Bank Resolution in Europe: the Unfinished Agenda of Structural Reform

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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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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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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.”

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. 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.

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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 Bretton 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

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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).
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. 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, 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.”

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. 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. This influential guidance contemplated an administrative receiver with significant discretionary authority, modeled on the U.S. Federal Deposit Insurance

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


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.

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. 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 Absorbing Capacity” (“TLAC”) (roughly, equity plus subordinated term debt) scaled to at least twice the amount of required equity capital on both risk-weighted and leverage measures. 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. 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. 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. 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).
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.
weighting for OECD sovereign debt (which permitted banks to earn a “risky” spread on purportedly risk-free assets\(^\text{16}\)) 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.\(^\text{17}\) Its creation has been described as a “revolution” and the “most ambitious project since the creation of the euro.”\(^\text{18}\) 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


\(^{17}\) 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 draw from that paper.

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, concessory 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 (ultimately 1 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.

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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 bail-in-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, 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,” have a complex organizational structure in which various financial services are provided by divisions of the bank or through subsidiaries of the bank. Putting an operating bank or some other operating financial entity through a resolution procedure...

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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).
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.” 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

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. First, it makes resolution more transparent and credible, as the bail-in-able debt at the holding company level is earmarked and effectively available for 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. 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. 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.

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.  
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. 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. 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%, 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

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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).
immediate default triggers and permitted the FDIC to transfer such contracts (appropriately bundled) to a successor financial firm. But a major additional concern for systemic stability is the run risk of diverse forms of short term credit, which include various money market instruments, conventional deposits above the insured amount, and “repo,” short term borrowing often secured by long term assets of uncertain value. 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. The FDIC has produced regulations with a “short term creditors first” credo. 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. 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. This means that a failed foreign subsidiary, for example, UK Lehman Brothers, would be subject

32 Dodd Frank Act, §§ 210(c)(8),(9),(13).
34 Id., § 210(c)(4).
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

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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. 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. 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.”

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.

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.”

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. 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. 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%. 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.


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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{48} The “business of banking” was narrowly defined to exclude banks from the provision of many financial services.\textsuperscript{49} And commercial banks were famously barred from engaging in securities underwriting and other investment bank activity by the Glass-Steagall Act.\textsuperscript{50} The result was a relatively small number of “money center” banks, thousands of “unit banks,” and many thousands of different financial service providers.\textsuperscript{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.\textsuperscript{52} In 1956 the holding


\textsuperscript{49} See 12 U.S.C § 23(7).


\textsuperscript{51} See Omarova & Tahyar, *supra* note 47, at 10.

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.” 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. 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.

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). 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). This is similar to the approach Swiss authorities have

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.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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.

\textsuperscript{58} James Shotter, \textit{Credit Suisse to overhaul structure}, FINANCIAL TIMES, Nov. 21, 2013.

\textsuperscript{59} Dodd-Frank Act § 619.

\textsuperscript{60} For elaboration on the various structural reform proposals in the EU and US, see John Armour et al, \textit{PRINCIPLES OF FINANCIAL REGULATION}, ch. 22 (forthcoming 2015); Financial Stability Board, \textit{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. 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. 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.

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 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. The failure of a separate

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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.
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. 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.

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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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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