the FDIC to protect depositors, mutualize risk, and guard against insurance abuse. And, as noted above, until banking liberalization that began in the 1970s, moral hazard was not a serious problem. On the few occasion in which large banks were on the verge of failure, the FDIC stepped in to rescue the distressed bank on the grounds of systemic harm to the regional economy or nationally.[74] The most notorious case was Continental Illinois in 1984, then the seventh largest bank by assets in the U.S., which the FDIC rescued in a transaction that

[67] See Federal Deposit Insurance Corporation, The First Fifty Years: A History of the FDIC 1933–1983, at 38 (1984) (citing Steagall's support).
[68] See id. at 40–43 (discussing opposition to deposit insurance legislation).
[69] See Charles W. Calomiris & Stephen H. Haber, FRAGILE BY DESIGN: THE POLITICAL ORIGINS OF BANKING CRISES AND SCARCE CREDIT, 187-192 (2014).
[70] See Thomas F. Hellmann et al., Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough, 90 Am. Econ. Rev. 147, 148–49, 162 (2000) (suggesting bank liberalization, including repeal of Regulation Q, contributed to moral hazard and increased number of financial crises).
[71] Reg Q was promulgated by the Federal Reserve in August 1933 pursuant to §11 of the Banking Act of 1933(better known as Glass-Steagall), formerly 12 CFR § 217. See generally R. Alton Gilbert, Requiem for Regulation Q: What It Did and Why It Passed Away, 68 Fed. Res. B. Of St Louis 22 (Feb. 1986).
[72] See generally Richard S. Carnell, Jonathan Macey & Geoffrey P. Miller, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 177-198 (4th ed. 2009).
[73] Gordon & Muller, supra note xx, at 185-86.
[74] See FDIC, Managing the Crisis: The FDIC and RTC Experience 635–36, 651 (1998)

bailed out creditors of the holding company parent as well as the uninsured depositors of the troubled bank.[75]

The traditional FDIC resolution mechanism protects "banks" and the "banking system," but it does not cover firms that are not banks but that may be affiliated with banks or that provide systemically important credit intermediation services as free-standing entities. For example, although U.S. law does not permit "banks" to underwrite or trade in non-governmental securities, the erosion and then outright repeal of Glass-Steagall in the 1980s and 1990s permitted banks to affiliate with general broker-dealers through a holding company structure.[76] So, large U.S. banks became subsidiaries of bank holding companies The largest banks created "financial holding companies," which permitted them to affiliate with any financial service provider. The bank might well be financed through equity or credit issued by the public holding company parent ("Topco"), as well as by deposits; the bank might use deposits to finance some of the activities of the affiliates (subject to various limits). The consequence was complex intra-organization credit and equity arrangements. The FDIC's resolution authority does not run to Topco or the non-bank subsidiaries of Topco. This problem was revealed in the Continental Illinois case: The FDIC had only the power to put the *bank* into an FDIC resolution procedure, meaning certain default on intra-entity debt owed by the bank to the holding company parent.[77] This in turn would have led to bankruptcy of the parent, which was not a "bank"; the bankruptcy would have been handled by the bankruptcy court, not the FDIC. Rather than face the disruption from the bankruptcy of a significant financial institution, the FDIC, working with the Fed, devised a plan that rescued the parent (including the parent's creditors) as well as the bank.[78]

The financial crisis forced U.S. regulators to once again confront the critical dilemma revealed by the Continental Illinois case. First, in the run up to the financial crisis, an increasingly large fraction of credit intermediation had moved away from bank-based intermediation to market-based intermediation.[79] Although market-focused non-banks did not issue "deposits," they held long term credit assets which they funded through short term credit issuances, including a particularly runnable form of short term finance, "repo," secured short

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[75] Gordon & Muller, supra note 53, at 187-190. Indeed, some trace the advent of the "too big to fail" bank to the Continental Illinois case. Gary H. Stern & Ron J. Feldman, Too Big To Fail: The Hazards of Bank Bailouts 13-17 (2004).

[76] See James R. Barth et al., Policy Watch: The Repeal of Glass-Steagall and the Advent of Broad Banking, J. Econ. Perspectives Spring 2000, at 191, 191 (explaining effect of repeal of Glass-Steagall).

[77] See Federal Deposit Insurance Corporation, History of The Eighties Vol. 1: An Examination of the Banking Crises of the Early 1990s, at 244 (1997), available at https://www.fdic.gov/bank/historical/history/235_258.pdf (explaining how FDIC was prevented from using its full resolution powers because of certain agreements that the bank had with the holding company).

[78] See id. (describing controversial resolution plan implemented by the FDIC and the Fed).

[79] See Samuel Antill, David Hou & Asani Sarkar, Components of U.S. Financial Sector Growth, 1950-2013, 20 FRBNY Econ. Policy Rev. Dec. 2014, at 59, 61, available at http://www.ny.frb.org/research/epr/2014/1412anti.pdf ("Growth in shadow banking has been fueled by rapid expansion in credit intermediation services by asset management and securities firms"). .

term borrowing often collateralized by long term assets of uncertain value.[80] The FDIC had no authority to address the failure of such institutions, despite their bank-like function and bank-like vulnerability. Thus as Bear Stearns headed to failure, the Federal Reserve was left with unpalatable choices: Either rescue Bear Stearns or Lehman Brothers through merger, which protected creditors fully and shareholders partially, or be prepared to deal with a disorderly resolution through bankruptcy.[81] Lehman Brothers showed the limits of the bankruptcy strategy.[82]

Second, even where a bank was involved, the bank might well be entangled in a large financial conglomerate. Although the bank could be resolved, the non-bank affiliates and parent would face a bankruptcy. Citibank, for example, was an operating subsidiary of Citigroup, Inc. Citigroup's total assets in 2008 were approximately $2 trillion, only half of which were assets of Citibank. Without the capacity to resolve the entire entity, the FDIC's resolution power with respect to Citibank left it with incomplete powers. Either it could rescue all of Citigroup (which might have exceeded the capacity of the Deposit Insurance Fund and possibly its drawing rights on the U.S. Treasury) or it could resolve Citibank alone and face the disorderly bankruptcy of Citigroup.[83]

III. How the FDIC Proposes to Resolve a Failing SIFI Under Dodd-Frank: "Single Point of Entry"

For path dependent reasons that we describe in Part IV, a systemically important financial firm in the U.S. will almost invariably be organized through a holding company structure in which the principal assets of Topco, the publicly-traded parent, are shares in the operating subsidiaries that carry on the diverse businesses of the entity. The SIFI will commonly engage in commercial banking, both retail and wholesale; the capital markets business, including broker-dealer activity, trading, and investment banking; assets management through various investment advisors; and various financial service activities, for example custodial and clearing activities. All of these functions will be organized as direct or indirect subsidiaries of the Topco parent. Some of the subsidiaries will be organized in the U.S., others outside the U.S. The subsidiaries

[80] See Adam Copeland et al, Key Mechanics of the U.S. Tri-Party Repo Market, FRBNY Econ. Policy Rev., Nov. 2012, at 17, 17–28 (providing overview of U.S. repo market) For the run risks of such funding, see Gary Gorton & Andrew Metrick, Securitized Banking and the Run on Repo, 104 J. Fin. Econ. 425, Pincite (2012).
[81] See Gordon & Muller, supra note xx, at 182-84; Blinder, supra note 62, at 105 (discussing Fed's difficulties with Bear Stearns because it "was not a bank"); cf. id. at 122 ("[Lehman CEO Richard] Fuld suggested that the Fed protect Lehman by turning it into a bank holding company").
[82] See supra note 7 and accompanying text (describing losses associated with taking Lehman into bankruptcy).
[83] See Citigroup, Inc. Form 10-Q, K,,for the quarter ended Sept.30, 2008, at 4, 82 (reporting total assets of $2.1 trillion, and liabilities of 1.9 trillion, less than half of which were reflected by deposits). The FDIC's ordinary line of credit with Treasury was $100 billion; it could borrow up to $500 billion with consent of Treasury and the Fed; the Deposit Insurance Fund had fallen to $10.4 billion in the 2d quarter of 2008 because of the failure of 24 banks in 2008. Jessica Holzer, FDIC Considers Borrowing From Treasury to Shore Up Deposit Insurance, Wall St. J, Sept. 18, 2008, available at . http://www.wsj.com/articles/SB125328162000123101.

are likely to have complex financial arrangements with one another, entailing the intra-organizational transfer of funds and collateral. 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. Figures 1 and 2 below, drawn from an FDIC presentation, illustrate how a financial holding company operates in a relatively small number of different business segments but uses a complex legal organizational form.

As explained in Part II, Dodd-Frank has given the FDIC "Orderly Liquidation Authority" powers; that is, the power to resolve all SIFIs (banks and nonbanks) in a way that creditors, instead of taxpayers, will bear losses. The FDIC's announced OLA strategy is "single point of entry.",[84] That is, in the event of financial distress beyond the SIFI's capacity to address internally, the FDIC will initiate a receivership action against Topco while specifically avoiding bankruptcy or a bank resolution process for all subsidiaries of the entity that are "equity solvent," meaning that they have positive value on a going concern basis.[85]

Take the case of a large bank subsidiary that suffers a large write-down in its loan book or takes a massive loss on a derivatives position. Losses at the subsidiary level will be addressed initially through a write-down of the Topco parent's equity and then debt in its subsidiary and further advances as to the subsidiary as necessary. In short, Topco will be obliged to serve as a "source of strength" to its bank subsidiary to the extent of its capacity.[86] If such write-downs and advances would render Topco insolvent, the FIDC will trigger an OLA action employing the "Single Point of Entry" approach. Per the SPOE strategy, the new receivership transfers the assets of Topco, most particularly its ownership interest in its operating subsidiaries, to a new financial holding company organized by the FDIC, a "bridge" entity, Bridgeco. *Topco's* unsecured liabilities (not the liabilities of any subsidiary, which are unaffected) become claims

[84] Federal Deposit Insurance Corporation, "Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy," 78 Fed. Reg. 76614, 76615 (December 18, 2013).
[85] On the SPOE approach in detail, see John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, TOO BIG TO FAIL: THE PATH TO A SOLUTION 23–32 (Washington, DC: Bipartisan Policy Center, May 2013); see generally id. (providing comprehensive overview and policy recommendation of SPOE strategy). The FDIC has recently outlined the SPOE strategy in a request for public comments: Federal Deposit Insurance Corporation, "Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy," 78 Fed. Reg. 76614, 76615–76624 (December 18, 2013).
[86] One important element clarified in the Dodd-Frank Act is the obligation of Topco to cover losses in its operating subsidiaries, even where such losses would exceed Topco'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 Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety and Soundness*, in A. Berger, P. Molyneux, and J. Wilson, eds., THE OXFORD HANDBOOK OF BANKING (2010), 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 SPOE effective.

against the receivership. The FDIC estimates the extent of the losses, which it then apportions among equity holders and the unsecured creditors of Topco in accordance with their priority. Equity holders will almost assuredly be eliminated and some fraction of the unsecured debt will be written off. The remaining Topco unsecured debt is converted into equity claims and unsecured liabilities of Bridgeco, which is now fully capitalized. In effect, this Topco debt—known as "bail-in debt" is used to cover losses throughout the group and to re-equitize a Bridgeco successor.[87] The former Topco creditors become Topco shareholders. 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[88]. This is illustrated in figure 3 below, drawn from an FDIC briefing.

The upshot of this approach is that the holding company—the shareholders and debtholders of Topco—bears the losses of the operating subsidiaries.[89] The liabilities of the operating subsidiaries will not go into default and will not be exposed to losses. 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 and other potential unraveling effects.[90] The long term creditors and shareholders of Topco cannot run in the face of impending financial distress because of the nature of their commitment.[91] Because the subsidiaries' businesses are not disrupted—because the systemic shock is contained—the ultimate creditor losses will be much less.[92] 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.[93] To be sure, the SPOE strategy depends upon a sufficient layer of unsecured debt in the liability

[87] The SPOE approach was recently described by then Deputy Governor Paul Tucker as follows:

> "Single-point-of-entry resolution involves working downwards from the top company (Topco) in the group in an exercise that resolves the group as a whole, wherever its problems began. Think of it this way. Losses in subsidiaries are first transferred within the group to the Topco. If Topco is bankrupt as a result, the group needs resolving. Bailin can then be applied to the Topco's capital structure: writing off the equity and, most likely, subordinated debt; and writing down and partially converting into equity the senior (bonded) debt issued by Topco. Those bondholders become the new owners."

Paul Tucker, Resolution and Future of Finance (May 20, 2013), available at <http://www.bankofengland.co.uk/publications/Pages/speeches/2013/658.aspx>.

[88] See Dodd Frank Act §§ 204(d), 210(n)(8)(B). As Bridgeco is incorporated and operated by the FDIC, these obligations are full faith and credit obligations of the U.S. Government.

[89] See Bovenzi et al., supra note 85, at 27 ("[T]he FDIC could effectively cause any losses incurred at the operating subsidiary level to be pushed up to the failed holding company").

[90] See id. at 27–28.

[91] See id. at 28 ("The holding company's long-term, unsecured debt and other capital structure liabilities would be structurally subordinated to any debt at the operating subsidiary level

[92] See id. at 27–28 (noting operating subsidiaries "would be kept out of receivership or insolvency proceedings and would open for business at the normal opening time on the day after resolution weekend or resolution night").

[93] See The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act, FDIC Quarterly, No. 2, 2011, at 31, 34, available at https://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/Article2.pdf (explaining how resolution could have avoided massive losses of Lehman Bankruptcy).

structure of Topco, 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.[94]

An additional powerful feature of the SPOE is the way it can solve the multiple resolution regime problem for firms that have operations in different jurisdictions. If only Topco is put into resolution, if Bridgeco can re-equitize the within-group obligations of the foreign subsidiary ("Subco") as necessary to preserve Subco's solvency, and if the FDIC can flow liquidity support through Bridgeco to Subco, then Subco remains a solvent and functional entity throughout the resolution of the SIFI of which it is a part. The approach and its advantages are described in a joint FDIC-Bank of England paper that contemplates cooperation 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 cooperate 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.[95]

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[94] The FDIC describes the systemic stability advantages of a SPOE resolution as follows:

> U.S. SIFIs generally are organized under a holding company structure with a top-tier parent and operating subsidiaries that comprise hundreds, or even thousands, of interconnected entities that span legal and regulatory jurisdictions across international borders and share funding and support services. Functions and core business lines often are not aligned with individual legal entity structures. Critical operations can cross legal entities and jurisdictions and funding is often dispersed among affiliates as need arises. These integrated structures make it very difficult to conduct an orderly resolution of one part of the company without triggering a costly collapse of the entire company and potentially transmitting adverse effects throughout the financial system. * * * Additionally, the FDIC seeks to preserve financial stability by maintaining the critical services, operations and funding mechanisms conducted throughout the company's operating subsidiaries.
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> ***
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> The company's subsidiaries would remain open and operating, allowing them to continue critical operations for the financial system and avoid the disruption that would otherwise accompany their closings, thus minimizing disruptions to the financial system and the risk of spillover effects to counterparties. . . . . [Thus,] counterparties to most of the financial company's derivative contracts would have no legal right to terminate and net out their contracts. Such action would prevent a disorderly termination of these contracts and a resulting fire sale of assets.

FDIC, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76616 (Dec. 18, 2013).

The SPOE approach has received international recognition via the November 2012 Financial Stability Board guidance. See Financial Stability Board, Recovery and Resolution Planning: Make the Key Attributes Requirements Operational (Consultative Document, Nov. 2012), Annex 2, Guidance on Developing Resolution Strategies and Operational Resolution Plans , available at http://www.financialstabilityboard.org/publications/r_121102.pdf.

[95] FDIC and Bank of England, Resolving Globally Active, Systemically Important, Financial Institutions Par. 49 (December 10, 2012), available at <http://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

To use the Lehman example: In an SPOE world, Lehman UK would never have faced U.K. insolvency proceedings, because the FDIC would have assured its solvency and liquidity.[96] The Clearing House Association L.L.C. organized and conducted a comprehensive and sophisticated simulation exercise of the operability of OLA in November 2012.[97] This important test for the new system confirmed that Title II OLA 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 OLA approach and supported its consideration in other jurisdictions. As stated above, 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 %.[98] These figures and test results are so compelling that the U.S. is currently negotiating agreements with other countries—including Germany and Switzerland—with a view to reach similar agreements to the one in place with the UK.[99]

As previously noted, the critical element for success with this approach is a sufficient layer of unsecured term debt at the parent holding company level. This "self-insurance" layer must be large enough both to absorb the losses throughout the conglomerate that are left after equity is wiped-out and, upon conversion of the remainder, to recapitalize Bridgeco in accordance with Basel III and national requirements.[100] Moreover, to minimize contagion effects, the debt must be held outside the financial sector: it can't be that Bank A or even life insurer Z holds a significant chunk of the term debt of Bank F.[101] In order for the SPOE scheme to work effectively, the regulators' decision to put Bank F into receivership cannot be constrained by the concern that a write down of Bank F's term debt will imperil another systemically important financial institution.

[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.

[96] This is at least the hope. The possibility that the FDIC in practice is subject to practical considerations and subject to political pressure that would taint its unilateral perspective and approach cannot be excluded.

[97] The Clearing House, Report on the Orderly Liquidation Authority Resolution Symposium and Simulation, January 2013, available via <http://www.theclearinghouse.org/>.

[98] See FDIC Press Release describing the Lehman OLA report, <http://www.fdic.gov/news/news/press/2011/pr11076.html>. See *supra* note 45 and accompanying text. 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.

[99] FDIC Chairman Martin J. Gruenberg at the Clearing House Annual Conference in New York, November 21, 2013, available at <http://www.bloomberg.com/video/fdic-s-gruenberg-on-resolution-strategy-for-banks-g5YN2PiESFyCrIsIuANWJQ.html>.

[100] See Financial Stability Board, KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS 47–48 (October 2014), available at http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf (describing essential elements of recovery and resolution plans).

[101] Paul Tucker, The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seen Retrospective Clarifications and Elaborations 9 (European Summer Symposium in Economic Theory,Gerzensee,Sz., July 3, 2014). Financial Stability Board, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution – Consultative Document (Nov. 10, 2014), www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf., at 18 ("Regulation of Investors")

The FDIC is currently consulting with a view to ascertain precisely how much debt should be required to be available at the Topco level.[102] The Federal Reserve has indicated that it plans to propose a concrete long-term debt requirement for the largest SIFIs.[103] Indeed, because the self-insurance, "bail-in," approach to the resolution of systemically important banks has now become the international standard, the level of loss absorbency is likely to become a matter of international convention, like the capital rules set in Basel III. At the November 2014 summit meeting of the G-20 leaders, the post-crisis agenda-setter Financial Stability Board, submitted a proposal for "Total Loss Absorbency" (TLAC), capital plus loss-absorbing debt, equal to a least twice the amount of required equity capital on both risk-weighted and leverage measures.[104] 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.[105]

Financial institutions are unlikely to issue sufficient unsecured term debt without regulatory prodding.[106] Capital, not loss absorbency through unsecured term debt, has been the focus of Basel.[107] In the wake of the FDIC's and the international regulatory community's renewed focus on resolution through bail-in, the Fed has now signaled that it is likely to mandate such a capital structure innovation.[108] Other countries are exploring similar strategies: Switzerland, for example, allows banks to lower the overall amount of regulatory capital they are required to hold by making their businesses easier to separate in a crisis.[109]

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[102] FDIC, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, December 10, 2013, 78 Fed. Register 76614, 76623 (2013).
[103] The Board of Governors of the Federal Reserve has publicly stated that they will issue a proposed rulemaking that would establish a minimum amount of long-term unsecured debt and other loss-absorbing resources to support the FDIC's SPOE Strategy. See Daniel K. Tarullo, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, "Planning for the Orderly Resolution of a Globally Systemically Important Bank," Washington, D.C. (October 18, 2013), at p. 11 (available at <http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.pdf>).
[104] Financial Stability Board, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution – Consultative Document (Nov. 10, 2014), www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.
[105] Id., at 13. The threshold limits were based on calculation of losses during the recent financial crisis in an earlier consultation document. See Financial Stability Board, Issues for Consideration in the Development of a Proposal on Adequacy of Loss Absorbing Capacity in Resolution (memo to Steering Committee, SC/2013/45, Dec. 18, 2013).
[106] The customary positive slope of the yield curve may favor shorter term debt. Because of the run risk, short term is more likely to be "bailed out," hence cheaper. More generally, unsecured term debt, because it is better suited to bearing losses, is less likely to benefit from a "too big to fail" subsidy.
[107] See Bovenzi et al., supra note 74, at 28–29 (referencing Basel III capital-requirements proposals).
[108] See Janet L. Yellen, Regulatory Landscapes: A U.S. Perspective (June 3, 2013): "In consultation with the Federal Deposit Insurance Corporation, the Federal Reserve is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of long-term unsecured debt outstanding. Such a requirement could enhance the prospects for an orderly SIFI resolution. Switzerland, the United Kingdom, and the European Union are moving forward on similar requirements, and it may be useful to work toward an international agreement on minimum total loss absorbency requirements for global SIFIs", available at <http://www.federalreserve.gov/newsevents/speech/yellen20130602a.htm>. Accord, Daniel K. Tarullo, Industry Structure and Systemic Risk Regulation (December 4, 2013), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20121204a.htm>.
[109] James Shotter, Credit Suisse to overhaul structure, Financial Times, November 21, 2013.

To return to the main theme: one crucial advantage of the SPOE approach is that it offers a credible path to the resolution of large financial institutions without reliance on deposit insurance guarantees either to fund the transaction or to mitigate the risk of destructive depositor runs. The depository subsidiary will be protected by the debt layer at the holding company level, and, implicitly, by the administrator's determination to make the SPOE approach, once undertaken, succeed. Although some have asserted that uninsured deposits *should* be at risk, we think that such an approach would undermine the credibility of a resolution regime. Wholesale short-term credit suppliers in particular can engage in self-help, either through run behavior or through insistence on secured lending via repo. Both scenarios are destabilizing, the run risk for obvious reasons; the repo strategy because it may produce a slow run as creditors insist on larger haircuts on the securities taken as collateral. Because of the destructive effect of a run on a large SIFI in anticipation of loss-sharing by depositors, regulators are likely to provide forbearance. By contrast, imposition of losses on unsecured term creditors is credible, precisely because of the lock-in, and this in turn buttresses the disciplinary threat of resolution.

With a similar satisfactory resolution regime, the European Banking Union project can run on its two legs.

IV. Holding Company Structure: Path Dependence in the U.S.; Decision for the E.U.

A critical institutional feature for the success of SPOE is a top-level holding company whose assets consist primary of equity and intra-company debt claims in its operating subsidiaries and whose liabilities consist principally of non-runnable term debt. Large bank-centered financial companies in the United States 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.[110] Until approximately twenty years ago, the U.S. financial sector was highly balkanized. Bank expansion was limited by highly restrictive branching laws that limited interstate banking, even intrastate banking.[111] The "business of banking" was narrowly defined to exclude banks from the provision of many financial services.[112] And commercial banks were famously barred from engaging in securities underwriting and other investment bank activity by

[110] The following text draws from many sources, including Saule T. Omarova & Margaret Tahyar, That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States, 31 Rev. Banking & Fin. L. 113 (2011); Arthur E. Wilmarth, Jr., The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risk, 2002 Univ. Ill. L. Rev. 215 (2002); Charles C. Calomiris, Bank Deregulation in Historical Perspective (2000); Charles C. Calomiris & Stephen H. Haber, Fragile By Design 195- (2014); Richard S. Carnell, Jonathan R. Macey & Geoffrey P. Miller, The Law of Banking and Financial Institutions (4th ed. 2009).
[111] See, e.g., the McFadden Act of 1933, 12 U.S.C. § 36.
[112] See 12 U.S.C § 23(7).

the Glass-Steagall Act.[113] The result was a relatively small number of "money center" banks, thousands of "unit banks," and many thousands of different financial service providers.[114]

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.[115] 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."[116] 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 broaden 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.[117] 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.[118]

The point is this: The evolution of the U.S. banking system has proceeded in such a way that the largest banking groups are organized as bank holding companies. In general a public parent, Topco, sits astride a cluster of financial subsidiaries. Such a structure vastly facilitates a resolution strategy like SPOE. We shall explore later, in part VI, how the E.U.'s bank structural reform project, the so-called "Liikanen process," could be turned in this direction. But first, we must understand where Europe stands now.

V. EUROPEAN RESPONSES TO FAILING BANKS: MULTILEVEL BATTLES

[113] See §§ 16, 20, 21, 32, Banking Act of 1933, codified respectively at 12 U.S.C §§ 24 (Seventh),377, 378, 78; Inv. Co. Instit. v. Camp, 401 U.S. 617 (1971) (providing capacious reading of Glass Steagall).
[114] See Omarova & Tahyar, *supra* note 98 at 10 note 35.
[115] Compare 12 U.S.C. § 24 (Seventh). See generally Carnell et al., *supra* note 98, at 485-494.
[116] Bank Holding Company Act of 1956, 12 U.S.C. § 1841. See also Carl A. Sax & Marcus H. Sloan III, The Bank Holding Company Act Amendments of 1970, 39 Geo. Wash. . Rev. 1200 (1970).
[117] See generally, The Graham-Leach-Bliley Act of 1999, Pub. L. 106-102. Specifically, 12 U.S.C §§ 843(k) (4)(H), (I).
[118] See §§ 23A, 23B, 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*, 89 N.C. L. REV. 1683 (2011).

So far, this paper has considered the developments in the United States to illustrate the creation of the FDIC and its resolution powers operating in a federal system of banking regulation. The following Parts return to Europe to apply the insights gained from the U.S. context. This Part briefly describes the initial responses by European regulators to failing banks and the gradual development towards a federal resolution regime. It also sketches out the shortcomings of the current regulatory framework. Subsequently, Part VI will apply the key insights learned from the FDIC's experience, as discussed above, to develop a way forward for an effective and operational bank resolution framework within the Banking Union.

The European response to the banking crisis was characterized by four separate phases. Distinguishing these phases illustrates the European learning process during the crisis. Part V.A describes the first two phases. The first reaction was to fashion simple, straightforward, and typically uncoordinated bail-out programs, led by the individual Member States. During this phase, there was almost no E.U. level involvement. In the second phase, Member States began adopting national resolution regimes, at different speeds and with different priorities. Part V.B describes the third phase, marked by efforts to coordinate national resolution regimes by way of the E.U. Bank Recovery and Resolution Directive. This directive harmonizes the national regimes, but essentially leaves resolution power on the State level. Part V.C describes the latest step: An attempt to federalize resolution power and authority at the E.U. level. This is the second pillar of the Banking Union, which is of special interest for the present study.

A. *National Responses: From Bail-Outs to Resolution Regimes*

1. *Uncoordinated Bailouts*. — The Crisis hit hard in Europe. Reactions were characterized at first by a reinvigoration of the nation state: national governments and Member States were the main players during 2007-09, and the federal E.U. institutions were almost muted. It was the national governments that took decisions over bailouts, which proved difficult in many instances precisely because of the cross-border character of many large banks in Europe. The most salient example was the Benelux-based Fortis Bank, whose pan-European character created particular difficulties.[119] E.U. institutions played a decidedly secondary role, principally though the review of the bailouts through the lens of E.U. "state aid" rules[120]—which were then bent to virtual non-recognition.[121] While academics quickly moved to criticize bailout programs,[122] policymakers moved more slowly from bailout to resolution.

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[119] See, in detail, Martin Čihák and Erlend Nier, *The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union*, 2 Harv. Bus. L. Rev. 395 (2012) at p. 429-430.

[120] The E.U. state aid framework seeks to ensure that no State supports domestic firms over others, thereby distorting competition in the European internal market. See Treaty on the Functioning of the European Union (TFEU), Article 107.

[121] Conor Quigley, State Aid and the Financial Crisis, *in* Legal Challenges in the Global Financial Crisis (Wolf-Georg Ringe & Peter M. Huber, eds., 2014), at 131; Mathias Dewatripont, *European Banking: Bailout, Bail-in and State Aid Control*, 34 INT'L. J. OF INDUSTRIAL ORGANIZATION 37 (2014).

2. *Transition to Resolution Regimes*. — After a number of costly bailouts[123] the U.K. was the first European country to introduce a formal resolution scheme. Initially adopting emergency legislation,[124] the U.K. moved to a more permanent rescue mechanism through the Banking Act 2009.[125] This Act assigned the role of the lead authority to the Bank of England (rather than to the Treasury); it allowed for a number restructuring alternatives, including the possibility of putting a bank into temporary public ownership (TPO).[126] Many of the instruments are similar to the powers of the U.S. FDIC and were in fact inspired by the FDIC Improvement Act (FDICIA) of 1991.[127] The Banking Act has been used twice, for rather minor cases.[128] It is important to note that the government also introduced requirements, set out under the Financial Services Act 2010, for all deposit-taking institutions and significant investment firms to produce recovery and resolution plans (so-called "living wills").[129]

Several other European states introduced similar measures. In Germany, the paradigm shift from the "rescue" phase to the "restructuring" phase was marked by the implementation of the Restructuring Act on January 1, 2011.[130] Under the new regime, the German market

[122] Mathias Dewatripont & Xavier Freixas, *Bank resolution: a framework for the assessment of regulatory intervention*, 27 Oxford Review of Economic Policy 411, 427 ff (2011); Thomas F. Huertas, *The Road to Better Resolution: From Bail Out to Bail In*, LSE Special Paper 195/2010, December 2010, available at http://www2.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP195.pdf; Eva Hüpkes, *Special bank resolution and shareholders' rights: balancing competing interests*, 17 Journal of Financial Regulation and Compliance 277, 301 (2009); Hans-Joachim Dübel, *The Capital Structure of Banks and Practice of Bank Restructuring*, CFS Working Paper No 2013/04, available at https://ideas.repec.org/p/zbw/cfswop/201304.html.

[123] The crisis at mortgage lender Northern Rock marked the beginning of the U.K.'s slide into large-scale state ownership of the banking system. At the height of the global financial panic, the British government took dramatic steps to nationalize Royal Bank of Scotland and Lloyds TSB. A £20 billion injection was exchanged for a 58 % stake in RBS, and £17 billion bought 40 % of Lloyds.

[124] The *Banking (Special Provisions) Act 2008* was introduced as emergency legislation to facilitate the steps to save Northern Rock in 2008. It was subsequently used for two other cases, the rescue of Bradford and Bingley and the UK assets of Icelandic banks Kaupthing and Landsbanki. See Bank of England, Resolutions prior to the Banking Act 2009, available at http://www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/prior.aspx#.

[125] Banking Act 2009, c. 1 (U.K.). Two other major banks fell victim to the crisis in 2008: Royal Bank of Scotland (RBS) and HBOS/Lloyds. They both had to be recapitalized. See Andrew Porter et al., Financial Crisis: HBOS and RBS 'to be nationalised' in £50 Billion State Intervention, Telegraph (Oct. 12, 2008), http://www.telegraph.co.uk/finance/financialcrisis/3185120/Financial-crisis-HBOS-and-RBS-to-be-nationalised-in-50-billion-state-intervention.html. Learning from these experiences, the government designed the Banking Act 2009 to equip the regulator with adequate powers to deal with all possible situations. On the Banking Act, see in detail P Brierley, *The UK Special Resolution Regime for Failing Banks in an International Context*, Bank of England Financial Stability Paper No 5, at 4 (July 2009).

[126] See, in more detail, Emilios Avgouleas, *Banking supervision and the special resolution regime of the Banking Act 2009: the unfinished reform*, 4 Capital Markets Law Journal 201, 212 ff (2009); Kern Alexander, *Bank Resolution Regimes: Balancing Prudential Regulation and Shareholder Rights*, 9 J. Corp. L. Stud. 61, 90 ff. (2009).

[127] The FDICIA (P.L. 102-242, 105 Stat. 2236) was the U.S. response to the 1980s Savings & Loans financial crisis.

[128] Dunfermline Building Society, the largest building society in Scotland, and Southsea Mortgage and Investment Company.

[129] Financial Service Act 2010, c. 28, § 7.

[130] Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz) of December 9, 2010, BGBl I 2010, 1900.

supervisor BaFin received extended powers of intervention and special restructuring; further, reorganization instruments for German banks were introduced. The costs of any such measures would no longer be borne by the taxpayer but instead by the banking industry.[131] Technically, this is to be achieved by means of a bank levy payable by all German banks, the proceeds of which flow into the newly established Restructuring Fund administered by the newly created Federal Agency for Financial Market Stabilization (FMSA).[132] Amounts payable under the bank levy increase with the bank's size and its degree of interconnectedness within the financial system. The goal is to raise a Fund of EUR 70 billion, accruing over a number of years.[133]

A more general look at this early post-crisis phase in Europe reveals an evolution from the traditional bailout, in which all creditors were protected even if shareholders were wiped out, to more differentiated, modern versions where occasionally creditors have had to join in as well. Indeed, when Spain bailed out its savings banks (known as "*cajas*") in 2012, it decided to impose losses not just on common shareholders, but also on preferred shareholders, and unsecured bondholders, including many retail investors.[134] Similarly, in the very recent nationalization of Dutch bank and insurance group SNS Reaal, the Netherlands imposed losses on SNS Reaal's shareholders, subordinated debt holders, and some hybrid securities, but not on senior debt or covered bonds.[135] The Dutch government made use of new powers granted under the 2012 Intervention Act.[136]

3. *Shortcomings*. — The general perception during the crisis was that the European response to the Crisis was inadequate and insufficient in many respects. First, the renaissance of

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[131] Previously, following the collapse of Lehman Brothers, the German government had introduced a state-backed financial market stabilization package (Financial Market Stabilization Act (Finanzmarktstabilisierungsgesetz) of October 17, 2008, BGBl I 2008, 1982). Central to this bail-out scheme was the establishment of the Special Financial Market Stabilization Fund (SoFFin) administered by the newly created German FMSA. The SoFFin served to fund rescue and stabilization measures for the German financial industry in the form of guarantees, recapitalizations, risk transfers and, as from mid-2009, bad bank schemes. The initial financial sector rescue package phased out on December 31, 2010. In some ways, this package was seen as a success in that it helped to avoid bank runs and a credit crunch. However, it became apparent in the aftermath of the crisis that the stabilization of the financial markets by way of emergency bail-out legislation could only be a starting point for major structural regulatory reforms. Lawmakers recognized that bail-outs of financial institutions which are "too big to fail" may lead to moral hazard and misappropriation of resources.

[132] Officially, "Bundesanstalt für Finanzmarktstabilisierung". Information in English is available at http://www.fmsa.de/en/.

[133] See http://www.fmsa.de/en/fmsa/restructuring-fund/bank-levy/index.html.

[134] Graziella Marras, Basel III, Resolution, Bail-in, Bailout, Ring-fencing, and Banking Union: What Does the Future Hold for Banks and Their Investors, Market Integrity Insights (Feb. 25, 2013), http://blogs.cfainstitute.org/marketintegrity/2013/02/25/basel-iii-resolution-bail-in-bailout-ring-fencing-and-banking-union-what-does-the-future-hold-for-banks-and-their-investors/.

[135] T Escritt and A Deutsch, Dutch nationalise SNS Reaal bank group in $14 billion rescue, *Reuters* February 1, 2013, available at http://uk.reuters.com/article/2013/02/01/uk-dutch-finance-cbank-idUKBRE9100A420130201.

[136] Wet van 24 mei 2012 tot wijziging van de Wet op het financieel toezicht en de Faillissementswet, alsmede enige andere wetten in verband met de introductie van aanvullende bevoegdheden tot interventie bij financiële ondernemingen in problemen (Wet bijzondere maatregelen financiële ondernemingen), Dutch Official Journal (Staatsblad), number 241 on June 12, 2012.

the individual nation-state during the crisis (as discussed above) meant that each E.U. Member State was concerned with itself, and failed to take into account the European dimension of the bank rescues (or omitted rescues) that took place. This led to collective action problems and externalities, particularly given the nature and extent of cross-border banking in the E.U. In one notable case, Benelux-based Fortis Bank, there were severe difficulties in determining the individual states' responsibilities for resolution purposes. Fortis Bank had a strong presence in all three Benelux countries and was subject to a relatively well-developed cooperation agreement among its supervisors.[137] Despite this, the authorities from the different Member States were unable to agree on a rescue plan that might have maintained the cohesion of the group structure. A genuine European solution was out of the question, as the E.U. itself was equipped with no resolution powers. As a consequence, the concerned states failed to sustain a multilateral resolution, and the group was split up along geographical boundaries and not along a more logical and cost-effective division between business lines.[138] The resolution plan sacrificed value.

The second, and related, problem was the observed forbearance of national regulators towards their own supervisees; i.e., their own banks. Supervisors exhibited leniency towards their own banks at various moments in the financial crisis partly because they feared the consequences of their intervention and partly because they wanted to shield their own supervisory failures.[139] These pressures were particularly strong in situations where several or many local banks had problems and intervention risked a credit crunch. But failure to intervene early intensified the crisis overall because of the cross-border externalities. Therefore, the only way to effectively overcome the inherent national bias is to implement supervision and resolution on the European level.

The third European problem related to the interconnectedness between a State and its banks. As the financial crisis developed into the European sovereign debt crisis, it became clear that some countries' balance sheets were simply not large enough to rescue their own banks. The perceived interdependence of sovereign and bank creditworthiness created a downward spiral of weak banks progressively undermining sovereigns that were, in turn, trying to bail out their own failing banks. Today, European banks continue to hold large amounts of bonds from their home

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[137] European Commission, Impact assessment accompanying Communication on an E.U. framework for cross-border crisis management in the banking sector, 2009, at p 16-17, available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/091020_impact_en.pdf.
[138] Zdenek Kudrna, *Cross-Border Resolution of Failed Banks in the European Union after the Crisis: Business as Usual*, 50 Journal of Common Market Studies 283, 288-90 (2012); European Commission, *supra* note 125..
[139] See the case studies for eight different European banks described at Hans-Joachim Dübel, *The Capital Structure of Banks and Practice of Bank Restructuring*, CFS Working Paper No 2013/04, available at https://ideas.repec.org/p/zbw/cfswop/201304.html, at p. 4 ff.

governments.[140] In recognition of these deep problems, the Euro Area Council declared in June 2012 that it is "imperative to break the vicious circle between banks and sovereigns."[141]

All three problems have been particularly salient within the Eurozone, where a common monetary policy in the hands of the ECB has spurred close economic and financial integration and increased the possibility of cross-border spillover effects in the event of bank crises.[142] The existing mechanisms were hardly sufficient to handle these effects. Coordination between supervisors turned out to be nothing more than a first step. The state aid restrictions[143] proved to be an ineffectual anti-bailout tool, yet the bailouts themselves were insufficient to end the crisis. The self-evident shortfalls prompted ECB president Mario Draghi to assert that only a centralized resolution scheme could "credibly pursue the least cost resolution strategy, assessing possible cross-border spillover effects and systemic concerns, and ensuring that resolution costs are first and foremost borne by the private sector. It would thereby minimize resolution costs without recourse to taxpayer money."[144]

B. More Internationally-Coordinated Efforts

1. *Pre-BRRD Coordination*. — In order to prevent future crises and to address the "too-big-to-fail problem," policymakers and regulators found it necessary to develop an internationally harmonized recovery and resolution regime for systemically important banks (SIBs) and financial institutions. This was the hour of the Financial Stability Board (FSB), an international body which had been created in 1999 to coordinate internationally the work of national financial authorities and international standard setting bodies.[145] Though the FSB was little recognized in its first decade, the crisis provided the opportunity for the organization to play an active role in shaping the coordination of international regulatory efforts. In 2011, the FSB adopted its "Key Attributes" of effective resolution regimes, a type of best-practices guide, that

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[140] Daniel Gros, Banking Union with a Sovereign Virus: The Self-serving Treatment of Sovereign Debt, Intereconomics 93 (2013). See also Alberto Gallo et al., European Banks: Still Too Big to Fail, The Revolver: RBS Macro Credit Research, Jan. 23, 2014, at 4, available at http://static.presspeople.com/attachment/cd8316b272864aacaf2161ef83016d09.
[141] Euro Area Summit Statement, June 29, 2012.
[142] European Commission, *Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union*, September 12, 2012, at p 3.
[143] See *supra* note 108.
[144] M Draghi, *Introductory statement at the hearing of the Committee on Economic and Monetary Affairs of the European Parliament*, February 18, 2013.
[145] See Chris Brummer, Minilateralism 107-09, 193 (Cambridge Univ. Press 2014); See James R. Barth et al., Systemically Important Banks (SIBs) in the Post-Crisis Era: 'The' Global Response, Reponses Around the Globe for 135 Countries, in Allen N. Berger, Philip Molyneux & John O.S. Wilson, eds., THE OXFORD HANDBOOK OF BANKING (Oxford University Press, 2nd edition 2014), chapter 26 (describing G20-FSB interaction and initiatives); Daniel E. Nolle, Who's in Charge of Fixing the World's Financial System? The Un[?]der-Appreciated Lead Role of the G20 and the FSB, in 24 Financial Markets, Institutions & Instruments 1 (2015).

was then updated in October 2014.[146] These Key Attributes recommended, inter alia, that the scope of national resolution regimes should extend to all financial institutions whose failure could have systemic consequences; that national regulators should wield broad resolution powers, including transfer powers and explicit bail-in powers to write down debt and to convert it to equity; creditor safeguards; and that the funding in resolution should come from deposit guarantee scheme funds or separate resolution funds. Addressing the international dimension of bank failures, the Key Attributes recommended an approach to cross-border resolution based on "modified universalism," with a presumption of cooperation between home and host authorities—but host authorities would be in a fallback position to take independent action if necessary to protect financial stability in the host jurisdiction. The Key Attributes have received powerful political endorsement, most notably by way of formal declaration at the G20 Summit 2011 in Cannes.[147]

In the wake of these recommendations, national governments adjusted their already-adopted resolution mechanisms. U.K. lawmakers decided to reform the Banking Act of 2009 in order to extend the scope of the resolution mechanism to include non-banks whose failure could be systemic, to include branches of non-E.U. foreign banks in the E.U. within the Act's scope and to include explicit bail-in tools. These considerations led to the amendment of the Banking Act 2009 via the Financial Services Act 2012[148] and the Financial Services (Banking Reform) Act 2013[149]. Eventually the E.U. Bank Recovery and Resolution Directive delivered many of these reforms for Europe generally.[150]

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[146] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2014), available at http://www.financialstabilityboard.org/publications/r_141015.pdf.
[147] G20, CANNES SUMMIT FINAL DECLARATION – BUILDING OUR COMMON FUTURE: RENEWED COLLECTIVE ACTION FOR THE BENEFIT OF ALL, November 4, 2011, at para 28, available at https://www.g20.org/sites/default/files/g20_resources/library/Declaration_eng_Cannes.pdf.
[148] Financial Services Act 2012 (ch 21), Part 8.
[149] The Financial Services (Banking Reform) Act 2013, ch. 33, available at <http://www.legislation.gov.uk/ukpga/2013/33/pdfs/ukpga_20130033_en.pdf>.
[150] See *infra* part V(4).

2. *The Path Towards the E.U. Bank Recovery and Resolution Directive*. — We have previously described the front-line role of the Member States in addressing the financial crisis.[151] During the same period, E.U. governance institutions worked to prepare a systematic response.[152] The Commission initially pursued a two-part strategy to address bank failures: first, to enhance macro- and micro-supervision on the E.U. level; and secondly, to begin to harmonize Member States' resolution mechanisms. Focusing on the latter, an October 2009 Commission Communication presented the Commission's views on the development of a regulatory framework for limiting the systemic impact of a failing cross-border bank.[153] In 2010, the Commission announced an E.U. "framework" for a bank resolution fund.[154] Importantly, this framework envisioned only a supporting role for the E.U., leaving power in the Member States' hands and ensuring that "*Member State authorities* have common tools that can be used in a coordinated manner to allow prompt and legally robust action in the event of major banking failures, protecting the broader financial system, avoiding costs for taxpayers and *ensuring a level playing field*."[155] The European Commission stressed that it could not go further:

> In principle, pooling resources into a single pan-EU resolution fund would deliver clear benefits by: increasing risk diversification; delivering economies of scale; reducing the amount that would be subject to burden sharing; providing the right incentives for cooperation; speeding up decision-making; and guaranteeing a level playing field. It would also better reflect the pan-EU nature of banking markets, in particular for cross border banking groups. However, the Commission recognizes that it would be very difficult to begin with the creation of an EU Resolution Fund in the absence of an integrated EU supervisory and crisis management framework. The European approach to the establishment of bank resolution funds should mirror the broader approach to supervisory arrangements. For that reason, an appropriate first step could be a system based around the establishment of a harmonized network of national funds linked to a set of coordinated national crisis management arrangements."[156]

Following this first step, a 2010 Communication aimed to identify the elements of "coordinated national crisis management arrangements."[157] It specified that national authorities should be broadly equipped with common, effective tools and powers to tackle bank crises at the earliest possible moment while avoiding costs for taxpayers. The common toolbox would

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[151] See *supra* parts V(1),(2).

[152] Wolf-Georg Ringe and Peter M. Huber (eds), Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro, and Regulation (2014). See also Lucia Quaglia, Financial regulation and supervision in the European Union after the crisis, 16 Journal of Economic Policy Reform 17 (2013).

[153] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic And Social Committee, the European Court of Justice and the European Central Bank: An E.U. framework for Cross-Border Crisis Management in the Banking Sector*, COM(2009) 561 final, 20 October 2009.

[154] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank: Bank Resolution Funds*, COM(2010) 254 final, 26 May 2010.

[155] Id., at 5 (emphasis added).

[156] Id., 6-7.

[157] European Commission, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank: An E.U. Framework for Crisis Management in the Financial Sector*, COM(2010) 579 final, 20 October 2010.

include: (i) preparatory and preventative measures, including "living wills"[158]; (ii) supervisory power to force a bank to undertake early stage remedial action[159]; and (iii) resolution tools, such as the power to effect a takeover of a failing bank by a sound institution or a transfer of all or part of its business to a temporary bridge bank, so as to ensure both the continuity of essential services and the orderly management of failure.

Unlike the Member States, the Commission also had to grapple with the specific problem of *cross-border* banking. Cross-border banking dramatically increased in the E.U. in the years before the financial crisis,[160] but no system existed to deal with the complications of the failure of a bank that operated in multiple States. In the 2010 Communication, the Commission proposed arrangements to ensure that local authorities coordinated and cooperated as fully as possible in order to minimize harmful effects of a cross-border bank failure.[161] Again, this left the national authorities as key players and facilitated cooperation; it built on existing supervisory colleges (groups of national supervisors) to set up resolution colleges (where supervisors and national authorities in charge of resolution would meet), for the purposes of crisis preparation and management.[162] The Commission established the European Banking Authority (EBA) to have a coordination and support role in crisis situations amongst the primarily responsible national authorities.[163]

During the following years, the Commission undertook the slow and painful process of pushing through a legislative project to harmonize resolution powers across the E.U. Member States. This required approval of the European Parliament and the European Council, a body in which the Member States are directly represented. Adoption of the E.U. Bank Recovery and Resolution Directive finally came in April 2014.[164] The BRRD corresponds to earlier expectations for a European instrument, and follows through on the themes of earlier announcements. It also adopts many of the proposals made by the Financial Stability Board's "Key Attributes."[165] Essentially, the Directive requires all E.U. Member States (not just the

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[158] A living will requirement would call for institutions and authorities to prepare for both recovery and resolution through anticipatory planning for financial stress or failure.
[159] Such remedial action could include such the replacement of management, the implementation of a recovery plan, or the divestiture of activities or business lines that posed an excessive risk to its financial soundness.
[160] Dirk Schoenmaker, *The European Banking Landscape after the Crisis*, Duisenberg School of Finance Policy Paper No. 12, April 2011, p. 2, available at http://www.dsf.nl/home/research/publications/dsf_policy_papers. See also Jakob de Haan, Sander Oosterloo, and Dirk Schoenmaker, FINANCIAL MARKETS AND INSTITUTIONS: A EUROPEAN PERSPECTIVE (2nd edition Cambridge: Cambridge University Press, 2012), chapter 10.3.
[161] See supra note 142.
[162] Id.
[163] Schoenmaker, supra note 148, at 12-13.
[164] 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, [2014] OJ L173/190.
[165] See *supra* note 91.

Eurozone countries) to ensure that their national supervisory and resolution authorities have a minimum set of common tools and powers that would enable them to avert and, where necessary, manage the orderly failure of a bank. It gives national resolution authorities powers to resolve branches of banks based in other countries in certain circumstances, and provides a framework for improved cooperation between relevant national supervisory and resolution authorities. An important feature of the proposal is the emphasis it puts on "bail-in" as a regulatory tool.[166] Furthermore, at the end of 2012, the Commission further consulted on a similar framework for non-bank financial institutions.[167]

C. *Resolution in a Banking Union*

1. *A European Banking Union.* — In a certain way, the project to create a Banking Union in Europe has superseded the efforts to harmonize all domestic resolution mechanisms within the E.U. The 2010-2012 sovereign debt crisis demonstrated that new strategies were needed to overcome the dangerous links between sovereigns and their banks. Regulators agreed that the solution required the federalization of some important tasks, including banking supervision, resolution, and deposit guarantee schemes.[168] Thus, the catchphrase for banking regulation has become to "break the link between sovereigns and banks."[169] At the most basic level, the objective is to ensure a level playing field for the European banking industry, to remove any national biases or supervisory forbearance, and to prevent the hiding of bad assets within—or even leniency towards—so-called "national champions."[170] But the Banking Union is supposed to go well beyond that: Its objective is to eliminate the asset and liability matching on a national level that has been a driver of the E.U. sovereign debt crisis.[171]

Thus, just three weeks after the BRRD proposal, regulators in the Euro-area summit on June 29, 2012 agreed, in principle, to establish a full Banking Union, calling for urgent steps to implement it by the end of the year.[172] Regulators envisioned a European resolution authority, a

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[166] BRRD (*supra* note 152) Articles 43-58.
[167] European Commission, *Consultation on a possible framework for the recovery and resolution of nonbank financial institutions*, 5 October to 28 December 2012, http://ec.europa.eu/internal_market/consultations/2012/nonbanks_en.htm.
[168] See European Commission, Memo/14/294, Banking Union: Restoring Financial Stability in the Eurozone 1–10 (2014), available at http://europa.eu/rapid/press-release_MEMO-14-294_en.pdf (outlining plans for Banking Union).
[169] E.g., Alessandro Giovannini, Banking Union: Will the EU Manage to Break the Link Between Sovereigns and Banks, Sovereign Debt Initiative (Jan. 17, 2014), http://sovdebt.org/2014/01/17/banking-union-will-the-eu-manage-to-break-the-link-between-sovereigns-and-banks/.
[170] See Yves Mersch, Member, Executive Board of the European Central Bank, Speech at the seminar "Auf dem Weg zu mehr Stabilität: The Banking Union—A European Perspective: Reasons, Benefits and Challenges of the Banking Union (Apr. 5, 2013), http://www.ecb.europa.eu/press/key/date/2013/html/sp130405.en.html (outlining these benefits of Banking Union).
[171] See id. ("Neither would a European supervisor insist on national asset and liability matching […]").
[172] Euro Area Summit Statement (June 29, 2012), available at <http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf>.

European resolution fund funded by banks' contributions, and a fiscal backstop in form of the (already established) European Stability Mechanism to accompany a common supervisor and deposit insurance scheme.[173] As a first step, the European Commission presented its proposals for a Single Supervision Mechanism.[174] In March 2013, the European Parliament and the Council reached agreement on the SSM, envisaging a major legislative package that would entrust the ECB with responsibility for banking supervision and adopt the operating rules of the EBA.[175]

In parallel, E.U. institutions began working on the second pillar of the Banking Union: resolution. In a speech in February 2013, ECB President Mario Draghi outlined the policy objectives of the future Single Resolution Mechanism:

> The Single Resolution Mechanism should be centered in a Single Resolution Authority with a European Resolution Fund at its disposal. . . . First, the Single Resolution Authority needs to dispose of a robust resolution framework, one that provides it with enforceable resolution tools and powers. In this respect, the proposed bank recovery and resolution directive is key. […] Second, the Single Resolution Authority needs access to resolution financing. It should therefore have a European Resolution Fund at its disposal, which should be financed by the private sector via risk-based ex ante levies. The European Resolution Fund should be backed by a public backstop mechanism, the support of which would need to be recouped via special ex post levies on the private sector. This means that it would be fiscally neutral over the medium term. Third, the Single Resolution Authority should have an institutional set-up that allows for independence, sufficient operational capacity and a robust accountability framework with effective judicial protection against resolution decisions ex post. The Commission is currently assessing the options for the institutional anchoring of the Single Resolution Authority.[176]

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[173] International Regulatory Strategy Group, *EU Banking Union – Operational Issues and Design Considerations* (October 4, 2012), available at <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2012/E.U.-banking-unions-final3.pdf>.

[174] European Commission, *Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*, COM(2012) 511 final, September 12, 2012; European Commission, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (E.U.) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards its interaction with Council Regulation (E.U.) No…/… conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*, COM(2012) 512 final, September 12, 2012. See also, European Commission, *Communication from the Commission to the European Parliament and the Council: A Roadmap towards a Banking Union*, COM(2012) 510 final, September 12, 2012.

[175] An important step towards a real banking union in Europe: Statement by Commissioner Michel Barnier following the trilogue agreement on the creation of the Single Supervisory Mechanism for the Eurozone, Press Release of March 19, 2013, available at http://europa.eu/rapid/press-release_MEMO-13-251_en.pdf. The final instruments adopted to create the SSM are cited in note 20 above. See on the SSM in detail, Eddy Wymeersch, *The Single Supervisory Mechanism or SSM, Part One of the Banking Union*, Ghent University Financial Law Institute Working Paper No. 2014-01, available at http://ssrn.com/abstract=2403859; Eilis Ferran & Valia Babis, *The European Single Supervisory Mechanism*, 13 J. Corp. L. Stud. 255 (2013).

[176] M Draghi, *Introductory statement at the hearing of the Committee on Economic and Monetary Affairs of the European Parliament*, February 18, 2013.

The Commission produced a proposal for a robust Single Resolution Authority in July 2013.[177] This proposal did not survive the E.U. polycentric decision-making process, resulting instead in a resolution structure that risks indecisiveness in a crisis and invites the protection of national champions.[178] From the outset, Germany and other E.U. Member States preferred a "college" or "network" of national resolution authorities to operate as E.U. decision maker instead of creating a new E.U. body. Indeed, some German government officials raised constitutional objections[179] and other Member States contended that a new SRM required revision of the E.U. Treaties. German Finance Minister Wolfgang Schäuble therefore suggested an alternative two-step approach: a coordinated network of national authorities as a first step, and the introduction of a central E.U. resolution authority in the more distant future, following a Treaty revision.[180] In a similar vein, the French and German governments adopted a joint paper in May 2013 to propose a "single resolution board" that would be composed of national resolution authorities.[181] In fact, they were proposing the old-style European approach of establishing "colleges" of national bodies on the European level, such as CESR,[182] due to their reluctance to relinquish their sovereignty.

It is therefore no surprise that the Commission's July 2013 proposal proved to be extremely controversial—the Council (representing the Member States) sought more influence in

[177] European Commission, Proposal for a Regulation of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (E.U.) No 1093/2010 of the European Parliament and of the Council, July 10, 2013, COM(2013) 520 final.

[178] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, [2014] OJ L225/1 ("SRM Regulation").

[179] Quentin Peel and Alex Barker, Berlin hits at banking union plan, *Financial Times* (London, July 11, 2013), p. 2. See also the analysis by think tank Centrum für Europäische Politik, Bankenabwicklung für die SSM-Staaten (SRM), cepAnalyse no 42/2013, October 7, 2013, who argue that TFEU Article 352 would be a preferable legal basis (which however requires unanimity in Council), available at http://www.cep.eu/uploads/tx_cpspolitmonitor/cepAnalyse_COM_2013_520_Bankenabwicklung_01.pdf. These constitutional concerns should have been mitigated by the January 2014 ECJ decision C-270/12 *United Kingdom v Parliament and Council* ECLI:EU:C:2014:18, available at http://curia.europa.eu/juris/document/document.jsf?text=&docid=146621&page Index=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=12829 (sustaining ESMA's rules against short-selling).

[180] Wolfgang Schäuble, *Banking union must be built on firm foundations*, Financial Times of May 13, 2013, p. 9. This suggestion was however criticized by the European Commission and the ECB. For example, ECB Executive Board member Jörg Asmussen rejected Schäuble's proposal swiftly and called for a timely adoption of both pillars. See Paul Carrel, ECB's Asmussen rejects German finance minister's view on bank union, Reuters, May 13, 2013, available at http://uk.reuters.com/article/2013/05/13/uk-ecb-bankingunion-idUKBRE94C0P320130513. See also, speech by Yves Mersch, Member of the Executive Board of the ECB, Barclays Research Conference, London, May 17, 2013, available at http://www.ecb.int/press/key/date/2013/html/sp130517_1.en.html.

[181] France and Germany – Together for a stronger Europe of Stability and Growth, May 29, 2013, at p. 5, available at http://blogs.r.ftdata.co.uk/brusselsblog/files/2013/05/Together-for-a-stronger-Europe-of-Stability-and-Growth-1.pdf.

[182] CESR was the former Committee of European Securities Regulators, a network of national regulators. It has now been replaced by ESMA, the European Securities and Markets Authority.

the resolution process while the European Parliament played its federalist foil.[183] In April 2014, the counterparties finally reached a compromise that was enacted into law that summer.[184] The legislation introduces a new centralized E.U. body, the Single Resolution Board (the "Board"), which will direct the resolution process for financial institutions in the Eurozone and in other signatory E.U. countries.[185] This Board (presumably on recommendation of the ECB as supervisor per the SSM) will initiate the resolution of an institution and will be responsible for the key decisions on how it would be resolved.[186] However, the European Commission—purportedly for constitutional reasons—will retain the ultimate decision on whether to resolve an institution, usually (but not necessarily) on the proposal of the Board.[187] The Council may, in exceptional circumstances, oppose the decision.[188] In practice, though, we expect that both Commission and Council would be extremely unlikely to deviate from the Board's proposals, due to the latter's expertise in bank resolution and the urgency circumstances that drive a resolution decision. The Board would then instruct a national resolution authority to execute the decision.[189]

The SRM is accompanied by a Single Bank Resolution Fund (the "Fund"), financed by annual contributions from the banks protected by it.[190] The target size of the Fund is 1 % of covered deposits of all credit institutions authorized in the participating Member States, currently estimated at roughly EUR 55 billion.[191] The Board would use the Fund to ensure the operability

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[183] The European Parliament claims victory in a sense that the final compromise "has repaired many of the serious flaws in the initial Council position". See European Parliament, Parliament negotiators rescue seriously damaged bank resolution system, Press Release of March 20, 2014, available at http://www.europarl.europa.eu/pdfs/news/expert/infopress/20140319IPR39310/20140319IPR39310_en.pdf.

[184] See the SRM Regulation, *supra* note 166. Further, European Commission, *Statement – European Parliament and Council back Commission's proposal for a Single Resolution Mechanism: a major step towards completing the banking union*, March 20, 2014. The looming European Parliament elections in May 2014 played a decisive role in bringing the negotiating parties to reach a deal.

[185] The so-called "Participating Member States", see SRM Regulation, *supra* note 166, Article 4. The Board would be composed of a number of permanent members as well as representatives from the Commission, the Council, the ECB and the national resolution authorities. See SRM Regulation, Article 43.

[186] See in detail on the operation of the SRM, Danny Busch, *Governance of the Single Resolution Mechanism*, unpublished working paper, June 2, 2014.

[187] SRM Regulation, Article 18(7). The reason for giving the Commission the last word appears to stem from the constitutional principle usually referred to as the "Meroni doctrine". This goes back to one of the early ECJ cases, 9/56 and 10/56, *Meroni v High Authority* [1957/1958] ECR 133, which essentially put limits on the Commission's powers to delegate discretionary authority. The press release accompanying the proposal states that "For legal reasons, the final say could not be with the Board". European Commission, Press Release IP/13/674, July 10, 2013. In the ECJ's recent decision upholding a delegation to ESMA, see *supra* note 167, the legalism may provide a cover for a political accommodation. For more detail, see Eilis Ferran, European Banking Union: Imperfect, But It Can Work, W.P. April 2014, available at <http://ssrn.com/abstract=2426247>, p. 19 ff.

[188] SRM Regulation, *supra* note 166, Article 18(7), (8).

[189] SRM Regulation, *supra* note 166, Article 18(9).

[190] See already Commission proposal, *supra* note 165, Articles 64-73.

[191] The target level of the Fund is currently a percentage of the amount of covered deposits. However, the Commission will decide whether a percentage of total liabilities of financial institutions would be a more appropriate basis. See SRM Regulation, *supra* note 166, recital 105. On the estimation of EUR 55 billion, see Commission proposal, *supra* note 165, at p. 14.

of the failing bank in the short run; the Commission emphasizes that it is not a bail-out fund designed to take losses. [192] The creation of the Fund proved to be one of the most controversial aspects of the SRM.[193] Such an E.U.-level federal fund raised the specter of cross-subsidy from the prudent North to the profligate South, a third-rail throughout the crisis. Other parties raised E.U. constitutional concerns. Thus the Commission outsourced certain aspects—in particular, details on the transfer and mutualization of contributions to the Fund—from the SRM Regulation into a separate, Intergovernmental Agreement (IGA) that exists alongside the Regulation.[194] Twenty-six E.U. member states (all but Sweden and the United Kingdom) signed this IGA May 21, 2014.[195]

Unsurprisingly, the final outcome of the SRM is a typical Brussels compromise. The competences in the resolution process have been allocated to several players, apparently to alleviate concerns from opposing sides. Thus, the decision to shut down a bank involves all of the European Central Bank, the Board of the SRM (comprising permanent members, the Commission, the Council, the ECB, and national resolution authorities), and the Commission.[196] National authorities will execute the resolution, not the SRB or the Commission (although on instruction by the latter). This may also create some leeway for national regulators to influence the resolution process.[197] These are serious but acceptable flaws. The main problem of the negotiation outcome, however, is the resolution fund. Its target size in the region of just EUR 55 billion is way too small, even in the eyes of the ECB.[198] Consequently, the size of the Fund has already been subject to sharp criticism.[199] To remedy this problem, the European Parliament insisted that the fund be able to borrow on the capital market, in order to replenish its funds.[200] Further, the Parliament pushed the target date for the full size of the Fund being available forward to 8 years instead of 10 years after the SRM's coming into force and by insisting on an earlier date for the mutualization of existing national resolution schemes.[201] Despite these changes, the Fund, as it has been adopted, cannot credibly support the resolution of a SIFI. The capital market borrowing option is insufficient—governments will not endorse such loans, and the Fund may only be able to tap the European Stability Mechanism (ESM) in exceptional

[192] Commission proposal, *supra* note 165, at p. 13.
[193] See, e.g., Benjamin Fox, Brussels on Collision Course with Germany on Banking Union, EU Observer (Jul. 10, 2013, 6:59 P.M.) ("Just as controversial is the concept of a single bank resolution fund . . . .").
[194] SRM Regulation, *supra* note 166, Article 1(3).
[195] Agreement On The Transfer And Mutualisation Of Contributions To The Single Resolution Fund, Council Document 8457/14, available at http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%208457%202014%20INIT.
[196] As explained above, in certain situations, the Commission's decision is even subject to objection by the Council.
[197] In a similar vein, see the assessment by Ferran, supra note 28, at 18-19.
[198] John O'Donnell & Tom Körkemeier, Europe strikes deal to complete banking union, Reuters, March 20, 2014, available at http://uk.reuters.com/article/2014/03/20/uk-eu-bankingunion-idUKBREA2J0IW20140320.
[199] Mark Wall, Deutsche Bank's chief euro zone economist, and academic economist Paul De Grauwe have both considered the Fund as insufficient, see O'Donnell & Tom Körkemeier, *supra* note 186.
[200] See SRM Regulation, *supra* note 166, Article 74; further, European Parliament, Press Release, March 20th, 2014, supra note 171.
[201] See European Parliament, Press Release, March 20, 2014, supra note 171.

circumstances.[202] Finally, the eight-year transition period means that the Fund will not have any clout at all during its first years.

In sum, we are skeptical of the credibility of the Resolution Mechanism, in particular its financial strength.[203] The Banking Union's original goal was to replace the deadly nexus between a weak bank and a weak sovereign with a European solution that would have sufficient strength to shut down the bank. However, the Banking Union cannot achieve this goal without a financially strong resolution mechanism. The situation is all the more serious as the third pillar of the Banking Union—deposit guarantee—has been removed.

3. Deposit Insurance—Policymakers and academics regard deposit insurance as an important and integral part of modern financial regulation.[204] In particular, early common rules on deposit guarantees helped drive the development of the European market for financial services.[205]

The E.U. adopted its first Directive on Deposit Guarantee Schemes ("DGS") in 1994, achieving minimum harmonization of deposit protection policies across Member States.[206] The DGS required at minimum a modest EUR 20,000 guaranteed by Member States. In 2009, in response to the exigencies of the financial crisis, the E.U. raised the minimum level to EUR 100,000 by December 31, 2010.[207] Later, the E.U. again revised the DGS alongside the adoption of the SRM,[208] with the objective of harmonizing and simplifying protected deposits, achieving faster payouts, and improving the financing of national deposit schemes.[209] The revised DGS Directive requires ex ante funding of all national systems. The targeted amount is 0.8% of covered deposits, to be collected from banks over a 10-year period though fees employing a risk-based component. A recent FSB survey shows that most E.U. Member States

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[202] Statement of Eurogroup and ECOFIN Ministers on the SRM backstop, December 18, 2013: "In the transition period, bridge financing will be available either from national sources, backed by bank levies, or from the ESM in line with agreed procedures." Available at <http://www.eurozone.europa.eu/media/502738/20131218-SRM-backstop-statement.pdf>.

[203] In a similar vein, Wolfgang Münchau, *Europe should say no to a flawed banking union*, FIN. TIMES, March 17, 2014: "Step back from this technical debate for a moment and recall why the eurozone needs a banking union in the first place: to prevent doubts about the solvency of national governments from undermining confidence in their banks. Unless the resolution fund has the backstop of further European funding, that cannot happen."

[204] See Asli Demirüç-Kunt et al., *Deposit Insurance Around the World* (World Bank W.P. 3628 ,June 2005), available at <http://ssrn.com/abstract=756851>; see also Asli Demirüç-Kunt et al., *Determinants of Deposit-Insurance Adoption And Design*, 17 J. Fin. Intermed. 407 (2008) (assessing rationales).

[205] Takis Tridimas, *EU Financial Regulation: Federalization, Crisis Management, and Law Reform*, in: THE EVOLUTION OF EU LAW (Paul Craig and Gráinne de Búrca, eds., 2nd edn, OUP 2011) at p. 783.

[206] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes [1994] OJ L 135/5.

[207] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, [2009] OJ L68/3.

[208] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes (recast) [2014] OJ L173/149.

[209] See European Commission, Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [recast], Brussels, 12 July 2010, COM(2010) 368 final.

are already compliant with the principles of the new version[210]; however, the size of insurance funds is very small, well below even the lowest target under discussion during the legislative process.[211]

Crucially, however, deposit insurance remains even after the most recent reforms a predominantly national affair. As we explain above, original proposals to erect a third Banking Union pillar to create a common deposit guarantee scheme were quietly dropped.[212]

VI. Operation of Our Proposal Under E.U. Law

This Part evaluates the insights gained from the analysis of the FDIC's resolution power against the current framework present in the E.U. as described in Part V. Part VI.A uses the FDIC analysis to develop the main proposal for an effective banking resolution regime in the Banking Union. Part VI.B compares this proposal against the existing legal framework and identifies which changes and adaptations are necessary. Part VI.C summarizes the key benefits that this proposal has over the existing regime.

A. *Key Elements for the Future Banking Resolution Mechanism*

Our vision for banking resolution in Europe rests on four elements. First, is crucial that the European Banking Union adopt and sustain a federalized resolution procedure. Otherwise, it will not be able to resolve a fundamental systemic weakness in the E.U. financial sector—the interconnection between sovereign capacity and bank stability. Second, resolution can sufficiently complement supervision to form an effective Banking Union only if the resolution authority has strong, broad powers not subject to the veto of an interested Member State. Third, an effective resolution mechanism for Europe's G-SIBs and other systemically important banks will require structural reorganization of banking groups into holding company structures. Finally, the U.S. example shows that that "bail-in-able" debt can address the funding problem as an effective form of bank self-insurance that is particularly important in the case of G-SIBs.

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[210] Ex-post-funded deposit insurance is still present in some Member States, including Italy, the Netherlands, and the U.K.

[211] Financial Stability Board, *Thematic Review on Deposit Insurance Systems: Peer Review Report* (February 2012) Table 7, at p. 52.

[212] See *supra* note 2 and accompanying text. The Q&A section on the reformed deposit insurance directive spells this out at a well-hidden place. The bottom of the page reads:

> Should we have a pan-European Deposit Guarantee Scheme in the EU? A pan-EU DGS is not currently under discussion. The text opens the way to a voluntary mechanism of mutual borrowing between the Deposit Guarantee Schemes from different EU countries. This is the only form of mutualisation foreseen at this stage. The pan-European Deposit Guarantee Scheme could be a potential option in the future once the current banking reforms (e.g. BRRD Bank Resolution and Recovery Directive) have been implemented and the other elements of the banking union such as the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are in place.

http://europa.eu/rapid/press-release_MEMO-14-296_en.htm?locale=en.

1. *Centralization*—Bank resolution in the European Union will be most efficient and effective in the hands of one strong regulator. Indeed, the capacity of the SRB to wield the BRRD powers in a way that attends to the interest of the EU banking system as a whole rather than the interests of a particular Member State is a crucial element in the success of the Single Resolution Mechanism. The evolution of the FDIC in the system of U.S. banking regulation illustrates the importance of a central, unbiased, and well-funded institution. The FDIC was created in response to weak, state-based insurance systems that could not prevent the bank failures of the Great Depression and avoid the consequent externalities.[213] Even though the U.S. at the time had comparatively local banks,[214] lawmakers chose to federalize deposit insurance and a federal resolution process as the most credible way to foster systemic stability. The case for a centralized E.U. resolution process is even stronger, given the large number of banks operating cross-border and the well-advanced integration of financial services in the E.U.[215] This simple lesson drawn from the U.S. regime reinforces the EU-specific arguments in favor of centralized resolution.[216]

This principle may help resolve the controversy around the development of the EU resolution mechanism and its procedures. The initial preference of the Franco/German tandem for a resolution "college" of national supervisors was, as described above, transmuted into the Single Resolution Board, on which the relevant national supervisors will be represented.[217] To establish the Board's autonomy, it is important for it to develop an internal infrastructure that includes two critical elements: well-developed administrative procedures that would apply in case of a resolution and a staff that is capable of carrying forward a resolution or, where that task has been delegated to national authorities, the capacity for robust monitoring to assure that the resolution is effectively implemented. Such procedures, staff building, and practices could constrain national protectionist impulses. Indeed, the European Commission itself compares the Single Resolution Board with the FDIC, an autonomous, self-governing body.[218]

Centralization is not inconsistent within the retained role of national regulators in the resolution system. The ECB's supervisory remit extends beyond the European G-SIBS. As the U.S. experience shows, bank failures (and resolutions) are far more common for smaller banks,

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[213] Roger Lowenstein, There's a Reason for Deposit Insurance, NEW YORK TIMES, March 24, 2013, at p. 3.
[214] See *supra* part II.
[215] See, on the comparative level of cross-border penetration of banking, Dirk Schoenmaker, *The European Banking Landscape after the Crisis*, Duisenberg School of Finance Policy Paper No. 12, April 2011, p. 2, available at <http://www.dsf.nl/home/research/publications/dsf_policy_papers>. See also Jakob de Haan, Sander Oosterloo, and Dirk Schoenmaker, FINANCIAL MARKETS AND INSTITUTIONS: A EUROPEAN PERSPECTIVE (2nd edition Cambridge: Cambridge University Press, 2012), chapter 10.3.
[216] E.g., breaking the sovereign/bank link; or supplementing the SSM. See *supra* part I.
[217] See supra note 169–170 and accompanying text (discussing Franco/German college preference).
[218] See the calculations in the Commission proposal, *supra* note 165, at p. 98.

which do not present systemic risks.[219] In the referral of such cases by the ECB to the SRB, it is easy to see a useful role for national authorities in devising a resolution solution, particularly such smaller banks. Such a solution is likely to include some version of purchase and assumption and perhaps a payout under deposit guarantee schemes, which are established and administered under the laws of the Member States. On the other hand, the SRB has important monitoring role to play, to assure uniform compliance and application of the BRRD. In particular this means "bail-in" of shareholder and creditor claims per the BRRD's requirement of convertible "gone concern" liabilities,[220] prior to a payout on deposit insurance.

2. *Strong Resolution Powers*—Crucially, a European resolution authority must have complete discretion to write down debt and to convert it to equity. The FDIC experience demonstrates that when the resolution authority is confronted with a bank failure, it must have the power to use these strong and credible tools, as it considers necessary, in order to resolve the bank without causing major economic disruption. In each case, the Single Resolution Board will have to decide whether the best solution is to restructure the failing bank as a going concern (through bail-in), to restructure it as a gone concern (that is, through a bridge bank or a combination of bridge bank and bail-in) or to wind it down in full or in part. The resolution framework must enable the SRB to choose among all of those alternatives. Such write-down powers further have to be accompanied by the capacity for significant restructuring as necessary to return a "new" or "bridge" bank to long-term financial viability.

3. *Structural Requirements***.** The Board's write-down powers can work effectively only where two conditions are satisfied. First, the bank that is to be resolved must have in its liability structure sufficient subordinated term debt so that, in the event of bank failure, the conversion of debt into equity will be sufficient to absorb asset losses without impairing deposits and other short term credit. This is crucial to avoiding a run that would destabilize the bank and, depending on the circumstances, create systemic financial distress.[221] Second, G-SIBs and perhaps other significant financial institutions must be organized in such a way as to permit debt conversion without putting core financial constituents through a bankruptcy.[222] This is very important to assure the ongoing, non-disrupted operation of important financial activity that is organized in

[219] Over the 2007-2014 period, which included the heart of the financial crisis, 523 banks or thrifts failed in the US. FDIC Failures and Assistance Transactions, generated from the FDIC's Historical Statistics on Banking webtool, https://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30&Header=1. The only systemic institution to fail in the period was Lehman Brothers,which was not a bank. TARP infusions and other assistance protected systemically important banks, less than a dozen.

[220] This is the so-called "Minimum Requirement for Own Funds and Eligible Liabilities (MREL)," BRRD Art. 45; European Banking Authority, Consultation Paper: Draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU (Nov. 28, 2014), https://www.eba.europa.eu/-/eba-consults-on-criteria-for-determining-the-minimum-requirement-for-own-funds-and-eligible-liabilities-mrel- (describing this requirement).

[221] See supra Part III (describing how this aspect of FDIC's SPOE plan maintains stability and avoids systemic distress in the event of a large-bank failure).

[222] See on this argument in more detail, Jeffrey Gordon and Wolf-Georg Ringe, Bank Resolution in Europe: The Unfinished Agenda of Structural Reform, ECGI Working Paper 2015, http://ssrn.com/abstract=2548251.

legally and contractually complex forms. Avoidance bankruptcy for the operating subsidiaries also facilitates resolution of banks with important cross-border activities; if the subsidiaries are not put into bankruptcy, many difficult cross-border resolution problems can be avoided.[223] The goal, after all, in resolution of a G-SIB is to minimize own-firm losses, to minimize other-firm losses because of systemic distress, and thus to avoid damage to the real economy. Effective resolution also minimizes the necessary amount of bailin-able funds. Thus, an effective central resolution mechanism would require banks to adopt these structural characteristics if they have not already done so. As in the US, this will mean a holding company structure in which the public parent issues sufficient unsecured term debt so as (i) to cover losses at the operating subsidiary level that, when upstreamed, exceed the company's Tier 1 capital; and (ii) through the further conversion of the unsecured term debt, to re-equitize the BHC.[224]

4. *Funding*—Effective resolution requires a federal funding mechanism deployable at the discretion of the resolution authority to supply funding to a reorganizing institution. This funding is crucial for the early operations of the new "bridge" bank or the reorganized firm. Critically, this "funding" ought to be in the form of liquidity provisions at a time when private sources are closed to the resolving bank, not a bailout. The Banking Union should create this fund ex ante, through levies on the financial industry. In doing so, it could avoid the suggestion that it sought to provide a failing bank with taxpayer support and thereby make the threat of resolution a credible disciplinary measure. The levies should be adjusted on a risk-based assessment of the bank's activities—that is, banks engaged in riskier activities would pay higher fees—geared perhaps to match the G-SIB systemic risk surcharge.

The Single Bank Resolution Fund meets these criteria in principle, but it is, as explained, insufficient in its target size. In the U.S., the Treasury provides a substantial credit line to the FDIC, which has repayment priority on the assets of the resolved institution.[225] If that is inadequate, the credit is repaid over time through additional levies on the financial sector. Moreover, the FDIC can guarantee obligations of the bridge bank, backed by the full faith and credit of the U.S.[226] By contrast, the current version of the Fund will have limited range to augment its resources: It will be permitted to borrow on the capital markets, but it will not have the backing of the E.U. Member States.[227] In light of potentially massive liquidity needs in

[223] See supra Part III (describing how FDIC's resolution plan would help avoid subsidiary bankruptcy).
[224] See *supra* notes ##.
[225] See Dodd-Frank, § 210(o)(6) (maximum for an institution is 10 percent of consolidated assets and 90 percent of fair market value of the assets post resolution). See Dodd Frank, § 204(d) (describing repayment priorities). The FDIC guarantees of Bridgeco debt are not subject to explicit limit.
[226] See *supra* part I [on FDIC authority under OLA].
[227] SRM Regulation, Article 74. See Chris Mallon et al., EU Banking Union: Political Agreement Reached on Single Resolution Mechanism, Skadden, Arps, Slate, Meagher & Flom LLP (Apr. 10, 2014), http://www.skadden.com/sites/default/files/publications/EU_Banking_Union_Political_Agreement_Reached_on_Single_Resolution_Mechanism.pdf (noting borrowing ability of Fund).

connection with the resolution of a large financial institution, this setup for the Fund will not provide a credible financial backstop.[228] It needs serious improvement.

Two steps are necessary to remedy the current design. First, the FDIC example (funding supported by Treasury debt issuances), supports the proposition that the SRB needs access to immediate liquidity financing by the ECB.[229] As a monetary authority, not a fiscal authority, the ECB is not designed to bear losses (and should not be). However, though the bail-in-able debt feature of our resolution proposal is meant to provide loss absorbency that could be extended to cover ECB advances, the ECB should be a backstop to provide an additional protective measure. Specifically, the necessary liquidity support should come through an ECB facility that is capitalized with the Resolution Fund. This would put the Resolution Fund in a first-loss position, much as various Federal Reserve facilities in the fall of 2008 were capitalized with TARP funds.[230] If the ECB nevertheless incurs losses, the SRB should subject the financial industry to subsequent assessments to cover such losses. Thus existing and contingent funding of the Single Bank Resolution Fund should pave the way for significant ECB liquidity provision. We will revisit this idea in more detail below.[231]

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Were these four conditions to be fulfilled, a sound and effective resolution mechanism could operate in the E.U. Such a mechanism would be credible even where the sovereign behind the bank is weak. Effectively, a resolution mechanism designed along the lines described above would lead to *self-insurance* of deposits rather than external deposit insurance, thus mitigating the need for a third pillar of the Banking Union. For this to work, the structural elements introduced above are crucial: The SIFI'a balance sheet must include a thick layer of subordinated debt with sufficient loss absorbency so that depositors and other short term credit providers are protected against loss. Functionally, long-term subordinated debt, not federal deposit insurance, insures the deposits.[232] This type of self-insurance is the key to avoiding destructive runs that can produce fire sale liquidations and negative asset valuation spirals. Additionally, the firm must be organized through a holding company structure, with the unsecured term debt issued at the holding company level, such that the bail-in-able debt is structurally, rather than contractually, subordinated to runnable debt at the operating subsidiary level. The SRB could thus resolve the

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[228] Cf. International Monetary Fund, Cross-Border Bank Resolution: Recent Developments 10 (2014) (discussing centrality of liquidity provision to resolution procedures).
[229] See *infra* section VI.2.
[230] See Bd. of Governors of the Fed. Reserve Sys., Quarterly Report on Federal Reserve Balance Sheet Developments 17–18 (March 2013), available at http://www.federalreserve.gov/monetarypolicy/files/quarterly_balance_sheet_developments_report_201303.pdf (noting use of TARP funds in lending facilities).
[231] See *infra* section VI.2. It has been suggested that the Fund is actually unnecessary, because after the failing institution has been recapitalized with a bail-in, the ECB could provide customary support as lender of last resort to a solvent, functioning bank. Given the valuation uncertainties and the importance of protecting the ECB at moment of high stress, we believe the Fund would be best used to provide loss absorbency for the liquidity facilities that would stabilize the newly resolved bank as well the financial system generally.
[232] Obviously, Member States would continue to provide deposit insurance on their level.

SIFI without putting the operating subsidiaries through a resolution process. These features offer the greatest possibility for a minimally disruptive, thus credible, SIFI resolution.

A resolution mechanism that ticks these boxes would obviate the need for a separate, federal deposit insurance tool. Indeed, our "self-insurance" proposal could be even more effective than a traditional deposit insurance mechanism on the E.U. level, not least because it avoids the difficulties associated with the relatively low cap of traditional deposit insurance coverage. As noted previously, EUR 100,000 is the current prescription;[233] the (once envisaged) centralized E.U. Deposit Guarantee Scheme would probably have come out similarly. Such a cap, however, would not protect the much larger deposits of non-financial firms, wealthy individuals, or interbank loans; neither would it protect short-term credit issuances sold on the money market. As the holders of these claims, which may well constitute the bulk of "runnable" bank liabilities, would not be protected by deposit insurance, as currently stands a significant run risk remains. By contrast, the "self-insurance" approach is not limited overall, as long as sufficient bail-in-able debt remains. Further, deposit insurance suffers from well-known weaknesses such as creating moral hazard for banks and causing reduced monitoring by depositors.[234] In comparison to these drawbacks, a self-insurance system funded by market issuances of term debt is likely to price risk-taking more effectively than deposit insurance's risk-adjusted fees. As we have outlined above, the ECB would be able to recover any losses incurred in providing necessary post-resolution liquidity ex post. Such a system would significantly mitigate moral hazard concerns.

B. *Adapting the Proposal to the Current Legal Framework*

This section discusses how the existing European institutional framework would permit a European Single Resolution Authority to use the FDIC-like powers that developed above. But first, a caveat: Some aspects of the emerging E.U. framework for bank resolution are still in the legislative pipeline; in particular, many secondary laws, implementation measures, and delegated acts are still outstanding. Nevertheless, the SRM Regulation as the main instrument and the accompanying Intergovernmental Agreement have been successfully adopted.[235] As things stand now, it is likely that E.U. will fulfill (or can fulfill with only minor amendments) the first and second principles, centralization and broad discretion. The SRM Regulation provides a Single

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[233] Directive 2014/49/EU, *supra* note 196. See above section V.5.

[234] Franklin Allen, Elena Carletti and Agnese Leonello, *Deposit insurance and risk-taking*, 27 Oxford Review of Economic Policy 464, 468-71 (2011); Charles W. Calomiris, *Is Deposit Insurance Necessary? A Historical Perspective*, 50 The Journal of Economic History 283 (1990).

[235] See *supra*, part V(5). The "SRM Regulation" is the centerpiece of the legislative framework: Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, [2014] OJ L225/1.

Resolution Board as a centralized body,[236] independent from the ECB, and relatively independent from the Member States' resolution authorities.[237] The Board will exercise responsibility to large banks only, but that would correspond to our focus on SIFIs.[238] Though the Board may cooperate with and hand over some of its day-to-day work to national resolution authorities (analogous to the Single Supervisory Mechanism), that would be satisfactory as long as the ultimate responsibility for and final decision of resolution lies with an E.U. body.[239]

Secondly, as to the resolution powers, the competences of the future SRM are modeled after the powers included in the BRRD.[240] This directive has been praised for its strong support for bail-in powers.[241] Moreover, it provides a robust and credible statutory mechanism to write down debt. The intra-jurisdictional problems associated with a contractual approach do not arise within the Banking Union, as the authority would be exercised by an E.U. body in accordance with E.U. law.[242] As to bonds subject to a non-E.U. jurisdiction, the BRRD follows the preferred "hybrid" approach.[243] As to the scope of the bail-in tool, the BRRD lists a number of eligible types of liabilities, which seems broadly in line with our reflections.[244]

1. *Inadequate Funding in the Current Regime*—Despite a clear path toward centralization and robust powers, *funding* of the Resolution Mechanism remains a critical and often contentious issue among Member States.[245] Whereas political economy considerations suggest that it policymakers struggle to justify new funding financed by the taxpayer, voters may respond more

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[236] Our compromise "capital call" solution developed above could be introduced by an amendment to the SRM Regulation, if deemed necessary.
[237] SRM Regulation, *supra* note 222, Articles 42-48; in particular note the independence enshrined in Article 47. See already Yves Mersch, Member of the Executive Board of the ECB, Speech at Finanzplatztag, February 27, 2013.
[238] The SRB will effectively only take responsibility for those banks that will be subject to ECB supervision under the SSM, see SRM Regulation, *supra* note 214, Articles 2 and 7.
[239] According to the SRM Regulation, *supra* note 214, national authorities carry out the decisions by the SRB and may be specifically ordered to implement SRB decisions. See SRM Regulation, Articles 18(9), 29. Even outside its scope, the SRB may ultimately take over responsibility from non-complying national resolution authorities: See SRM Regulation, Article 7(4)(b).
[240] SRM Regulation, *supra* note 210, Articles 23-29. See Yves Mersch, Member of the Executive Board of the ECB, at the seminar "Auf dem Weg zu mehr Stabilität – Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis" organized by Europolis and Wirtschaftswoche, Berlin, April 5, 2013, at <http://www.ecb.int/press/key/date/2013/html/sp130405.en.html>.
[241] Thomas Huertas & María J. Nieto, *A game changer: The E.U. banking recovery and resolution directive*, September 19, 2013, <http://www.voxeu.org/article/banking-recovery-and-resolution-directive>; Freshfields Bruckhaus Deringer, *Key points from the EU Recovery and Resolution Directive*, p. 2, available at <http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/RRP/EU%20Directive%20key%20points.pdf>.
[242] See on such legal problems for national bail-in tools, Chris Bates & Simon Gleeson, *Legal aspects of bank bail-ins*, 5 Law and Financial Markets Review 264, 269-270 (2011).
[243] See Bates & Gleeson, *supra* note 217, at p. 270.
[244] BRRD, *supra* note 16, Article 38.
[245] IMF Working Paper, *Crisis Management and Resolution for a European Banking System* (WP 10/70, 2010), at p. 61. On the funding of the BRRD, see María J. Nieto & Gillian G. Garcia, *The Insufficiency of Traditional Safety Nets: What Bank Resolution Fund for Europe?*, LSE Financial Markets Group Special Paper 209, May 2012, available at <http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP209.pdf>.

favorably to resolution funding that comes directly from the financial industry. As we have seen above,[246] the emerging framework introduces a funding framework in line with these expectations. The banking union framework sets up a Single Bank Resolution Fund, which is to be financed by risk-based, *ex ante* levies on the industry.[247] The plan is to build up the Fund over several years to a target level of 1 % of covered deposits in the banking system.[248] On the basis of 2011 data, this would correspond to roughly EUR 55 billion.[249] Where the Fund is not big enough to cover the costs of a bank rescue, the Commission proposes to collect *ex post* contributions from the financial industry.[250] Where even *ex post* funding is not sufficient or readily available, the Fund should, according to the SRM Regulation, engage in borrowing from third parties.[251]

We do not believe that the target size of EUR 55 billion is sufficient for the SRM to efficiently resolve a large failed financial institution.[252] The Crisis proved that the financial support required to sustain a large, systemically important global financial institution is a multiple of that amount—it would be in the region of EUR 500 billion or more, to be readily available on the "critical Monday morning" after the typical, decisive rescue weekend when the institution reopens its doors.[253] Funds on that scale will not be covered by a fund that is made up of annual contributions. Funds of that size will only credibly be provided by a central bank.[254] In fact, one lesson from the U.S. experience is that a resolution funding mechanism exclusively drawing upon funds provided by the banking sector alone is unlikely to be sustainable in the long run.[255] Unsurprisingly, Jack Lew, U.S. Secretary of the Treasury, openly has criticized the planned resolution fund as being insufficiently small.[256]

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[246] See above section V.4.
[247] Some aspects of the Fund are regulated in the SRM Regulation, *supra* note 210, Articles 67 ff. The other aspects are detailed in the separate intergovernmental agreement, *supra* note 175.
[248] SRM Regulation, *supra* note 210, Article 69.
[249] Commission proposal, *supra* note 157, at pp. 14-15.
[250] SRM Regulation, *supra* note 210, Article 71 and recital 78.
[251] SRM Regulation, *supra* note 210, Articles 73 and 74.
[252] In a similar vein, experts have criticized the resolution fund as a "paper tiger". See Benjamin Fox, *Eurozone bank fund needs credit line, Draghi says*, E.U.Observer, September 24, 2013, available at http://euobserver.com/economic/121545.
[253] Mats Persson & Raoul Ruparel, *The eurozone banking union: A game of two halves*, December 2012, available at http://archive.openeurope.org.uk/Content/Documents/Pdfs/bankinguniontwohalves.pdf, at p. 11.
[254] Persson & Ruparel, ibid, at p. 11: "the key for a functioning resolution fund is to have access to liquidity when a crisis hits. This would have to come in the form of direct line to the ECB or national treasuries."
[255] See, to this end, the account at Anthony Saunders, Regulatory Experience in the US and its Lessons for European Banking Union, Working Paper 2013, available at <http://ssrn.com/abstract=2353545> at p. 7: "[I]t is extremely unlikely that a privately (bank) funded deposit insurance scheme can survive a period of systemic or contagious bank failures as occurred during the 1980s in the US during a real estate crisis or in the recent 2008-2009 crisis. In both cases, government intervention was required either through lines of credit to the fund being drawn upon or outright bailouts by the US Treasury of large failing insolvent banks as reflected in the $100 billion plus bailout of the 10 largest US banks in the initial stage of the 2008 TARP."
[256] James Fontanella-Khan, European Parliament challenges plan for €55bn bank rescue fund, *Financial Times*, January 17, 2014, quotes Mr. Lew as saying: "We don't think it's big enough. We don't think it's fast enough."

Thus, policymakers must reconsider the funding side of the SRM. We would assign the primary role of providing liquidity to the restructuring process to the European Central Bank, the only player with access to unlimited funds. We therefore envision an ECB liquidity facility that is specifically designed for this purpose as a credible backstop for resolution funding. At the same time, the ECB must be prohibited from taking losses: what is required is quick access to liquidity without loss-bearing obligation.[257] To this end, the currently agreed-upon SRM Fund could be made useful and operational by capitalizing such an ECB facility.

The proposed setup would protect the ECB from loss-taking on three different levels: First, as we maintain, the strong level of bail-in-able debt at the Topco level would effectively absorb all losses in most cases; additional financial resources would normally not be required. Nevertheless, the modest Resolution Fund (which can be bolstered by borrowing on the capital markets) could serve as a second line of defense, as it flows into the ECB liquidity facility. Such a setup would put the Resolution Fund in a first loss position, much as the various Federal Reserve facilities in fall of 2008 were capitalized with TARP funds. The ECB would recoup funds from the financial industry in the unlikely event of losses, similar to the SRM approach for the replenishment of the Resolution Fund.[258]

At an earlier stage of the policy debate, lawmakers had envisioned the former bailout-fund European Stability Mechanism (ESM) to serve as a credible backstop for resolution funding.[259] This would not be far from its task to directly recapitalize banks, as originally promised as a reward for the establishment of an effective single supervisory mechanism.[260] Under the final framework, the ESM will now only serve as a transitional backstop until the

[257] The SRM proposal assigns both roles to the proposed Single Resolution Fund: "The primary objective of the Single Resolution Fund is to ensure financial stability, rather than to absorb losses or provide capital to an institution under resolution. The Fund should not be considered as a bailout fund. There might be however exceptional circumstances where, after sufficiently having exhausted the internal resources (at least 8% of the liabilities and own funds of the institution under resolution), the primary objective could not be achieved without allowing the Fund to absorb those losses or provide the capital. It is only in these circumstances when the Fund could act as a backstop to the private resources." See Commission proposal, *supra* note 157, p. 13. Contrast, for example, the position of the European Banking Federation (EDF), EBF Positioning on the Principles underlying the Single Resolution Mechanism, September 17, 2013, p. 2: "the EBF firmly believes that the princip[al] tool for absorbing losses and recapitalising restructured banks is bail-in and not the SRF. The level of outstanding senior unsecured long-term debt currently held by banks - around €1.1 trillion - is 20 times the size proposed for the SRF. Bail-in would absorb all or most of the cost of a bank failure in most circumstances."

[258] SRM Regulation, *supra* note 210, Article 71.

[259] Vítor Constâncio, Vice-President of the ECB, Speech at the conference "Financial Regulation: Towards a global regulatory framework?", Chatham House City Series, London, March 11, 2013. He further states that "In the longer term, the fiscal backstop to the Banking Union could perhaps replicate the successful arrangements we see in the U.S. where the Treasury provides a credit line to the FDIC, which is repaid over time through additional levies on the financial sector." Id.; see also Jörg Asmussen, ECB executive board member, Building Banking Union, Atlantic Council, London, July 9, 2013.

[260] Euro Area Summit Statement, June 29, 2012, available at http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf.

Fund has reached its full target size.[261] Apart from the ECB's much greater clout, using ECB liquidity instead of payments out of the ESM would have the additional advantage that any decision to use ESM funds would be taken by the Eurozone Finance Ministers and that the support of (most members of) this group is necessary to provide funds in any given case.[262] Thus, in political terms, there is a higher threshold for using the ESM as compared to ECB funding. Moreover, the separate decisionmaking process of the Ministers makes the ESM an unlikely source of immediate massive liquidity required by an SRB intervention. A related issue is that the ESM as currently structured would not be able to provide funds to non-Eurozone Member States that have opted to join the Banking Union. In order to do that, a change of the ESM Treaty would be required.

The bottom line is that we see ECB funding as the only credible resolution backstop. This would however not make the current Resolution Fund redundant. Quite the contrary: the Fund provides critical support for the ECB's liquidity facility, protecting the ECB against losses. The combination of a relatively modest resolution Fund with unlimited central bank funding could be the best of both worlds: Together, they would fulfill the need for credibility of the resolution mechanism, shield the ECB from loss-bearing, and guarantee the involvement of the financial industry.

2. Avoiding a Bailout via Structural Reform— Let us summarize the argument thus far. The original E.U.-level response to the crisis was a bailout, with the ESM playing an analogous role to TARP in recapitalizing the financial system. However, the political constraints on the ESM (and the linkage to sovereign financial stability) made it less effective in that regard. Post-crisis reform has focused on avoiding bailouts by providing a credible resolution mechanism for systemically important financial institutions in which losses are borne by creditors instead of the taxpayers. Such a mechanism has two important elements. First, the resolving authority or central bank must have the capacity to provide sufficient financial support to the failed financial institution during the reorganization period. This has been addressed through a refashioned role for the Single Bank Resolution Fund in conjunction with the ECB's necessary role. Second, there must be a mechanism in place to recapitalize the failed firm through self-insurance, in the form of bail-in of unsecured term debt. Obviously, the level of bail-in-able debt is crucial—but so is the ex-ante structure of the firm and its balance sheet. The goal is to devise a structure that makes bail-in credible while minimizing systemic distress costs arising from the resolution.[263]

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[261] Statement of Eurogroup and ECOFIN Ministers on the SRM backstop, December 18, 2013: "In the transition period, bridge financing will be available […] from the ESM in line with agreed procedures." Available at http://www.eurozone.europa.eu/media/502738/20131218-SRM-backstop-statement.pdf.

[262] See the Treaty Establishing the European Stability Mechanism ("ESM Treaty"), available at <http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf>.

[263] See *supra* Part VI.B.1

The first of these two elements, the level of bailin-able debt, is now the subject of the FSB's proposal at the November 2014 summit of G-20 leaders for "Total Loss Absorbency Capacity" ("TLAC") (roughly, equity plus subordinated term debt) scaled to a least twice the amount of required equity capital on both risk-weighted and leverage measures.[264] The required level of TLAC for each firm will vary, depending on the particular institution, from at least 16% up to 25% of risk weighted assets.[265] 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. Ultimately the internationally agreed-upon standard should be integrated into E.U. law through modification of the Bank Recovery and Resolution Directive. The BRRD already includes a provision that requires banks to "meet, at all times, a minimum requirement for own funds and eligible liabilities"(MREL).[266] The EBA is to draft technical standards for the calculation of these required liabilities, but ultimately the Member States will fix the required figures.[267] Presumably the ECB will monitor compliance with the E.U. standard as part its supervisory duties to assure that each SIFI maintains a sufficient amount of unsecured term debt subject to bail-in powers.[268]

The structural reform of EU G-SIBs is not now on the agenda but needs to be. Systemically important European banks, typically organized as "universal banks,"[269] have a complex organizational structure in which various financial services are provided by divisions of the bank or through subsidiaries of the bank.[270] Furthermore, as recent research suggests, the

[264] Financial Stability Board, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution – Consultative Document (Nov. 10, 2014), www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.
[265] Id., at 13. The threshold limits were based on calculation of losses during the recent financial crisis in an earlier consultation document. See Financial Stability Board, Issues for Consideration in the Development of a Proposal on Adequacy of Loss Absorbing Capacity in Resolution (memo to Steering Committee, SC/2013/45, Dec. 18, 2013).
[266] BRRD, *supra* note 144, Article 45.
[267] BRRD, *supra* note 144, Article 45(6).
[268] See a similar comment by British Bankers' Association (BBA), *BBA Briefing: European Commission's draft Recovery and Resolution Directive* (August 2012) at p. 4, available at <http://www.bba.org.uk/download/8120>.
[269] See on the European universal banking model Jordi Canals, UNIVERSAL BANKING: INTERNATIONAL COMPARISONS AND THEORETICAL PERSPECTIVES (Oxford: Oxford University Press, 1997) at pp. 6-11. The typical U.S. "holding company" group model is not popular on the European side of the Atlantic. Final Report of the High-level Expert Group on reforming the structure of the E.U. banking sector, chaired by Erkki Liikanen (October 2, 2012), at p. 137. See also Institute of International Finance, Making Resolution Robust—Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions, June 2012, at p. 52; Bob Penn, Single point of entry resolution: a milestone for regulators: a millstone for banks?, Allen & Overy memorandum, available at <http://www.allenovery.com/publications/en-gb/lrrfs/uk/Pages/Single-point-of-entry-resolution.aspx>.
[270]See James R. Barth, Daniel E. Nolle & Apanard Prabha, *Banking Structure, Regulation, and Supervision in 1993 and 2013: Comparisons Across Countries and Overtime*, 13 J. Int'l Bus. & L. 231, tbl. 4 (2014); World Bank Bank Regulation and Supervision Survey (2011), http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html; James R. Barth et al. Commercial Banking Structure, Regulation and Performance: An International Comparison Office of the Comptroller of the Currency, E&PA Working Paper 97-6, March 1997, www.occ.gov/publications/publications-by-type/economics-working-

divergence and the complexity of most E.U. banks' structure is such that it is virtually impossible to even depict their organizational structure.[271] 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.[272] 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. Moreover, bail-in will work haphazardly in such a structure. Where exactly is the loss-absorbing debt to be stationed? Will that match up with the entity (ies) that are put in resolution? Since the bail-in debt is issued by an operating subsidiary, its loss-absorbing quality relative to other debt claims will be a product of careful drafting of subordination clauses; the inevitable gaps and ambiguities may be the subject of dispute, which also will inject destabilizing uncertainty.

The alternative is a Single Point of Entry system like the FDIC has fashioned for the U.S. This approach, which pivots off a holding company structure, has a number of distinct advantages.[273] First, SPOE resolution is more transparent and credible, as the bailin-able debt at the holding company level is earmarked and effectively available for regulatory activation. Because only the holding company is put in resolution, there is no question but that the holding company debt is structurally subordinated to the debts of the operating subsidiaries, which are not in resolution. Secondly, SPOE 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. It reduces the risk that regulators in various jurisdictions will race to grab assets for the purpose of protecting national creditors.[274] Finally, and most importantly, the SPOE 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

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papers/1999-1993/working-paper-1997-6.html. (Tables 5, 6a, 6b). Richard J. Herring & Anthony M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 J. FIN. RES. SERVICES 471, 481-489 (1990); Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety and Soundness*, in A. Berger, P. Molyneux, and J. Wilson, eds., The Oxford Handbook of Banking (2010).

[271] Final Report of the High-level Expert Group on reforming the structure of the E.U. banking sector, chaired by Erkki Liikanen (October 2, 2012), at p. 52.

[272] Cf. text accompanying notes 72–83 (discussing difficulty of Lehman bankruptcy because of complexity of structure).

[273] In most recent policy initiatives, SPOE is given preference over the competing "Multiple Points of Entry." See, e.g. Finma, *Resolution of global systemically important banks – FINMA position paper*, August 7, 2013; Martin J. Gruenberg, FDIC Chairman, Comments to the Volcker Alliance Program Washington, D.C. (October 13, 2013), available at <https://www.fdic.gov/news/news/speeches/archives/2013/spoct1313.html>; FDIC and Bank of England, RESOLVING GLOBALLY ACTIVE, SYSTEMICALLY IMPORTANT, FINANCIAL INSTITUTIONS (December 10, 2012), available 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?* (September 11, 2014), available at <http://www.scoperatings.com/study/download?id=c2da6224-fa08-491c-aed2-93fa2de5eebe&q=1>.

[274] See European Parliament, Directorate General for Internal Policies, SINGLE RESOLUTION MECHANISM – NOTE (February 2013), at p. 13.

valuation spirals and other knock-on effects. An SPOE resolution offers the promise of minimizing overall creditor losses, which in turn will reduce the level TLAC required to achieve systemic stability.

However, the structure of European banks must change in order for the SPOE strategy to be effective. The E.U. is in the midst of a structural exercise that currently focuses on a version of the Volcker Rule's separation of proprietary trading from banking and, additionally, that would break out the trading activity that remains permissible into a separately capitalized subsidiary. These structural reforms are reflected in a Proposed Structural Measures Regulation,[275] a reworking of structural reform proposals initially made in the Liikanen Report in 2012.[276] In our view, the missing organizational element is to require firms to move to a holding company structure in which unsecured term debt is issued by the parent and short-term debt obligations are issued only by operating subsidiaries. Such a structure would permit bail-in without triggering a run and without putting core financial constituents through a bankruptcy.

We see three alternative regulatory mechanisms that could achieve this result. First, the Structural Measures Regulation could be modified to require a holding company structure for G-SIBs, with appropriate placement of the critical elements of TLAC. Second, the ECB as supervisor could insist on such a holding company structure for G-SIBs as part of its duties under the BRRD to insist on a "living will" that will facilitate orderly resolution of such firms.[277] Third, the ECB (or the European Banking Authority) could impose capital charges on G-SIBs that do not adopt a holding company form, in light of the additional systemic risk such firms present, as contemplated by the Capital Requirements Regulation and Directive (CRR/CRD IV) under the Basel III framework.[278]

Using differential capital charges is an incentives-based approach. Critics may take exception, arguing that in deciding whether to reorganize to avoid the extra capital charge, firms may insufficiently internalize the systemic risk of their failure or, indeed, may see their unresolvability as the ultimate bail-out trump.[279] On the other hand, if mandatory legislation is not possible, incentives may work. Switzerland could serve as an example in this context.

[275] European Commission, 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 (Jan. 29, 2014).
[276] Final Report of the High-level Expert Group on reforming the structure of the E.U. banking sector, chaired by Erkki Liikanen (October 2, 2012). The Liikanen Report itself followed UK ring-fencing proposal made in the Independent Commission on Banking Final Report (September 2011), commonly called the "Vickers' Report," after its chair.
[277] See supra notes 110, 138 (explaining how living wills requirements obligate banks to plan for failure).
[278] Capital Requirements Regulation and Directive: Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV); Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR).
[279] In other words, SIFIs will not be interested in "opting in" into a SPOE resolution scheme precisely because they anticipate that the complexity and uncertainty of alternative resolution strategies (such as "Multiple Points of Entry") will be a barrier to resolution and therefore increases the chance for bail-out rather than bail-in. This argument is similar to banks' incentives to remain "too big" or "too interconnected" to fail.

Recently adopted Swiss rules on banks' 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 similar to the U.S. holding company structure.[280] Once the new structure is in place, Credit Suisse plans to issue sufficient bail-inable debt from its group holding company in order to facilitate the SPOE approach.[281] Following new regulation in the U.K., British banks are also beginning to issue debt at the holding company level.[282]

The soundness of our approach is confirmed by and would go hand in hand with the Basel accord. Basel III imposes additional capital requirements for G-SIBs, the precise extent of which will depend on various predictors for systemic risk creation (e.g., the bank's size or its interconnectedness).[283] Banking structure could (and should) play a role in this context, as structural choices significantly affect the costs and thus the credibility of bank resolution. Adoption of a holding company structure and other elements that would facilitate Singe Point of Entry should count significantly in the systemic risk "mark-up." Put differently, if legislation is not available and an outright administrative mandate seems too tough for the ECB at this early stage of its supervisory mission, our idea might best be implemented by charging additional capital for a structure that would not facilitate the SPOE resolution approach.

C. *Key Advantages of Our Solution*

To be sure, every new direction in the architecture of international financial regulation is costly, and requiring European banks to change their structure of operation would entail significant costs.[284] Nevertheless, we believe that our solution would have a number of key advantages that would far outweigh these costs, especially in comparison to the currently proposed system of banking resolution in the E.U.

(1) First, our proposal would produce a much more effective resolution process within the European Banking Union, and at much lower costs. If a SIFI has in its liability structure sufficient unsecured term debt, in the event of bank failure the conversion of debt into equity will be sufficient to absorb asset losses without impairing deposits and other short term credit. The advantage of targeting resolution at the holding company level is that the operating subsidiaries of the banking group can carry on and will not be disrupted. Further, this "self-insurance"

[280] James Shotter, Swiss bank creditors face bail-in risk, Financial Times, August 8, 2013; James Shotter, Credit Suisse to overhaul structure, Financial Times, November 21, 2013. According to rating agency Fitch (as quoted here), it is likely that other European banks are under pressure to follow the example. See also James Shotter, UBS overhaul brings special dividend, Financial Times, May 7, 2014, p. 18.
[281] James Shotter, Credit Suisse to overhaul structure, Financial Times, November 21, 2013.
[282] Sam Fleming, Banks address "too big to fail" question with debt shift, *Financial Times*, December 26, 2013.
[283] See, on the CRD IV implementation, European Commission, *Memo: Capital Requirements – CRD IV/CRR – Frequently Asked Questions*, July 16, 2013, available at <http://europa.eu/rapid/press-release_MEMO-13-690_en.pdf>.
[284] Penn, *supra* note 255.

approach would avoid fire sales and contagion and thus dramatically reduce the overall costs of a bank failure, as evidenced by the Clearing House simulation exercise and FDIC projections of a Lehman resolution via SPOE.[285]

(2) Second, a banking resolution pillar strengthened in this way would make the Banking Union operational even without the third pillar, a federal deposit guarantee scheme. That is, our concept of "self"-insurance would make the Banking Union altogether less dependent on "state" insurance. As previously discussed, the current political situation in Europe means that a fully-fledged Banking Union with all three pillars is likely out of the question. In this political deadlock, a self-insurance resolution mechanism would overcome the sensitive issue of mutualization of debt. From a political economy perspective, a proposal that requires SIFIs to self-insure against failure and engage in structural reform should also be much easier to sell to the ordinary voter than an expensive state-financed resolution process, deposit insurance or bailout programs.

(3) Finally, a self-insured SIFI resolution mechanism along the lines we suggest would ensure that financial institutions can be resolved without difficulty *on a global stage*. The global market requires transatlantic, if not global responses to the problem of failing banks.[286] The Single-Point-of-Entry approach would facilitate cross-border resolution on a worldwide scale far better than the current project does. Regulators worldwide have confirmed that they prefer the SPOE strategy over the Multiple Point of Entry approach ("MPOE"). The Swiss banking watchdog Finma has recently expressed its preference for an SPOE system,[287] as have the German BaFin,[288] and the Bank of England and the FDIC in a joint statement.[289] The alternative MPOE approach would require cooperation and joint action of several regulators, which would create information problems and follow-up costs: essentially, the SIFI would fragment during a resolution process. To be sure, the SPOE approach is essentially built on mutual trust: accepting that the regulator responsible for the holding company will be equipped and willing to deal with the entire financial group in an adequate way.[290] Although some progress has been made, full trust still has not been achieved, as evidenced by the fact that U.S. regulators have required foreign banks to operate in the U.S. through intermediate holding companies (IHCs).[291] We find

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[285] See *supra* note 81 and accompanying text.
[286] Commissioner Michel Barnier, *The EU and US: leading partners in financial reform*, Speech at the Peterson Institute for International Economics, Washington DC, June 13, 2014, available at <http://europa.eu/rapid/press-release_SPEECH-14-465_en.htm?locale=en>.
[287] Finma, Resolution of global systemically important banks – FINMA position paper, August 7, 2013.
[288] Remarks by Martin J. Gruenberg, FDIC Chairman, to the Volcker Alliance Program Washington, D.C. (October 13, 2013), available at <https://www.fdic.gov/news/news/speeches/archives/2013/spoct1313.html>.
[289] FDIC and Bank of England, Resolving Globally Active, Systemically Important, Financial Institutions (December 10, 2012), available at <http://www.fdic.gov/about/srac/2012/gsifi.pdf>.
[290] William C. Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, Remarks at the Tenth Asia-Pacific High Level Meeting on Banking Supervision, Auckland, New Zealand, February 26, 2014, available at <http://www.newyorkfed.org/newsevents/speeches/2014/dud140226.html>.
[291] Federal Reserve System, Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 13498 (March 11, 2014) (see esp. 12 CFR § 252.153.); Daniel K. Tarullo, Regulating

these concerns legitimate under the current circumstances. On a more optimistic note, one could argue that were there a credible European resolution regime in place—such as the one suggested here—the regulatory concerns towards the domestic operation of foreign banks would disappear. The requirement, for example, to establish an IHC could then be abandoned.[292]

CONCLUSION

This paper develops a way forward for the project to create a European Banking Union, and looks across the Atlantic for inspiration. As U.S. banking history bears many similarities with the current salient issues in Europe, the U.S. experience provides legitimate and valuable lessons.[293]

Our central argument is that the EU should adopt an approach comparable to the strategy devised by the FDIC to implement the "Orderly Liquidation Authority" under Dodd-Frank. Such an approach can overcome the lack of enthusiasm for adequate funding of a resolution mechanism and the unlikelihood of a federal deposit insurance system. We offer a route by which a Banking Union can live without a truly robust resolution fund and without centralized deposit insurance. European SIFIs should instead "self-insure"; that is, they should hold sufficient bail-in-able debt at the Topco level. This would require three important preconditions: first, that systemically important institutions have in their liability structure sufficient subordinated term debt so that in the event of bank failure, the conversion of debt into equity will be sufficient to absorb asset losses without impairing deposits and other short term credit; secondly, that the organizational structure of the financial institution will permit such a debt conversion without putting core financial constituents through a bankruptcy, and thirdly, that central bank funding deployable at the discretion of the resolution authority will be available to supply liquidity to a reorganizing bank. On these conditions, a resolution fund and deposit insurance both play a subsidiary role in resolution. What is more, such a "self-insurance" model would even have a number of advantages over the traditional deposit guarantee approach.

These conceptual ideas can be adapted into the current E.U. framework by modifying enacted and proposed rules. A centralized E.U. resolution authority with wide discretionary powers would be key to our approach. Further, we would propose changes to the proposed Structural Measures (Liikanen) Regulation or various supervisory measures that would provide a path for E.U. G-SIBs to hold sufficient unsecured term debt at the Topco level, in line with the

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Large Foreign Banking Organizations (March 27, 2014) (available at <http://www.federalreserve.gov/newsevents/speech/tarullo20140327a.htm>).

[292] In a similar move, the draft Liikanen implementation would give the ECB the power to exempt foreign subsidiaries of E.U. banks from E.U. ringfencing requirements, provided that a sufficiently robust group-level resolution strategy between the foreign country and the E.U. exists. See the reform proposal on the structure of E.U. banking, *supra* note 262, Article 4(2).

[293] Geoffrey Miller, America's Dual Banking System: Lessons for Europe, Presentation at the 2012 Transatlantic Corporate Governance Dialogue, Brussels, December 17, 2012; Anthony Saunders, Regulatory Experience in the US and its Lessons for European Banking Union, Working Paper 2013, available at http://ssrn.com/abstract=2353545.

TLAC proposals. Together, these measures would facilitate a SPOE approach to resolution for large European banks. As a byproduct, prescribing such a holding company structure for banks would make cross-border resolution much easier in E.U.-wide, transatlantic, and global situations.

Finally, we make a contribution to the current impasse around funding of the centralized resolution mechanism. In our view, a specific resolution fund, drawing from industry contributions, as currently proposed, is not sufficiently strong to be ultimately credible. We believe that liquidity in a resolution situation in Europe needs to be provided by a central bank: thus, the ECB could be tasked with providing liquidity for the resolution process. The proposed resolution fund could then assume the role of providing first loss protection for the ECB.

Taken together, these measures would strengthen the current Banking Union project, overcome political difficulties, and ensure a consistent approach to bank resolution across the Western world. This would "enable large and complex cross-border firms to be resolved without threatening financial stability and without putting public funds at risk".[294]

[294] FDIC and Bank of England, Resolving Globally Active, Systemically Important, Financial Institutions (December 10, 2012), available at <http://www.fdic.gov/about/srac/2012/gsifi.pdf, at ii.