

ESSAY

BANK RESOLUTION IN THE EUROPEAN BANKING UNION: A TRANSATLANTIC PERSPECTIVE ON WHAT IT WOULD TAKE

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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

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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.

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INTRODUCTION

The European Union (E.U.) 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 and the follow-on Eurozone sovereign debt and banking crisis during 2010–2013. 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

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, to apply a single-point-of-entry (SPOE) approach 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. Thus, serious losses

1. Michel Barnier, Eur. Comm’r for Internal Mkts. and Servs., *The EU and US: Leading Partners in Financial Reform*, Speech at the Peterson Inst. for Int’l Econ. 3 (June 13, 2014), available at http://europa.eu/rapid/press-release_SPEECH-14-465_en.htm?locale=en [hereinafter Barnier, *The EU and US*] (on file with the *Columbia Law Review*).

2. John O’Donnell & Tom K orkemeier, *Europe Strikes Deal to Complete Banking Union*, Reuters (Mar. 20, 2014, 1:57 PM), <http://www.reuters.com/article/2014/03/20/eu-bankingunion-idUSL6N0MH1ZM20140320> (on file with the *Columbia Law Review*).

at operating subsidiaries can be moved upstream to the holding company, where they are absorbed first by the write-down of equity and then by unsecured term debt. The result is a so-called bail-in, imposing losses on creditors, 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, and the risk of destabilizing runs by short-term creditors will be minimized.

(2) The second advantage is that a banking resolution pillar strengthened in this way would make the Banking Union operational without needing 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 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 (MPOE)

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.

approach. The Swiss Financial Market Supervisory Authority (FINMA), a banking watchdog, has recently stated its preference for the SPOE system,⁴ as have the German BaFin⁵ 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 SPOE as a global standard, the current pressure by U.S. regulators for foreign banks to operate in the United States 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 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. Consequently, Title II of the Dodd-Frank Act put in place “Orderly Liquidation Authority” (OLA), a resolution mechanism for SIFIs administered by the FDIC. OLA transcends deposit insurance in two important ways. First, Title II covers nondepository 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.

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> (on file with the *Columbia Law Review*).

5. See Martin J. Gruenberg, Chairman, FDIC, Remarks to the Volcker Alliance Program 10 (Oct. 13, 2013) [hereinafter Gruenberg, Remarks to the Volcker Alliance Program], available at <https://www.fdic.gov/news/news/speeches/archives/2013/spoct1313.html> (on file with the *Columbia Law Review*).

6. FDIC & Bank of Eng., Resolving Globally Active, Systemically Important, Financial Institutions 1 (2012), available at <http://www.fdic.gov/about/srac/2012/gsifi.pdf> (on file with the *Columbia Law Review*).

7. See Fed. Reserve Sys., Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,242 (Mar. 27, 2014) (codified in 12 C.F.R. § 252.153) (discussing intermediate holding company requirement for large foreign banks); Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Regulating Large Foreign Banking Organizations, Remarks at the Harvard Law School Symposium on Building the Financial System of the Twenty-First Century: An Agenda for Europe and the United States 13 (Mar. 27, 2014), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20140327a.htm> [hereinafter Tarullo, Regulating Large Foreign Banking Organizations] (on file with the *Columbia Law Review*) (same).

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's 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 the FDIC's 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's 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 resolution⁸ and, for

8. This is known as the Bank Recovery and Resolution Directive. Directive 2014/59, 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,

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.

Part VI applies the fruit of our comparative focus to propose how the SRM can become more effective operationally, making the “resolution” a more credible disciplinary device and thus strengthening 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 systemically 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 2007–2009 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 worst financial crisis since the Great Depression. Lehman's bankruptcy led to a multifaceted 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 United States 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 United States, for example, Congress anted up \$700 billion through the Troubled Assets Relief Program; the FDIC provided loan guarantees to financial institutions of up to \$1.5 trillion; the U.S. Treasury guaranteed money

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 O.J. (L 173) 190 [hereinafter BRRD].

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 of a Single Resolution Mechanism and a Single Resolution Fund and Amending Regulation (EU) No. 1093/2010, 2014 O.J. (L 225) 1 [hereinafter SRM Regulation].

market funds 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

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,

10. For a general account, see 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, 164–66 & n.25, 192 n.132 (2011). For an insider's account of the U.S. Government's response, see generally Timothy Geithner, *Stress Test: Reflections on Financial Crises* (2014).

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., *The Revolver: RBS Macro Credit Research, European Banks: Still Too Big to Fail* 9–10 (2014), available at <http://static.presspeople.com/attachment/cd8316b272864aacaf2161ef83016d09> (on file with the *Columbia Law Review*) (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, *Final Report* 11–19, 39–41, 119 (2012) [hereinafter *Liikanen Report*], available at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf (on file with the *Columbia Law Review*) (explaining how growth in E.U. banking sector leading up to crisis “significantly outpaced EU GDP growth”).

13. Banks are required to set aside capital for risky assets against the possibility of losses. Under the applicable conventions, sovereign debt issued by OECD countries was deemed to carry “zero” risk, and 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 Daniel Gros, *Banking Union with a Sovereign Virus: The Self-Serving Treatment of Sovereign Debt*, *Intereconomics*, Mar./Apr. 2013, at 93, 94 (arguing for increase in risk weights); Viral V. Archarya & Sascha Steffen, *The “Greatest” Carry Trade Ever? Understanding Eurozone Bank Risks* 33–34, 39 (NBER, Working Paper No. 19039, 2013), available at <http://www.nber.org/papers/w19039.pdf> (on file with the *Columbia Law Review*).

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 bailout programs, pressing for the adoption of restructuring tools that could “resolve” a large failing bank or other financial 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., as well as 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

14. The most obvious case was Ireland, but the problem generalized as the crisis wore on. See Eur. Comm’n, Representation in Ireland, http://ec.europa.eu/ireland/key-eu-policy-areas/economy/index_en.htm (on file with the *Columbia Law Review*) (last updated Nov. 18, 2014) (discussing sovereign debt issues associated with financial collapse in Ireland and how the sovereign financial crisis spread to rest of E.U.).

15. For an account of the European financial crisis, see Liikanen Report, *supra* note 12, at 4–11, 21–22, 24–31; see also Eur. Comm’n, The Financial and Economic Crisis, http://ec.europa.eu/economy_finance/explained/the_financial_and_economic_crisis/why_did_the_crisis_happen/index_en.htm (on file with the *Columbia Law Review*) (last updated Apr. 9, 2014) (providing high-level overview of crisis).

16. A prominent proponent was Ben Bernanke, then-Chairman of the Federal Reserve. See Oversight of the Federal Government’s Intervention at American International Group: Hearing Before the H. Comm. on Fin. Servs., 111th Cong. 13 (2009) (statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System), available at <http://archives.financialservices.house.gov/media/file/hearings/111/111-20.pdf> (on file with the *Columbia Law Review*) (“AIG highlights the urgent need for new resolution procedures for systemically important, nonbank financial firms.”).

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, 288–90 (2012). See also *infra* text accompanying note 126. Some can claim prescience in seeing urgency for new resolution regimes. See Robert R. Bliss, Resolving Large Complex Financial Organizations, *in* Market Discipline in Banking: Theory and Evidence 3, 4–5 (George G. Kaufman ed., 2003) (advocating, in 2003, for study of large-bank failure resolution).

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 mechanisms 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 ongoing 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

The first step has been the creation of a Single Supervisory Mechanism (SSM) for Eurozone banks, in which the European Central Bank (ECB) has been given the additional mandate of supervising all “significant” Eurozone banks.²² Vivid demonstration of both the novelty

18. For an overview of various policy responses until 2011, see Basel Comm. on Banking Supervision, *Resolution Policies and Frameworks—Progress So Far* (2011), available at <http://www.bis.org/publ/bcbs200.pdf> (on file with the *Columbia Law Review*).

19. BRRD, *supra* note 8.

20. European Council 28/29 June 2012 Conclusions, 2012 O.J. (C 76) 1.

21. See 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 (EU) No. 1093/2010 of the European Parliament and of the Council, at 2, 7, COM (2013) 520 final (July 10, 2013) [hereinafter SRM Proposal] (noting “the establishment of the Single Supervisory Mechanism ensures a level playing field in the supervision of banks and diminishes the risk of forbearance” and is “a crucial step . . . to ease funding conditions for vulnerable sovereigns and banks and break the link between the two”); SRM Regulation, *supra* note 9, at 3 (“The establishment of the SRM will ensure a neutral approach in dealing with failing banks and therefore increase stability of the banks . . .”).

22. A bank is deemed “significant” when it meets one of the following five conditions: (1) the “total 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 “established in a Member State”; (4) the bank conducts significant cross-border activities relative to its total assets/liabilities; (5) the bank receives assistance from a Eurozone bailout fund, the European Stability Mechanism. Eur. Cent. Bank, *Guide to Banking Supervision 8* (2014) [hereinafter ECB, *Guide to Banking Supervision*], available at <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision20141.1.en.pdf> (on file with the *Columbia Law Review*). Overall, at present, 130 banks are subject to

and the urgency of the Banking Union project is reflected by the timeline for approval and implementation of the SSM. The 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

ECB supervision, representing about 80% of all banks' assets. See Eur. Cent. Bank, Comprehensive Assessment (Oct. 26, 2014), <https://www.bankingsupervision.europa.eu/banking/comprehensive/html/index.en.html> (on file with the *Columbia Law Review*). The Banking Union primarily addresses the Eurozone countries, but other non-Euro E.U. Member States can sign up for it. On the SSM, see the speech by Jörg Asmussen, Member, Exec. Bd. of the Eur. Cent. Bank, Speech Before the Atlantic Council: Building Banking Union (July 9, 2013) (on file with the *Columbia Law Review*); see also Nicolas Véron, Europe's Single Supervisory Mechanism and the Long Journey Towards Banking Union, Bruegel Policy Contribution, Oct. 2012, at 1, 5 ("The proposal suggests that the geographical perimeter of the SSM is the euro area, and adds the possibility of 'close supervisory cooperation' for those non-euro area member states that desire it.").

23. Commission Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning the Policies Relating to the Prudential Supervision of Credit Institutions, COM (2012) 511 final (Sept. 12, 2012) [hereinafter European Commission, SSM Proposal]. Alongside this, the Commission also proposed another regulation to adapt the rules governing the European Banking Authority (EBA). Commission Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No. 1093/2010 Establishing a European Supervisory Authority (European Banking Authority) as Regards Its Interaction with Council Regulation (EU) No. 1/08 Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions, COM (2012) 512 final (Sept. 12, 2012) [hereinafter European Commission, Proposal to Amend EBA Rules]; see also Press Release, Eur. Comm'n, 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 (Mar. 19, 2013), http://europa.eu/rapid/press-release_MEMO-13-251_en.pdf [hereinafter Barnier Press Release] (on file with the *Columbia Law Review*) (announcing "essential step" of "major legislative package" of SSM and EBA). The Council gave its final blessing in October 2013. See Press Release, Council of the European Union, Council Approves Single Supervisory Mechanism for Banking (Oct. 15, 2013), http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/139012.pdf (on file with the *Columbia Law Review*) ("The Council today adopted regulations creating a single supervisory mechanism for the oversight of banks and other credit institutions, thus establishing one of the main elements of Europe's banking union.").

24. The final package consists of two instruments: Regulation (EU) No. 1024/2013 of the European Parliament and of the Council of 15 Oct. 2013 Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions, 2013 O.J. (L 287) 63 [hereinafter SSM Regulation], and Regulation (EU) No. 1022/2013 of the European Parliament and of the Council of 22 October 2013 Amending Regulation (EU) 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 (EU) No. 1024/2013, 2013 O.J. (L 287) 5 [hereinafter Regulation Amending EBA Rules].

25. For detailed guidance on how the ECB will implement its supervisory duties, see generally ECB, Guide to Banking Supervision, *supra* note 22.

The second pillar, the Single Resolution Mechanism, proved more controversial and uncertain. The European Commission's initial proposal for creation of the SRM came in July 2013.²⁶ This proposal was met with fierce political criticism, and its constitutional 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 decisionmaking 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.

26. SRM Proposal, *supra* note 21.

27. See Quentin Peel & Alex Barker, Berlin Rejects Brussels' Attempt to Grabbing Power to Shut Banks, *Fin. Times* (July 10, 2013, 8:17 PM), <http://www.ft.com/intl/cms/s/0/ad8cfe12-e982-11e2-9f11-00144feabdc0.html> (on file with the *Columbia Law Review*) (noting Germany attacked European Commission "for overstepping its legal powers with a proposal to make itself the top authority for winding up eurozone banks"). 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 European Court of Justice (ECJ) decision endorsing the role of the European Securities and Markets Authority (ESMA) in prohibiting certain aspects of short selling. Case C-270/12, *United Kingdom v. Parliament and Council*, at ¶¶ 27–119 (Jan. 22, 2014), <http://curia.europa.eu/juris/document/document.jsf?text=&docid=146621&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=12829> (on file with the *Columbia Law Review*).

28. SRM Regulation, *supra* note 9, at 1.

29. Council Agreement 8457/14, Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund (2014) available at <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%208457%202014%20INIT>; see also *infra* notes 209–210 and accompanying text (describing agreement).

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

31. SRM Proposal, *supra* note 21, at 3–5; see also Opinion of the European Central Bank on a 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 (EU) No. 1093/2010 of the European Parliament and of the Council, 2013 O.J. (C 76) 2, 3 (opining single resolution authority "is better placed to guarantee optimal resolution action . . . than a network of national resolution authorities," because "[c]oordination between national resolution systems has not proved sufficient . . . in a cross-border context").

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, forced the Banking Union designers to give up on this element.³³ Media reports suggest that the European Commission, when putting forth the proposals for the SSM, had planned to publish simultaneously a detailed roadmap to a European deposit insurance fund.³⁴ 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.³⁵ 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 all.³⁶ 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.³⁷

The Banking Union represents a major shift in attitude toward 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

32. For a more optimistic view, see Elis Ferran, *European Banking Union: Imperfect, But It Can Work 3* (Univ. of Cambridge Faculty Law Legal Studies Research Paper Series, Paper No. 30/2014, 2014), available at <http://ssrn.com/abstract=2426247> (on file with the *Columbia Law Review*) ("Some form of common system for deposit protection (DGS) is also intended but not immediately.").

33. See Alex Barker, *Brussels Shelved Bank Deposit Scheme*, *Fin. Times* (Sept. 13, 2012, 5:51 PM), <http://www.ft.com/intl/cms/s/0/e2dd12ec-fdbe-11e1-9901-00144feabdc0.html> (on file with the *Columbia Law Review*) ("German objections forced Brussels to shelve an ambitious blueprint for a single guarantee scheme . . . , laying bare the political obstacles facing a full banking union.").

34. E.g., *id.*

35. *Id.*

36. The *Financial Times* reported 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)." *Id.* Edira would then replace national deposit guarantee arrangements. *Id.*

37. *Id.*

guarantee plan,³⁸ and regulators are devising plans to make the Banking Union work without joint deposit guarantee.³⁹

The question is whether the European Banking Union can stand as a one-and-a-half-legged stool. After all, various experts have asserted the necessity of a “fully-fledged” banking union with “all three pillars.”⁴⁰ The next sections offer a transatlantic perspective on how a resolution authority could be improved to operate effectively, and how it could even do so without a joint deposit guarantee scheme.

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

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 nonbank institutions that were beyond the resolution authority of the FDIC. Second, depository institutions—the banks—were themselves such large, complex institutions, and so tied up with nonbanking affiliates, that the losses might

38. For example, the recent SRM proposal no longer mentions a single deposit guarantee mechanism, but refers to (harmonized) national schemes only. SRM Proposal, *supra* note 21, at 3, 15.

39. 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, Vice President, Eur. Cent. Bank, *The Nature and Significance of Banking Union*, Speech at the Conference “Financial Regulation: Towards a Global Regulatory Framework?” (Mar. 11, 2013), available at <http://www.ecb.int/press/key/date/2013/html/sp130311.en.html> (on file with the *Columbia Law Review*).

40. See, e.g., Véron, *supra* note 22, at 3 (“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.”); Benoît Cœuré, Member, Exec. Bd., Eur. Cent. Bank, *Why the Euro Needs a Banking Union*, Speech at the Conference “Bank Funding—Markets, Instruments and Implications for Corporate Lending and the Real Economy” (Oct. 8, 2012), available at http://www.ecb.europa.eu/press/key/date/2012/html/sp121008_1.en.html (on file with the *Columbia Law Review*) (“[W]e 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.”).

have swamped the Deposit Insurance Fund had the FDIC decided via the “systemic risk” exception that it could offer protective assistance.⁴¹

The U.S. government responded with the Dodd-Frank Act, which, *inter alia*, instituted an “Orderly Liquidation Authority” (OLA) 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.⁴²

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.

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

41. In 2009, even after injections from the Troubled 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. FDIC, *Toward a Long Term Strategy for Deposit Insurance Management*, FDIC Quarterly, Third Quarter 2010, at 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 Gen. for the Troubled Asset Relief Program, *Extraordinary Financial Assistance Provided to Citigroup, Inc.* 6, 20 tbl.1 (2011). See also *infra* note 85 (discussing limit on FDIC’s line of credit with U.S. Treasury).

42. 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 Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(n)(8)(A), 124 Stat. 1376, 1507-08 (2010) (codified at 12 U.S.C. § 5390(n)(8)(A) (2012)).

the FDIC the power to establish a successor firm, a “bridge bank,”⁴³ and to supply liquidity support either through lending the proceeds from a drawdown on a U.S. Treasury credit line or by providing full-faith-and-credit guarantees of bridge-bank debt issuances.⁴⁴ 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.⁴⁵ 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 “assurance” 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.⁴⁶

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.⁴⁷ “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 brings an abrupt halt to the

43. *Id.* § 210(h) (codified at 12 U.S.C. § 5390(h)).

44. *Id.* §§ 210(h)(2)(G)(iv), (n) (codified at 12 U.S.C. §§ 5390(h)(2)(G), (n)).

45. See FDIC, Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,616 (Dec. 18, 2013) [hereinafter FDIC, Notice, Single Point of Entry] (“[Long-term] debt in the failed company would be converted into equity that would serve to ensure that the new operations would be well-capitalized.”).

46. See Stephen J. Lubben, Roosevelt Inst., OLA After Single Point of Entry: Has Anything Changed 1–6 (2013), available at http://rooseveltinstitute.org/sites/all/files/Unfinished_Mission_Lubben_OLA_Has_Anything_Change.pdf (on file with the *Columbia Law Review*) (summarizing and critiquing FDIC proposal).

47. On the difference between the SPOE strategy and ordinary bankruptcy, see Douglas G. Baird & Edward R. Morrison, Dodd-Frank for Bankruptcy Lawyers, 19 *Am. Bankr. Inst. L. Rev.* 287, 299–302 (2011) (comparing Chapter 11 bankruptcy process with Dodd-Frank Title II receivership); David A. Skeel, Jr., Single Point of Entry and the Bankruptcy Alternative, in *Across the Great Divide: New Perspectives on the Financial Crisis* 311, 321–26, 329–33 (Martin Neil Baily & John B. Taylor eds., 2014), available at <http://www.hoover.org/sites/default/files/across-the-great-divide-ch15.pdf> (on file with the *Columbia Law Review*).

trading in financial claims that is the lifeblood 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 intervention will produce severe erosion in the franchise value of a failed financial firm and will deepen the losses for creditors.⁴⁸ 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 firesale valuations and a value-destructive disassembly of the firm’s business.⁴⁹ 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.⁵⁰

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.⁵¹ A major objective of resolution is to avoid systemic distress in the financial sector, a social good that may not coincide with the private objective of protecting the equal treatment or absolute priority of creditor claims.⁵² 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.⁵³ This is operationally equivalent to debtor-in-possession financing but has the advantage of assured availability in

48. See Randall D. Guynn, Are Bailouts Inevitable?, 29 *Yale J. on Reg.* 121, 137–40 (2012) (“[B]ankruptcy is a slow and deliberate process that is not designed for preserving systemically important operations critical to the functioning of the economy as a whole.”).

49. 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 Vishny, Fire Sales in Finance and Macroeconomics, 25 *J. Econ. Persp.* 29, 41–43 (2011) (surveying economics literature).

50. See Heidi Mandanis Schooner & Michael W. Taylor, *Global Bank Regulation: Principles and Policies* 243 (2010) (noting placing large banks into an ordinary liquidation process would cause “very real economic damage”).

51. See John Armour, Making Bank Resolution Credible 7–8 (Univ. of Oxford & ECGI Law, Working Paper No. 244/20124, Feb. 2014) (forthcoming in *Oxford Handbook of Financial Regulation* (Niamh Moloney et al. eds., 2015)), available at <http://ssrn.com/abstract=2393998> (on file with the *Columbia Law Review*) (describing original FDIC resolution model).

52. See Guynn, *supra* note 48, at 141 (noting Bankruptcy Code does not have goals of considering “public confidence or systemic risk”).

53. See *id.* at 144.

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.⁵⁴ 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.

To understand the U.S. resolution regime, it makes sense to start with resolution of a simple bank.⁵⁵ The Federal Deposit Insurance Act creates a special bank resolution procedure that grants the FDIC considerable discretion in addressing a bank failure.⁵⁶ One straightforward way to resolve a failed bank is through a “straight 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 depositors, from asset dispositions.⁵⁷ This is not the FDIC’s preferred approach, not just because of the ongoing 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.⁵⁸ Historically the FDIC’s favored approach has been a “purchase and assumption” (P&A) transaction,⁵⁹ 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.⁶⁰ That gap is funded by the Deposit Insurance Fund.⁶¹ 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

54. Press Release, FDIC, FDIC Report Examines How an Orderly Resolution of Lehman Brothers Could Have Been Structured Under the Dodd-Frank Act (Apr. 11, 2011) <http://www.fdic.gov/news/news/press/2011/pr11076.html> (on file with the *Columbia Law Review*). For a detailed analysis of the Lehman bankruptcy, see generally Michael Fleming & Asani Sarkar, Fed. Reserve Bank N.Y., *The Failure Resolution of Lehman Brothers*, Econ. Policy Rev., Dec. 2014, at 175, available at <http://www.ny.frb.org/research/epr/2014/1412flem.pdf> (on file with the *Columbia Law Review*).

55. See Gordon & Muller, *supra* note 10, at 185–90 (explaining FDIC’s original powers and its struggles regarding large banks).

56. Federal Deposit Insurance Act of 1950, Pub. L. No. 81-797, 64 Stat. 873 (codified as amended in 12 U.S.C. §§ 1811–1835a (2012)).

57. See FDIC, *Resolutions Handbook 19* (2014), https://www.fdic.gov/about/freedom/drr_handbook.pdf [hereinafter FDIC, *Resolutions Handbook*] (on file with the *Columbia Law Review*).

58. See *id.* at 6 (“This resolution option is only executed when the FDIC does not receive a P&A bid that meets the least cost test.”).

59. See *id.* at 16 (noting “P&A is the most common method used by the FDIC”).

60. See *id.* at 16–17.

61. 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).

deposits—whether or not insured—are carried over, particularly for larger banks.⁶² 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.⁶³

The P&A structure allows considerable flexibility. Not only can the FDIC allocate assets between its receivership and the acquirer, 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 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 Deposit Insurance Fund.

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

During the last real estate-related banking crisis in the United States, the savings and loan (S&L) crisis of the 1980s, the FDIC was criticized for excessive protection of uninsured creditors, particularly uninsured depositors.⁶⁴ These creditors were almost invariably protected, “bailed out,” even if the failed bank attracted an acquirer.⁶⁵ As a result, a 1991 legislative change now requires the FDIC to opt for the “least costly” resolution transaction—meaning least costly to the Deposit Insurance Fund—except where otherwise necessary to avoid a systemic distress, a judgment that requires the concurrence of the Fed and the U.S. Treasury.⁶⁶ No large banks failed in the 1991–2007 period, meaning that

62. This is now subject to a “least cost resolution” requirement, which in turn is subject to a systemic risk exception. See *infra* notes 64–67 and accompanying text (discussing origin of this requirement).

63. See generally FDIC, *Resolutions Handbook*, *supra* note 57, at 18–19.

64. See Alan S. Blinder, *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead* 162 (2013) (describing how “Congress had been badly burned by the S&L crisis” because FDIC had “toss[ed] money around without a compelling reason”).

65. 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 (on file with the *Columbia Law Review*) (discussing financial outlay from S&L crisis).

66. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, § 141, 105 Stat. 2236, 2273–79 (codified at 12 U.S.C. § 1823(c)(4)); see Blinder, *supra* note 64, at 162 (describing least-cost resolution requirement); Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 *Ann. 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

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.⁶⁷

Deposit insurance was controversial when it was initially adopted as part of the New Deal Banking legislation of the early 1930s.⁶⁸ 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 larger, more diversified, more resilient banks.⁶⁹ Deposit insurance was opposed by the large banks and by President Roosevelt, who asserted that the program would create moral hazard.⁷⁰ As part of the legislative compromise, the insured deposit level was capped at \$2,500 (approximately \$45,000 in 2013 dollars), a retail level, not a wholesale level.⁷¹

subject institutions were relatively small banks. FDIC, Historical Statistics on Banking, <https://www2.fdic.gov/hsob/> (follow “Failures & Assistance Transactions” hyperlink; select “Effective Date(s)” between 1991 and 2007; select “Insurance Fund” “DIF” as “Insurance Fund”; select “Produce Report” to arrive at report showing three failures) [hereinafter FDIC, Historical Statistics].

67. See FDIC, Historical Statistics, *supra* note 66.

68. On the history of the FDIC, see Charles W. Calomiris & Eugene N. White, The Origins of Federal Deposit Insurance, *in* *The Regulated Economy: A Historical Approach to Political Economy* 145, 145–88 (Claudia Goldin & Gary D. Libecap eds., 1994); Roger Lowenstein, There’s a Reason for Deposit Insurance, *N.Y. Times* (Mar. 24, 2013), <http://www.nytimes.com/2013/03/24/business/deposit-insurance-and-the-historical-reasons-for-it.html?pagewanted=all&r=0> (on file with the *Columbia Law Review*).

69. See FDIC, *The First Fifty Years: A History of the FDIC 1933–1983*, at 38 (1984) (citing Steagall’s support).

70. See *id.* at 40–43 (discussing opposition to deposit insurance legislation).

71. Banking Act of 1933, ch. 89, Pub. L. No. 66, sec. 8, § 12B(y), 48 Stat. 162, 179 (codified as amended at 12 U.S.C. § 1811); Oversight Hearing on “The Federal Deposit Insurance System and Recommendations for Reform” Before the S. Comm. on Banking, Hous. & Urban Affairs, 107th Cong. (2002) (prepared statement of the Hon. Alan Greenspan, Chairman, Bd. of Governors of the Fed. Reserve Sys.), http://www.banking.senate.gov/02_04hr/042302/grmspan.htm (on file with the *Columbia Law Review*) (describing evolution of deposit insurance cap and how deposit insurance both mitigated and exacerbated systemic risk in run-up to S&L crisis). For an overview of the state of U.S. banking before the Great Depression and the regulatory response, see Charles W. Calomiris & Stephen H. Haber, *Fragile By Design: The Political Origins of Banking Crises and Scarce Credit* 187–92 (2014).

In fact, until banking liberalization in the 1970s and 1980s, moral hazard because of deposit insurance was not much of a problem.⁷² 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.⁷³ Because banks could not bid up interest rates to compete for deposits, banks could generate profits on lower-risk/lower-yielding loans. The pre-existing geographic restrictions that limited bank branching also protected local deposit gathering and loan-making from competitive encroachments.⁷⁴

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 commonly *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 may well be the FDIC’s least-cost resolution strategy in many cases.⁷⁵ 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 the banking liberalization that began in the 1970s, moral hazard was not a serious problem. On the few occasions 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 or national economy.⁷⁶ The most notorious case was Continental Illinois in 1984, then the seventh largest bank by assets in the United States, which the FDIC rescued in a trans-

72. 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).

73. 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 C.F.R. § 217. For the history of Regulation Q, see generally R. Alton Gilbert, *Requiem for Regulation Q: What It Did and Why It Passed Away*, *Fed. Res. Bank of St. Louis Rev.*, Feb. 1986, at 22.

74. See generally Richard Scott Carnell, Jonathan R. Macey & Geoffrey P. Miller, *The Law of Banking and Financial Institutions 177–98* (4th ed. 2009) (describing rationale for geographic restrictions on banks and subsequent geographic expansion).

75. See Gordon & Muller, *supra* note 10, at 185–86 (discussing effectiveness of P&A transaction in preserving going concern value).

76. See FDIC, *Managing the Crisis: The FDIC and RTC Experience 635–36*, 651 (1998).

action that bailed out creditors of the holding company parent as well as the uninsured depositors of the troubled bank.⁷⁷

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 nongovernmental 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.⁷⁸ 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 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 intraorganization credit and equity arrangements. The FDIC’s resolution authority does not run to Topco or the nonbank 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 intraentity debt owed by the bank to the holding company parent.⁷⁹ 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 Federal Reserve, devised a plan that rescued the parent (including the parent’s creditors) as well as the bank.⁸⁰

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

77. Gordon & Muller, *supra* note 10, at 187–90. 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).

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

79. See Lee Davison, FDIC, Continental Illinois and “Too Big to Fail,” *in* *History of The Eighties Vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s*, 235, 244 (1997), available at https://www.fdic.gov/bank/historical/history/235_258.pdf (on file with the *Columbia Law Review*) (explaining how FDIC was prevented from using its full resolution powers because of certain agreements that bank had with holding company).

80. See *id.* (describing controversial resolution plan implemented by FDIC and the Fed).

market-based intermediation.⁸¹ Although market-focused nonbanks 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,” a kind of secured short-term borrowing that may be collateralized by long-term assets of uncertain value.⁸² 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.⁸³ Lehman Brothers showed the limits of the bankruptcy strategy.⁸⁴

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 nonbank affiliates and parent would face 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.⁸⁵

81. See Samuel Antill, David Hou & Asani Sarkar, Components of U.S. Financial Sector Growth, 1950–2013, FRBNY Econ. Pol’y Rev., Dec. 2014, at 59, 61 (“Growth in shadow banking has been fueled by rapid expansion in credit intermediation services by asset management and securities firms . . .”).

82. See generally Adam Copeland et al., Key Mechanics of the U.S. Tri-Party Repo Market, FRBNY Econ. Pol’y Rev., Nov. 2012, at 17, 17–21 (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, 447–48 (2012).

83. See Gordon & Muller, *supra* note 10, at 180–84 (discussing problems with both bankruptcy and business combination strategies for Lehman Brothers and Bear Stearns); Blinder, *supra* note 64, 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.”).

84. See *supra* notes 10, 53 and accompanying text (describing losses associated with taking Lehman into bankruptcy).

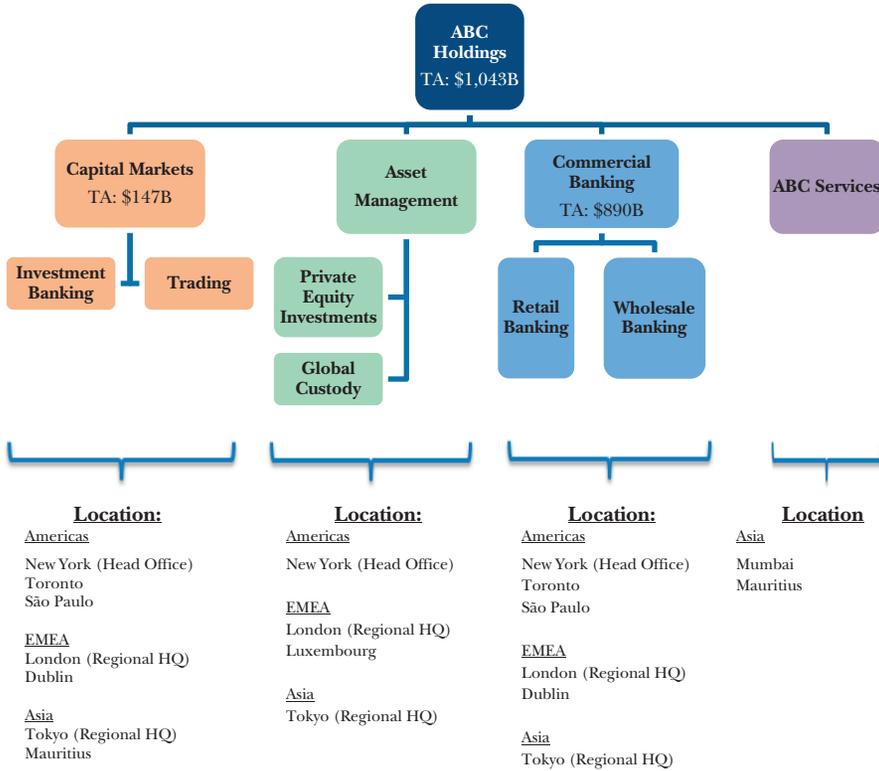
85. See Citigroup, Inc., Quarterly Report (Form 10-Q) 4, 82 (Sept. 30, 2008) (reporting total assets of USD 2.1 trillion and liabilities of \$1.9 trillion, less than half of which were reflected by deposits). The FDIC’s ordinary line of credit with Treasury was \$100 billion; it could borrow up to \$500 billion with consent of Treasury and the Fed. The Deposit Insurance Fund had fallen to \$10.4 billion in the second quarter of 2008 because of the failure of twenty-four banks in that year. Jessica Holzer, FDIC Considers Borrowing from Treasury to Shore Up Deposit Insurance, Wall St. J. (Sept. 18, 2008), <http://www.wsj.com/articles/SB125328162000123101> (on file with the *Columbia Law Review*).

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 United States 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; asset management through multiple 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 United States, others in non-U.S. jurisdictions. The subsidiaries are likely to have complex financial arrangements with one another, entailing the intraorganizational 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 that may operate in a relatively small number of different business segments will nevertheless use a complex legal organizational form.

FIGURE 1: BUSINESS STRUCTURE⁸⁶

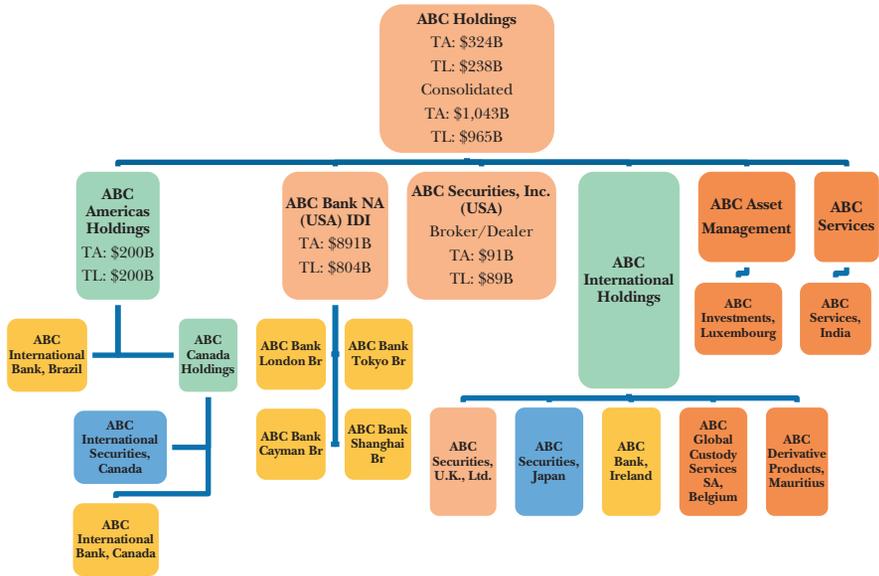
Organization Structure by Lines of Business & Jurisdiction



86. FDIC Advisory Comm. on Systemic Resolution, Dodd-Frank Act Title II: Resolution Strategy Overview 5 (2012), https://www.fdic.gov/about/srac/2012/2012-01-25_resolution-strategy.pdf (on file with the *Columbia Law Review*).

FIGURE 2: LEGAL STRUCTURE⁸⁷

Organization Structure by Legal Entity



Legend

- Identified Systemically Important Entities
- International Holding Company
- Foreign Bank and/or Branch
- Broker/Dealer
- Other

87. Id. at 6.

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.”⁸⁸ 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.⁸⁹

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 Topco’s equity and then debt in its subsidiary, followed by further advances 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.⁹⁰ If such write-downs and advances would render Topco insolvent, the FDIC 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, Bridgco. Topco’s unsecured liabilities (not the liabilities of any subsidiary, which are unaffected) become claims against the receivership. The FDIC estimates the extent of the losses, which it then apportions among equity holders and the

88. FDIC, Notice, Single Point of Entry, *supra* note 45, at 76,615.

89. On the SPOE approach in detail, see John F. Bovenzi et al., *Too Big to Fail: The Path to a Solution 23–32* (Wash., DC: Bipartisan Policy Ctr., 2013). For a general account, see Randall D. Guynn, *Framing the TBTF Problem: The Path to a Solution, in Across the Great Divide: New Perspectives on the Financial Crisis*, *supra* note 47, at 281, 281–301, available at <http://www.hoover.org/sites/default/files/across-the-great-divide-ch13.pdf> (on file with the *Columbia Law Review*). The FDIC has recently outlined the SPOE strategy in a request for public comments. FDIC, Notice, Single Point of Entry, *supra* note 45, at 76,615–24.

90. 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. This is the so-called “source of strength” doctrine, by which a bank holding company is obliged to support its subsidiaries. Although the doctrine has been contested in courts in the past, see Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety and Soundness*, *in The Oxford Handbook of Banking 195, 207* (Allen N. Berger et al. eds., 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.” 12 U.S.C. § 1831o-1 (2012). Presumably this means that Topco will be required to enter into the undertakings deemed necessary to assure that subsidiary liabilities can be upstreamed to the Topco parent and that Topco’s support can be downstreamed, as necessary to make SPOE effective.

unsecured creditors of Topco in accordance with their priority.⁹¹ 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.⁹² 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.⁹³ This is illustrated in Figure 3 below, drawn from a paper by Paul Tucker, former Deputy Governor of the Bank of England.

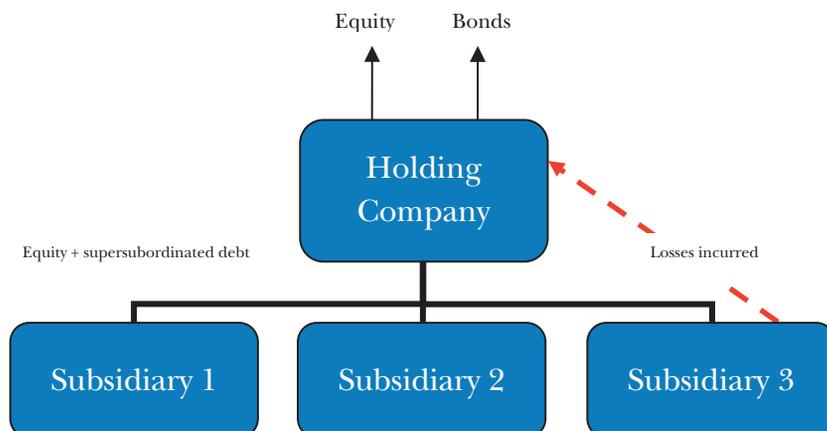
91. Martin J. Gruenberg, Acting Chairman, FDIC, Remarks to the Federal Reserve Bank of Chicago at the Bank Structure Conference (May 10, 2012), <https://www.fdic.gov/news/news/speeches/chairman/spmay1012.html> (on file with the *Columbia Law Review*).

92. 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. Bail-in 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, Deputy Governor for Financial Stability, Bank of Eng., Speech at the INSOL International World Conference: Resolution and Future of Finance (May 20, 2013), <http://www.bankofengland.co.uk/publications/Pages/speeches/2013/658.aspx> (on file with the *Columbia Law Review*).

93. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 204(d), 210(n)(8)(B), 124 Stat. 1376, 1455, 1598 (2010) (codified at 12 U.S.C. §§ 5384(d), 5390(n)(8)(B)) (identifying how FDIC may supply “funds for the orderly liquidation of a covered financial company” and noting FDIC may issue contingent liabilities during receivership). As Bridgeco is incorporated and operated by the FDIC, these obligations are full faith and credit obligations of the U.S. government.

FIGURE 3: SPOE RESOLUTION⁹⁴

- Losses incurred in subsidiaries: If greater than equity, intragroup debt is “written down”—transfers losses to Holding Company.
- If Holding Company is mortally wounded, it is resolved—bonds converted into equity. Bondholders become new owners.

The upshot of this approach is that the holding company—specifically, the shareholders and debtholders of Topco—bears the losses of the operating subsidiaries.⁹⁵ 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.⁹⁶ The long-term creditors and shareholders of Topco cannot run in the face of impending financial distress because of the nature of their commitment.⁹⁷ Because the subsidiaries’ businesses are not disrupted—because the systemic shock is contained—the ultimate creditor losses will be

94. Paul Tucker, Brookings, *Regulatory Reform, Stability, and Central Banking* 7 (2014), <http://www.brookings.edu/research/papers/2014/01/16-regulatory-reform-stability-central-banking-tucker> (on file with the *Columbia Law Review*).

95. See Bovenzi et al., *supra* note 89, 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’s receivership.”).

96. See *id.* at 27–28.

97. 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 . . .”).

much less.⁹⁸ 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.⁹⁹ To be sure, the SPOE strategy depends upon a sufficient layer of unsecured debt in the liability structure of Topco, but the claim is that in expectation of a well-managed resolution process, losses can be contained to the point that a reasonable level of unsecured debt (plus capital) can cover them.¹⁰⁰

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 a 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

98. 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”).

99. See *The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, FDIC Q., First Quarter 2011, at 31, 34, available at https://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/Article2.pdf (on file with the *Columbia Law Review*) (explaining how resolution could have avoided massive losses of Lehman bankruptcy).

100. The FDIC describes the systemic stability advantages of an 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

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, Notice, Single Point of Entry, *supra* note 45, at 76,615–16. The SPOE approach has received international recognition via the November 2012 Financial Stability Board guidance. See Fin. Stability Bd., Consultative Document: Recovery and Resolution Planning: Making the Key Attributes Requirements Operational 13–28 (2012), available at http://www.financialstabilityboard.org/publications/r_121102.pdf (on file with the *Columbia Law Review*) (detailing FSB's “Developing Resolution Strategies and Operational Resolution Plans”).

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 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.¹⁰¹

To use the Lehman example: In an SPOE world, Lehman U.K. would never have faced U.K. insolvency proceedings, because the FDIC would have assured its solvency and liquidity.¹⁰² The Clearing House organized and conducted a comprehensive and sophisticated simulation exercise of the operability of OLA in November 2012.¹⁰³ This important test for the new system confirmed that Title II OLA could be a “viable mechanism” for resolution of even large and complex SIFIs.¹⁰⁴ 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%.¹⁰⁵ These figures and test results are so compelling that the United States is currently negotiating agreements

101. FDIC & Bank of Eng., *supra* note 6, at 11–12. 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.” *Id.* at 11. This power could be obtained by specific contractual provision in the debt instrument.

102. This is at least the hope. This Essay cannot exclude the possibility that the FDIC in practice is subject to practical considerations and political pressure that would taint its unilateral perspective and approach.

103. The Clearing House, Report on the Orderly Liquidation Authority Resolution Symposium and Simulation (2013), <https://www.theclearinghouse.org/~//media/files/association%20documents/20130117%20tch%20resolution%20simulation%20symposium%20report.pdf> (on file with the *Columbia Law Review*). The Clearing House is the trade association for large banking organizations.

104. *Id.* at 6.

105. See *supra* note 54 and accompanying text. The main reason for the difference 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 U.K.¹⁰⁶

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 Bridgenco in accordance with Basel III and national requirements.¹⁰⁷ 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*.¹⁰⁸ 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.

The FDIC is currently consulting with a view to ascertain precisely how much debt should be required to be available at the Topco level.¹⁰⁹ The Federal Reserve seems almost certain to propose a concrete long-term debt requirement for the largest SIFIs.¹¹⁰ 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 absor-

106. See Bloomberg Bus., FDIC’s Gruenberg on Resolution Strategy for Banks (Nov. 21, 2013), <http://www.bloomberg.com/video/fdic-s-gruenberg-on-resolution-strategy-for-banks-g5YN2PiESFyCrIsIuANWJQ.html> (on file with the *Columbia Law Review*) (explaining ongoing international negotiations in pursuit of U.S.–U.K. model).

107. See Fin. Stability Bd., Key Attributes of Effective Resolution Regimes for Financial Institutions 47–48 (2014), http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf [hereinafter FSB, Key Attributes] (on file with the *Columbia Law Review*) (describing essential elements of recovery and resolution plans).

108. See Fin. Stability Bd., Consultative Document: Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution 18 (Nov. 2014), www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf [hereinafter FSB, Adequacy of Loss-Absorbing Capacity] (on file with the *Columbia Law Review*) (suggesting G-SIBs should “deduct from [their] own regulatory capital certain investments in the regulatory capital of other banks”); Paul Tucker, The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations 9 (July 3, 2014), http://www.cepr.org/sites/default/files/events/papers/6708_TUCKER%20Essay.pdf (on file with the *Columbia Law Review*) (explaining avoiding systemic fragility requires “[b]ank bonds not [to] be held by banks” or “anything resembling a bank”).

109. FDIC, Notice, Single Point of Entry, *supra* note 45, at 76,623.

110. See Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, “Planning for the Orderly Resolution of a Globally Systemically Important Bank”: Toward Building a More Effective Resolution Regime: Progress and Challenges 11 (Oct. 18, 2013), <http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.pdf> (on file with the *Columbia Law Review*) (stating Board of Governors will issue “a proposal that would require the largest, most complex banking firms to hold minimum amounts of long-term, unsecured debt at the holding company level”).

bency 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 Financial Stability Board, in its role as post-crisis agenda setter, submitted a proposal for “Total Loss Absorbency Capacity” (TLAC), meaning capital plus loss-absorbing debt, equal to at least twice the amount of required equity capital on both risk-weighted and leverage measures.¹¹¹ 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.¹¹²

Financial institutions are unlikely to issue sufficient unsecured term debt without regulatory prodding.¹¹³ Capital, not loss absorbency through unsecured term debt, has been the focus of Basel.¹¹⁴ 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.¹¹⁵ Other countries are exploring similar strategies.¹¹⁶

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 finan-

111. FSB, Adequacy of Loss-Absorbing Capacity, *supra* note 108, at 6.

112. *Id.* at 13. The threshold limits were based on calculation of losses during the recent financial crisis in an earlier consultation document. See Memorandum from the Fin. Stability Bd. to the Steering Comm., Issues for Consideration in the Development of a Proposal on Adequacy of Loss Absorbing Capacity in Resolution, SC/2013/45, Annex at 26–31 (Dec. 18, 2013) [hereinafter FSB Steering Committee Memo] (on file with the *Columbia Law Review*).

113. The customary positive slope of the yield curve may favor shorter-term debt. Because of the run risk, short-term debt 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.

114. See Bovenzi et al., *supra* note 89, at 28–29 (referencing Basel III capital-requirements proposals).

115. As Janet Yellen remarked,

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.

Janet L. Yellen, Vice Chair, Bd. of Governors of the Fed. Reserve Sys., Remarks at the International Monetary Conference: Regulatory Landscapes: A U.S. Perspective 5 (June 3, 2013), <http://www.federalreserve.gov/newsevents/speech/yellen20130602a.pdf> (on file with the *Columbia Law Review*); accord Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Industry Structure and Systemic Risk Regulation, Remarks at the Brookings Institution Conference on Structuring the Financial Industry to Enhance Economic Growth and Stability 12 (Dec. 4, 2012), <http://www.federalreserve.gov/newsevents/speech/tarullo20121204a.pdf> (on file with the *Columbia Law Review*).

116. Yellen, *supra* note 115.

cial 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 they are locked 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 UNITED STATES; DECISION FOR THE E.U.

A critical institutional feature for the success of SPOE is a top-level holding company whose assets consist primarily of equity and intra-company debt claims in its operating subsidiaries and whose liabilities consist principally of nonrunnable term debt issued to the public. 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.¹¹⁷ Until approximately twenty years ago, the U.S. financial sector was highly balkanized. Bank expansion was limited by restrictive branching laws that limited interstate banking, even intrastate banking.¹¹⁸ The "business of banking" was narrowly defined to exclude

117. The text in this Part draws from many sources, including Saule T. Omarova & Margaret E. 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); Calomiris & Haber, *supra* note 71, at 195–202; Charles W. Calomiris, *U.S. Bank Deregulation in Historical Perspective* (2000); Carnell, Macey & Miller, *supra* note 74; Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risk*, 2002 *Ill. L. Rev.* 215.

118. See, e.g., *McFadden Act of 1933*, ch. 191, 44 Stat. 1224 (codified at 12 U.S.C. § 36 (1988)) (establishing "conditions upon which a national banking association may retain or establish and operate a branch").

banks from the provision of many financial services.¹¹⁹ And commercial banks were famously barred from engaging in securities underwriting and other investment bank activity by the Glass-Steagall Act.¹²⁰ The result was a relatively small number of “money center” banks, thousands of “unit banks,” and many thousands of different financial service providers.¹²¹

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.¹²² 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.”¹²³ 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 BHCs could become “financial holding companies,” which were permitted to engage in a broader set of activities that were “financial in nature,” or “incidental” or “complementary” to such activity, and that could include both insurance underwriting and merchant banking activity.¹²⁴ All of these activities were to occur through

119. See 12 U.S.C. § 24 (Seventh) (2013) (limiting, for example, “[t]he business of dealing in securities and stock”).

120. The Glass-Steagall Act is the term commonly used to refer to four sections of the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended at 12 U.S.C §§ 24 (Seventh), 78, 377, 378a (2012)). See *Inv. Co. Inst. v. Camp*, 401 U.S. 617 (1971) (providing capacious reading of Glass-Steagall).

121. See Omarova & Tahyar, *supra* note 117, at 124 n.35 (tracking number of financial institutions).

122. See 12 U.S.C. § 24 (Seventh) (2013) (limiting ways in which banks can provide financial services directly). See generally Carnell, Macey & Miller, *supra* note 74, at 485–94.

123. Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841, 1843(k); see also Carl A. Sax & Marcus H. Sloan III, *The Bank Holding Company Act Amendments of 1970*, 39 *Geo. Wash. L. Rev.* 1200, 1218 (1970) (“Under the 1956 Act, bank holding companies were permitted to conduct nonbank business, all the activities of which were of a ‘financial, fiduciary or insurance nature’ and were ‘so closely related to the business of banking’ as to be a proper incident thereto.”).

124. See generally Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C. (2012))

subsidiaries of the bank holding company. Preexisting rules limited the extent to which the affiliated bank could provide financial support to these sibling subsidiaries.¹²⁵

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

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 toward 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 involvement at the E.U. level. 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.

(repealing Glass-Steagall and substantially amending the Bank Holding Company Act). More specifically, see 12 U.S.C. § 843(k)(4)(H), (I).

125. See Federal Reserve Act of 1913, ch. 6, §§ 23A, 23B, 38 Stat. 251 (codified as amended at 12 U.S.C. §§ 371c, 371c-1 (2012)); Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. Rev. 1683, 1686 (2011) (arguing Section 23A rules are too porous).

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 2007–2009, and the federal E.U. institutions were almost mute. National governments took the crucial 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.¹²⁶ E.U. institutions played a decidedly secondary role, principally though the review of the bailouts through the lens of E.U. “state aid” rules¹²⁷—which were then bent to virtual nonrecognition.¹²⁸ While academics quickly moved to criticize bailout programs,¹²⁹ policymakers moved more slowly from bailout to resolution.

2. *Transition to Resolution Regimes.* — After a number of costly bailouts,¹³⁰ the U.K. was the first European country to introduce a formal

126. See Martin Čihák & Erlend Nier, The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union, 2 Harv. Bus. L. Rev. 395, 429–30 (2012).

127. The E.U. state aid framework seeks to ensure that no Member State supports domestic firms over others, thereby distorting competition in the European internal market. See Consolidated Version of the Treaty on the Functioning of the European Union art. 107, Oct. 26, 2012, 2012 O.J. (C 326) 47.

128. Mathias Dewatripont, European Banking: Bailout, Bail-in and State Aid Control, 34 Int'l. J. Indus. Org. 37, 42 (2014) (describing post-bailout state aid provisions); Conor Quigley, State Aid and the Financial Crisis, in Legal Challenges in the Global Financial Crisis 131–35 (Wolf-Georg Ringe & Peter M. Huber eds., 2014).

129. See, e.g., Mathias Dewatripont & Xavier Freixas, Bank Resolution: A Framework for the Assessment of Regulatory Intervention, 27 Oxford Rev. Econ. Pol'y 411, 427 (2011) (advocating for ex ante approach to intervention); Eva Hüpkens, Special Bank Resolution and Shareholders' Rights: Balancing Competing Interests, 17 J. Fin. Reg. & Compliance 277, 285–86 (2009) (explaining how bailout programs “completely wiped out” or “significantly diluted” shareholders); Achim Dübel, The Capital Structure of Banks and Practice of Bank Restructuring 71–75 (Ctr. for Fin. Servs., Working Paper No. 2013/04, 2013), available at <https://ideas.repec.org/p/zbw/cfswp/201304.html> (on file with the *Columbia Law Review*) (drawing policy lessons from case studies); Thomas F. Huertas, The Road to Better Resolution: From Bail Out to Bail In 7 (London Sch. of Econ. & Political Sci. Fin. Mkts. Grp., Special Paper No. 195/2010, 2010), available at <http://www2.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP195.pdf> (on file with the *Columbia Law Review*) (“We must move away from a policy of full support for systemically important financial institutions . . .”).

130. The crisis at mortgage lender Northern Rock marked the beginning of the U.K.'s slide into (temporary) large-scale state ownership of the banking system. See Northern Rock Now in Public Hands, BBC News (Feb. 22, 2008, 11:01 AM), http://news.bbc.co.uk/2/hi/uk_news/politics/7258492.stm (on file with the *Columbia Law Review*) (discussing nationalization of Northern Rock). “[A]t 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.” Editorial, Bank-Bailout Lessons, Wall St. J. (June 1, 2012, 12:01 AM), <http://www.wsj.com/>

resolution scheme. Initially adopting emergency legislation,¹³¹ the U.K. moved to a more permanent rescue mechanism through the Banking Act 2009.¹³² This Act assigned the role of the lead authority to the Bank of England (rather than to the Treasury); it allowed for a number of restructuring alternatives, including the possibility of putting a bank into temporary public ownership.¹³³ Many of the instruments are similar to the powers of the U.S. FDIC and were in fact inspired by the FDIC Improvement Act of 1991.¹³⁴ The Banking Act has been used twice, for rather minor cases.¹³⁵ 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”).¹³⁶

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

articles/SB10001424052702303640104577437660160342388 (on file with the *Columbia Law Review*).

131. The Banking (Special Provisions) Act, 2008, c. 2 (U.K.) 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 & Bingley and the U.K. assets of Icelandic banks Kaupthing and Landsbanki. See Bank of Eng., Resolutions Prior to the Banking Act 2009, http://www.bankofengland.co.uk/financialstability/Pages/role/risk_reduction/srr/prior.aspx# (last visited Feb. 19, 2015) (on file with the *Columbia Law Review*) (discussing institutions resolved under the Banking (Special Provisions) Act).

132. 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, 8:32 PM), <http://www.telegraph.co.uk/finance/financialcrisis/3185120/Financial-crisis-HBOS-and-RBS-to-be-nationalised-in-50-billion-state-intervention.html> (on file with the *Columbia Law Review*) (discussing decision of U.K. government to take majority shareholder position in RBS and HBOS). 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 in detail, see Peter Brierley, Bank of Eng., Financial Stability Paper No. 5, The UK Special Resolution Regime for Failing Banks in an International Context 3–13 (2009).

133. See Kern Alexander, Bank Resolution Regimes: Balancing Prudential Regulation and Shareholder Rights, 9 *J. Corp. L. Stud.* 61, 90–92 (2009) (discussing restructuring powers granted by Banking Act 2009); Emiliós Avgouleas, Banking Supervision and the Special Resolution Regime of the Banking Act 2009: The Unfinished Reform, 4 *Cap. Mkts. L.J.* 201, 212–27 (2009) (detailing structure and objectives of Banking Act 2009 and discussing requirements and process for exercise of stabilization powers).

134. The Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified in scattered sections of 12 U.S.C.), was the U.S. response to the 1980s Savings & Loans financial crisis.

135. These cases were Dunfermline Building Society, the largest building society in Scotland, and Southsea Mortgage and Investment Company. See Jill Treanor, Southsea Bank Declared Insolvent, *Guardian* (June 16, 2011, 3:07 PM), <http://www.theguardian.com/business/2011/jun/16/southsea-bank-declared-insolvent> (on file with the *Columbia Law Review*).

136. Financial Services Act, 2010, c. 28, § 7 (U.K.).

Act on January 1, 2011.¹³⁷ Under the new regime, the German market 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.¹³⁸ Technically, this would 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).¹³⁹ Amounts payable under the bank levy increase with the size of the bank and its degree of interconnectedness within the financial system.¹⁴⁰ The target is to raise a fund of €70 billion over a number of years.¹⁴¹

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 retail bondholders.¹⁴² Similarly, in the 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.¹⁴³ The Dutch

137. Restrukturierungsgesetz [Restructuring Act], Dec. 9, 2010, Bundesgesetzblatt, Teil I [BGBl. I] at 1900 (Ger.).

138. Previously, following the collapse of Lehman Brothers, the German government had introduced a state-backed financial market stabilization package, Finanzmarktstabilisierungsgesetz [FMStG] [Financial Market Stabilization Act], Oct. 17, 2008, BGBl. I at 1982 (Ger.). See Allen & Overy, *The German Bank Restructuring and Bad Bank Regime: Its Impact on Investors* 5 (2012), available at <http://www.allenoverly.com/SiteCollectionDocuments/The%20German%20bank%20restructuring%20and%20bad%20bank%20regime.pdf> (on file with the *Columbia Law Review*) (discussing Special Market Stabilization Fund, a key aspect of German bailout scheme).

139. Officially, “Bundesanstalt für Finanzmarktstabilisierung.” For information in English, see FMSA, Federal Agency for Financial Market Stabilisation (FMSA), <http://www.fmsa.de/en/> (on file with the *Columbia Law Review*) (last visited Apr. 6, 2015).

140. FMSA, Bank Levy, <http://www.fmsa.de/en/fmsa/restructuring-fund/bank-levy/index.html> (on file with the *Columbia Law Review*) (last visited Apr. 6, 2015).

141. *Id.*

142. Graziella Marras, *Basel III, Resolution, Bail-in, Bailout, Ring-fencing, and Banking Union: What Does the Future Hold for Banks and Their Investors*, CFA Inst. Mkt. Integrity Insights Blog (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/> (on file with the *Columbia Law Review*).

143. Thomas Escritt & Anthony Deutsch, *Dutch Nationalise SNS Reaal Bank Group in \$14 Billion Rescue*, Reuters (Feb. 1, 2013, 4:35 PM), <http://uk.reuters.com/article/2013/02/01/uk-dutch-finance-cbank-idUKBRE9100A420130201> (on file with the *Columbia Law Review*).

government made use of new powers granted under the 2012 Intervention Act.¹⁴⁴

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 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, involving 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.¹⁴⁵ 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.¹⁴⁶ The resolution plan sacrificed value.¹⁴⁷

The second, and related, problem was the observed forbearance of national regulators toward their own supervisees, i.e., their own banks. Supervisors exhibited leniency toward 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.¹⁴⁸ These pressures were particularly strong

144. 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), Stb. 2012, p. 241 (Neth.), available at http://wetten.overheid.nl/bwbr0031641/geldigheidsdatum_1-02-2015 (on file with the *Columbia Law Review*) (providing special measures to deal with failing financial companies).

145. See Commission Impact Assessment Accompanying the 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, on an EU Framework for Cross-Border Crisis Management in the Banking Sector, at 16–17, SEC 1389 (2009) [hereinafter, European Union, Impact Assessment] (relating history of Fortis Bank).

146. Kudrna, *supra* note 17, at 288-90 (describing failure to sustain multilateral resolution in Fortis case); European Union, Impact Assessment, *supra* note 145, at 16–17 (same).

147. Cf. Kudrna, *supra* note 17, at 290 (noting Fortis break-up only had “relative success” (emphasis added)).

148. See Dübel, *supra* note 129, at 4–58 (providing case studies of failures of eight European banks).

in situations where several or many local banks had problems and intervention risked a credit crunch.¹⁴⁹ 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.¹⁵⁰ This trend was exacerbated by the "home bias" exhibited by European banks, in which they held large amounts of home-country sovereign debt.¹⁵¹ 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."¹⁵²

All three problems have been particularly salient within the Eurozone, where a common monetary policy in the hands of the ECB has prompted close economic and financial integration both among banks and among Member States and therefore increased the possibility of cross-border spillover effects in the event of a banking crisis.¹⁵³ 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 restrictions¹⁵⁴ proved to be an ineffectual antibailout 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

149. European Systemic Risk Bd., Advisory Sci. Comm., Forbearance, Resolution and Deposit Insurance 1 (2012), available at https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1_1207.pdf?78d247d3fd283c5df365c401e147f0f0 (on file with the *Columbia Law Review*).

150. Standard & Poor's Rating Servs., European Sovereigns 4 (2012), <http://www.standardandpoors.com/spf/swf/ereports/eurosovereign/EuroSovereign/document/AveDoc.pdf> (on file with the *Columbia Law Review*).

151. Gros, supra note 13, at 93; see also Gallo et al., supra note 12, at 4 (showing data on European banks' asset holdings).

152. Euro Area Summit Statement (June 29, 2012) [hereinafter Euro Area Summit Statement, available at https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf] (on file with the *Columbia Law Review*).

153. Communication from the Commission to the European Parliament and the Council: A Roadmap Towards a Banking Union, at 3, COM (2012) 510 final (Sept. 12, 2012) [hereinafter European Commission, Roadmap].

154. See supra note 127 (describing E.U. state aid rules).

foremost borne by the private sector. It would thereby minimise resolution costs without recourse to taxpayer money.”¹⁵⁵

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 international recovery and resolution framework for systemically important 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.¹⁵⁶ 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, which was then updated in October 2014.¹⁵⁷ 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 2011 G20 Summit in Cannes.¹⁵⁸

155. Mario Draghi, President, Eur. Cent. Bank., Introductory Statement at the Hearing of the Committee on Economic and Monetary Affairs of the European Parliament 3 (Feb. 18, 2013.)

156. See Chris Brummer, *Minilateralism* 107–09, 193 (Cambridge Univ. Press 2014); James R. Barth et al., *Systemically Important Banks (SIBs) in the Post-Crisis Era: The Global Response, and Responses Around the Globe for 135 Countries*, in *The Oxford Handbook of Banking* 617 (Allen N. Berger, Philip Molyneux & John O.S. Wilson eds., 2d ed. 2015) (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*, 24 *Fin. Mkts., Institutions & Instruments* 1, 3–14 (2015) (describing formation of and motivation behind FSB).

157. FSB, *Key Attributes*, supra note 107.

158. G20, *Cannes Summit Final Declaration—Building Our Common Future: Renewed Collective Action for the Benefit of All* ¶ 28 (2011), available at https://www.g20.org/sites/default/files/g20_resources/library/Declaration_eng_Cannes.pdf (on file with the *Columbia Law Review*).

In the wake of these recommendations, national governments adjusted their already adopted resolution mechanisms. U.K. lawmakers decided to reform the Banking Act 2009 in order to extend the scope of the resolution mechanism to include nonbanks 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 2012¹⁵⁹ and the Financial Services (Banking Reform) Act 2013.¹⁶⁰ Eventually the E.U. Bank Recovery and Resolution Directive delivered many of these reforms for Europe generally.¹⁶¹

2. *The Path Toward 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.¹⁶² During the same period, E.U. governance institutions worked to prepare a systematic response.¹⁶³ 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 second, 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.¹⁶⁴ In 2010, the Commission announced an E.U. "crisis management framework" that included a bank resolution fund.¹⁶⁵ 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

159. Financial Services Act, 2012, c. 21, at 169–97 (U.K.) (amending Banking Act 2009 in Part 8).

160. Financial Services (Banking Reform) Act, 2013, c. 33 (U.K.).

161. See *infra* text accompanying notes 177–182 (discussing adoption of BRRD).

162. See *supra* Parts V.A–B.

163. See generally *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro, and Regulation* (Wolf-Georg Ringe & Peter M. Huber eds., 2014); see also Lucia Quaglia, *Financial Regulation and Supervision in the European Union After the Crisis*, 16 *J. Econ. Pol'y Reform* 17, 18–25 (2013) ("A host of new regulatory initiatives were undertaken by the EU in the aftermath of the global financial crisis, besides the short-term crisis management measures adopted in the midst of the turmoil.").

164. 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 EU Framework for Cross-Border Crisis Management in the Banking Sector*, COM (2009) 561 final (Oct. 20, 2009).

165. 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 (May 26, 2010) [hereinafter *European Commission, Bank Resolution Funds*].

for taxpayers and *ensuring a level playing field.*¹⁶⁶ 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 recognises 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.¹⁶⁷

Following this first step, a 2010 Communication aimed to identify the elements of coordinated national crisis management arrangements.¹⁶⁸ It specified that national authorities should be broadly equipped with “common and effective tools and powers to tackle bank crises at the earliest possible moment” while avoiding costs for taxpayers.¹⁶⁹ The common toolbox would include: (i) “preparatory and preventative measures,” including “living wills”;¹⁷⁰ (ii) supervisory power to force a bank to undertake early stage remedial action;¹⁷¹ 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

166. *Id.* at 5 (emphasis added).

167. *Id.* at 6–7.

168. 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 EU Framework for Crisis Management in the Financial Sector, at 4–12, COM (2010) 579 final (Oct. 20, 2010) [hereinafter EU Framework for Crisis Management].

169. Memorandum from the Eur. Comm’n on an EU Framework for Crisis Management in the Financial Sector—Frequently Asked Questions 1 (Oct. 20, 2010), available at http://europa.eu/rapid/press-release_MEMO-10-506_en.pdf (on file with the *Columbia Law Review*).

170. EU Framework for Crisis Management, *supra* note 168, at 5–6. 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.

171. *Id.* at 8. Such remedial action could include the replacement of management, the implementation of a recovery plan, or the divestiture “of activities or business lines that pose an excessive risk to its financial soundness.” *Id.*

bank, so as to ensure both the continuity of essential services and the orderly management of failure.¹⁷²

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,¹⁷³ 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.¹⁷⁴ 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.¹⁷⁵ The Commission established the European Banking Authority (EBA) to have a coordination and support role in crisis situations amongst the primarily responsible national authorities.¹⁷⁶

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 2014.¹⁷⁷ 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."¹⁷⁸ Essentially, the Directive requires all E.U. Member States (not just the Eurozone countries) to put in place a minimum set of

172. Id. at 8–10.

173. Dirk Schoenmaker, *Duisenberg School of Finance Policy Paper No. 12, The European Banking Landscape After the Crisis 2 & fig.1* (2011), available at http://www.dsf.nl/home/research/publications/dsf_policy_papers (on file with the *Columbia Law Review*) (showing increase in cross-border banking leading up to crisis); see also Jakob de Haan, Sander Oosterloo & Dirk Schoenmaker, *Financial Markets and Institutions: A European Perspective* ch. 10.3, at 302–19 (2d ed. 2012) (same).

174. See Eur. Comm'n, *Bank Resolution Funds*, supra note 165, at 7 ("Establishing greater clarity and mutual understanding between authorities through more robust financing arrangements will also be key to aligning incentives between authorities to cooperate fully in the event of cross-border banking failure.").

175. See id. at 11 (proposing involvement of "colleges involving authorities in charge of resolution with a view to taking joint decision on the preparation for the resolution of a cross-border banking group").

176. See id. (noting EBA could oversee colleges); cf. Schoenmaker, supra note 173, at 17 ("The newly created European Banking Authority and the European Systemic Risk Board have thus their work cut out.").

177. BRRD, supra note 8.

178. See text accompanying notes 157–158 (describing main elements of FSB's Key Attributes).

common tools and powers for their national regulators that would enable them to avert and, where necessary, oversee the orderly failure of a bank.¹⁷⁹ 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.¹⁸⁰ An important feature of the proposal is the emphasis it puts on “bail-in” as a regulatory tool.¹⁸¹ Furthermore, at the end of 2012, the Commission further consulted on a similar framework for nonbank financial institutions.¹⁸²

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 2010–2013 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.¹⁸³ Thus, the catchphrase for banking regulation has become to “break the link between sovereigns and banks.”¹⁸⁴ At the most basic level, the objective is to ensure “a level playing field for the European banking industry and remove any national biases or supervisory forbearance, and prevent the hiding of bad assets—or even leniency—towards so-called ‘national champions.’”¹⁸⁵ But the

179. Eur. Scrutiny Comm., Draft Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directives 77/91/EC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No. 1093/2010, 2011–2012, H.C. 34012 (U.K.), <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmeuleg/86-vii/86vii09.htm> (on file with the *Columbia Law Review*) (presenting draft version of BRRD to U.K. Parliament).

180. *Id.*

181. BRRD, *supra* note 8, arts. 43–58.

182. See Eur. Comm’n, Consultation on a Possible Framework for the Recovery and Resolution of Nonbank Financial Institutions, http://ec.europa.eu/internal_market/consultations/2012/nonbanks_en.htm (on file with the *Columbia Law Review*) (last updated May 10, 2012) (noting consultation would take place from October to December 2012).

183. See Memorandum from the Eur. Comm’n, Memo/14/294, Banking Union: Restoring Financial Stability in the Eurozone 1–10 (Mar. 9, 2015), available at http://europa.eu/rapid/press-release_MEMO-14-294_en.pdf (on file with the *Columbia Law Review*) (outlining plans for Banking Union).

184. 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/> (on file with the *Columbia Law Review*).

185. Yves Mersch, Member, Exec. Bd. of the European Cent. Bank, Speech at the Barclays Research Conference: “Built to Last”: The New Euro Area Framework (May 17,

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.¹⁸⁶

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.¹⁸⁷ Regulators envisioned a European resolution authority, a 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.¹⁸⁸ As a first step, the European Commission presented its proposals for a Single Supervision Mechanism.¹⁸⁹ In March 2013, the European Parliament and the Council reached agreement on the SSM, envisaging a scheme that would charge the European Central Bank with responsibility for supervising significant banks.¹⁹⁰

2. *Implementing a Single Resolution Mechanism.* — In parallel, E.U. institutions began working on the second pillar of the Banking Union:

2013), available at http://www.ecb.int/press/key/date/2013/html/sp130517_1.en.html [hereinafter Mersch, Built to Last] (on file with the *Columbia Law Review*); see Yves Mersch, Member, Exec. Bd. of the European Cent. Bank, Speech at the Seminar Auf dem Weg zu mehr Stabilität—Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis [Towards More Stability: A Dialogue Between Science and Practice on the Development of the Banking Union]: The Banking Union—A European Perspective: Reasons, Benefits and Challenges of the Banking Union (Apr. 5, 2013) [hereinafter Mersch, Banking Union], <http://www.ecb.europa.eu/press/key/date/2013/html/sp130405.en.html> (on file with the *Columbia Law Review*) (outlining these benefits of Banking Union).

186. See *id.* (“Neither would a European supervisor insist on national asset and liability matching . . .”).

187. See Euro Area Summit Statement, *supra* note 152, at 1–2 (noting it is “imperative” to implement proposals “as a matter of urgency”).

188. See Anita Millar, Int’l Regulatory Strategy Grp., EU Banking Union—Operational Issues and Design Considerations 1 (2012), <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2012/EU-banking-unions-final3.pdf> (on file with the *Columbia Law Review*) (outlining regulatory proposals).

189. European Commission, SSM Proposal, *supra* note 23; European Commission, Proposal to Amend EBA Rules, *supra* note 23; see also Eur. Comm’n, Roadmap, *supra* note 153, at 4 (“This communication accompanies two legislative proposals, respectively for the setting up of a single supervisory mechanism by conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions and for adaptations to the Regulation setting up the European Banking Authority (EBA).”).

190. Barnier Press Release, *supra* note 23, at 1. The final instruments adopted to create the SSM are SSM Regulation, *supra* note 24, and Regulation Amending EBA Rules, *supra* note 24. See generally Eilis Ferran & Valia S.G. Babis, The European Single Supervisory Mechanism, 13 J. Corp. L. Stud. 255 (2013) (detailing SSM); Eddy Wymeersch, The Single Supervisory Mechanism or SSM, Part One of the Banking Union (Ghent Univ. Fin. Law Inst. Working Paper Series, Paper No. 2014-01, 2014), available at <http://ssrn.com/abstract=2403859> (on file with the *Columbia Law Review*) (same).

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.¹⁹¹

The Commission produced a proposal for a robust Single Resolution Authority in July 2013.¹⁹² This proposal did not survive the E.U. polycentric decisionmaking process, resulting instead in a resolution structure¹⁹³ that risks indecisiveness in a crisis and invites the protection of national champions. From the outset, Germany and other E.U. Member States preferred a “college” or “network” of national resolution authorities to operate as the E.U. decisionmaker instead of creating a new E.U. body. Indeed, some German government officials raised constitutional objections.¹⁹⁴ Other Member States contended that a new SRM required revision of the E.U. Treaties. German Finance Minister

191. Draghi, *supra* note 155, at 3–4 (emphasis omitted).

192. SRM Proposal, *supra* note 21.

193. SRM Regulation, *supra* note 9.

194. See Peel & Barker, *supra* note 27 (noting these objections). See also the analysis by think tank Centrum für Europäische Politik, *cepAnalyse*, No. 42/2013, *Bankenabwicklung für die SSM-Staaten (SRM) I* (2013), available at http://www.cep.eu/Analysen/COM_2013_520_Bankenabwicklung_SSM-Staaten/cepAnalyse_COM_2013_520_Bankenabwicklung.pdf (on file with the *Columbia Law Review*), which argues that Treaty on the Functioning of the European Union Article 352 would be a preferable legal basis (though that would require unanimity in Council). These constitutional concerns should have been mitigated by the January 2014 ECJ decision, *Case C-270/12, United Kingdom v. Parliament and Council* ¶¶ 115–119 (Jan. 22, 2014), 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> (on file with the *Columbia Law Review*) (sustaining ESMA’s rules against short-selling).

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.¹⁹⁵ In a similar vein, the French and German governments adopted a joint paper in May 2013 to propose a Single Resolution Board (SRB) that would be composed of national resolution authorities.¹⁹⁶ In fact, they were proposing the old-style European approach of establishing “colleges” of national bodies on the European level, such as CESR,¹⁹⁷ 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 the resolution process while the European Parliament played its federalist foil.¹⁹⁸ In April 2014, the counterparties finally reached a compromise that was enacted into law that summer.¹⁹⁹ The legislation introduces a new centralized E.U. body, the Single Resolution Board, which will direct the resolution process for

195. Wolfgang Schäuble, Banking Union Must Be Built on Firm Foundations, *Fin. Times* (May 12, 2013, 6:49 PM), <http://www.ft.com/intl/cms/s/0/8bdaf6e8-b89f-11e2-869f-00144feabdc0.html> (on file with the *Columbia Law Review*). This suggestion was however criticized by the European Commission and the ECB. For example, ECB Executive Board member Jörg Asmussen swiftly rejected Schäuble’s proposal 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, 5:21 PM), <http://uk.reuters.com/article/2013/05/13/uk-ecb-bankingunion-idUKBRE94COP320130513> (on file with the *Columbia Law Review*); see also Mersch, *Built to Last*, supra note 185 (advocating “banking union consisting of the SSM and the SRM”).

196. Press Release, *Présidence de la République, France and Germany—Together for a Stronger Europe of Stability and Growth 5* (May 29, 2013), available at <http://blogs.rftdata.co.uk/brusselsblog/files/2013/05/Together-for-a-stronger-Europe-of-Stability-and-Growth-1.pdf> (on file with the *Columbia Law Review*).

197. 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. ESMA In Short, ESMA, <http://www.esma.europa.eu/page/esma-short> (on file with the *Columbia Law Review*) (last visited May 1, 2015).

198. The European Parliament claimed victory in the sense that the final compromise “has repaired many of the serious flaws in the initial Council position.” Press Release, *European Parliament, Parliament Negotiators Rescue Seriously Damaged Bank Resolution System 1* (Mar. 20, 2014) [hereinafter *Press Release, Parliament Negotiators*], available at http://www.europarl.europa.eu/pdfs/news/expert/infopress/20140319IPR39310/20140319IPR39310_en.pdf (on file with the *Columbia Law Review*).

199. See SRM Regulation, supra note 9, pmbl. ¶ 24 (outlining scope of Council and Commission’s role in resolution process while leaving room for participation by national resolution authorities); see also Press Release, *Eur. Comm’n, European Parliament and Council Back Commission’s Proposal for a Single Resolution Mechanism: A Major Step Towards Completing the Banking Union 2* (Mar. 20, 2014), available at http://europa.eu/rapid/press-release_STATEMENT-14-77_en.htm (on file with the *Columbia Law Review*) (describing agreement, including parties’ respective roles). The looming European Parliament elections in May 2014 played a decisive role in bringing the negotiating parties to reach a deal.

financial institutions in the Eurozone and in other signatory E.U. countries.²⁰⁰ The SRB (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 will be resolved.²⁰¹ 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 SRB.²⁰² The Council may, in exceptional circumstances, oppose the decision.²⁰³ In practice, though, we expect that both the Commission and the Council would be extremely unlikely to deviate from the SRB's proposals, due to the latter's expertise in bank resolution and the urgent circumstances that drive a resolution decision. The SRB would then instruct a national resolution authority to execute the decision.²⁰⁴

The SRM is accompanied by a Single Bank Resolution Fund (the "Fund"), financed by annual contributions from the banks protected by it.²⁰⁵ 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 €55 billion.²⁰⁶ The Board would use the Fund to

200. These countries are those defined as "Participating Member States." SRM Regulation, *supra* note 9, art. 4, at 24–25. 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 *id.*, art. 43, at 65–66.

201. See Danny Busch, *Governance of the Single Resolution Mechanism* ¶¶ 9.08–9.48 (March 2015) (unpublished manuscript) (on file with the *Columbia Law Review*) (detailing operation of the SRM).

202. SRM Regulation, *supra* note 9, art. 18, § 7, at 42–43. 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, *Meroni & Co. v. High Authority*, which essentially put limits on the Commission's powers to delegate discretionary authority. Case 9/56, *Meroni & Co. v. High Authority*, 1958 E.C.R. 135, 146–54; Case 10/56, *Meroni & Co. v. High Authority*, 1958 E.C.R. 157, 173–75. The press release accompanying the proposal states: "For legal reasons, the final say could not be with the Board." Press Release, Eur. Comm'n, Commission Proposes Single Resolution Mechanism for the Banking Union 2 (July 10, 2013), available at http://europa.eu/rapid/press-release_IP-13-674_en.pdf (on file with the *Columbia Law Review*). In the ECJ's recent decision upholding a delegation to ESMA, Case C-270/12, *United Kingdom v. Parliament and Council* ¶¶ 115–119 (Jan. 22, 2014), 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> (on file with the *Columbia Law Review*), the legalism may provide a cover for a political accommodation. For more detail, see Ferran, *supra* note 32, at 19–22 (discussing effect of Case C-270-12 on legal basis for SRM and *Meroni* doctrine).

203. SRM Regulation, *supra* note 9, art. 18, §§ 7–8, at 42–43.

204. *Id.* art. 18, § 9, at 43.

205. See SRM Proposal, *supra* note 21, arts. 64–73, at 75–80 (describing constitution and activities of the Fund).

206. The target level of the Fund is currently "a percentage of the amount of covered deposits." SRM Regulation, *supra* note 9, pmbl. ¶ 105. However, the Commission will decide whether a percentage of total liabilities of financial institutions would be "a more

ensure the operability of the failing bank in the short run; the Commission emphasizes that it is not a bailout fund designed to take losses.²⁰⁷ The creation of the Fund proved to be one of the most controversial aspects of the SRM.²⁰⁸ 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.²⁰⁹ Twenty-six E.U. Member States (all but Sweden and the U.K.) signed this IGA on May 21, 2014.²¹⁰

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.²¹¹ 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.²¹² 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 €55 billion is way too small, even in the eyes of the ECB.²¹³ Consequently, the size of the Fund has

appropriate basis.” Id. On the estimation of €55 billion, see SRM Proposal, *supra* note 21, at 14–15.

207. SRM Proposal, *supra* note 21, at 13.

208. See, e.g., Benjamin Fox, Brussels on Collision Course with Germany on Banking Union, *EU Observer* (Jul. 10, 2013, 6:59 PM), <https://euobserver.com/economic/120822> (on file with the *Columbia Law Review*) (“Just as controversial is the concept of a single bank resolution fund . . .”).

209. See SRM Regulation, *supra* note 9, art. 1, at 21 (“The use of the Fund shall be contingent upon the entry into force of an agreement among the participating Member States . . .”).

210. Council Document No. 8457/14, Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund (May 14, 2014) [hereinafter IGA], available at <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%208457%202014%20INIT> (on file with the *Columbia Law Review*).

211. As explained above, in certain situations, the Commission’s decision is even subject to objection by the Council.

212. In a similar vein, see the assessment by Ferran, *supra* note 32, at 18–19 (discussing limits of SRM authority).

213. See John O’Donnell & Tom Körkemeier, Europe Strikes Deal to Complete Banking Union, *Reuters* (Mar. 20, 2014, 8:33 PM), <http://uk.reuters.com/article/2014/03/20/uk-eu-bankingunion-idUKBREA2J0IW20140320> (on file with the *Columbia Law Review*) (noting ECB’s view).

already been subject to sharp criticism.²¹⁴ To remedy this problem, the European Parliament insisted that the Fund be able to borrow on the capital market to augment its capacity.²¹⁵ Further, the Parliament pushed forward the target date for full funding to eight years instead of ten years after the SRM's coming into force by insisting on an earlier date for the mutualization of existing national resolution schemes.²¹⁶ 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 be able to tap the European Stability Mechanism (ESM) only in exceptional circumstances.²¹⁷ 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.²¹⁸ 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.²¹⁹ In particular, early common rules on deposit guarantees helped drive the development of the European market for financial services.²²⁰

214. Mark Wall, Deutsche Bank's chief Eurozone economist, and academic economist Paul De Grauwe have both considered the Fund insufficient. *Id.*

215. See SRM Regulation, *supra* note 9, art. 74, at 79 (“The Board shall contract for the Fund financial arrangements, including, where possible, public financial arrangements . . .”); see also Press Release, Parliament Negotiators, *supra* note 198, at 1 (“[A] system will be established, before the regulation enters into force, which will enable the bank-financed single resolution fund to borrow.”).

216. See Press Release, Parliament Negotiators, *supra* note 198, at 1.

217. See Statement of Eurogroup and ECOFIN Ministers on the SRM Backstop (Dec. 18, 2013) [hereinafter Statement of Eurogroup and ECOFIN Ministers on the SRM Backstop], available at <http://www.eurozone.europa.eu/media/502738/20131218-SRM-backstop-statement.pdf> (on file with the *Columbia Law Review*) (“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.”).

218. In a similar vein, see Wolfgang Münchau, Europe Should Say No to a Flawed Banking Union, *Fin. Times* (Mar. 16, 2014, 3:14 PM), <http://www.ft.com/intl/cms/s/0/0e6b4800-ab67-11e3-8cae-00144feab7de.html> (on file with the *Columbia Law Review*) (“Step back from this technical debate for a moment and recall why the eurozone needs a banking union . . . : 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.”).

219. See Asli Demirgüç-Kunt et al., Deposit Insurance Around the World: A Comprehensive Database 2 (World Bank Pol’y Res., Working Paper No. 3628, June 2005), available at <http://ssrn.com/abstract=756851> (on file with the *Columbia Law Review*)

The E.U. adopted its first Directive on Deposit Guarantee Schemes (DGS) in 1994, achieving minimum harmonization of deposit protection policies across Member States.²²¹ The DGS required at minimum a modest €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 €100,000 by December 31, 2010.²²² Later, the E.U. again revised the DGS alongside the adoption of the SRM,²²³ with the objective of harmonizing and simplifying protected deposits, achieving faster payouts, and improving the financing of national deposit schemes.²²⁴ The revised DGS Directive requires ex ante funding of all national systems.²²⁵ The targeted amount is 0.8% of covered deposits, to be collected from banks over a ten-year period through fees employing a risk-based component.²²⁶ A recent FSB survey shows that most E.U. Member States already comply with the requirements;²²⁷ however, the size of insurance funds is rather small, significantly below even the lowest target under discussion during the drafting process.²²⁸

Crucially, however, deposit insurance remains, even after the most recent reforms, a predominantly national affair. As we explain above,

(“Deposit insurance has become an increasingly used tool by governments in an effort to ensure the stability of banking systems and protect bank depositors . . .”); see also Asli Demirgüç-Kunt et al., *Determinants of Deposit-Insurance Adoption and Design*, 17 *J. Fin. Intermed.* 407, 408 (2008) (assessing rationales).

220. See generally Takis Tridimas, *EU Financial Regulation: Federalization, Crisis Management, and Law Reform*, in *The Evolution of EU Law 783* (Paul Craig & Gráinne de Búrca eds., 2d. ed. 2011) (explaining development of European market for financial services).

221. Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on Deposit-Guarantee Schemes, 1994 O.J. (L 135) 5.

222. 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 O.J. (L 68) 3, 3.

223. Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on Deposit Guarantee Schemes (recast), 2014 O.J. (L 173) 149 [hereinafter *Directive 2014/49/EU*].

224. See Commission Proposal for a Directive . . . / . . . /EU of the European Parliament and of the Council on Deposit Guarantee Schemes [recast], at 2, COM (2010) 368 final (July 12, 2010).

225. See Directive 2014/49/EU, *supra* note 223, art. 10, § 1, at 164 (requiring at minimum annual contributions).

226. *Id.* art. 10, § 2, at 164–65.

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

228. Fin. Stability Bd., *Thematic Review on Deposit Insurance Systems: Peer Review Report 54 tbl.7* (Feb. 8, 2012), available at http://www.financialstabilityboard.org/wp-content/uploads/r_120208.pdf?page_moved=1 (on file with the *Columbia Law Review*).

original proposals to erect a third Banking Union pillar to create a common deposit guarantee scheme were quietly dropped.²²⁹

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, it 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-inable” debt can address the funding problem as an effective form of bank self-insurance that is particularly important in the case of G-SIBs.

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 E.U. banking system as a whole rather than the

229. 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.

Memorandum from the Eur. Comm'n on Deposit Guarantee Schemes—Frequently Asked Questions 6 (Apr. 15, 2014), available at http://europa.eu/rapid/press-release_MEMO-14-296_en.pdf (on file with the *Columbia Law Review*).

interests of a particular Member State is a crucial element in the success of the SRM. 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.²³⁰ Even though the United States at the time had comparatively local banks,²³¹ lawmakers chose to federalize deposit insurance and create 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.²³² This simple lesson drawn from the U.S. regime reinforces the E.U.-specific arguments in favor of centralized resolution.²³³

This principle may help resolve the controversy around the development of the E.U. 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 SRB, on which the relevant national supervisors will be represented.²³⁴ 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, is capable of 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 SRB with the FDIC, an autonomous, self-governing body.²³⁵

Centralization is not inconsistent with 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

230. Lowenstein, *supra* note 68 (describing failures eventually leading to creation of FDIC).

231. See *supra* notes 68–71 and accompanying text (noting pre-New Deal “banking system was highly fragmented into relatively few large money center–banks with limited branching and thousands of small local banks”).

232. On the comparative level of cross-border penetration of banking, see Schoemaker, *supra* note 173, at 2 (noting increase in cross-border banking in Europe since 1997). See generally de Haan, Oosterloo & Schoemaker, *supra* note 173, at 303–16 (discussing structure of European banking market).

233. For example, breaking the sovereign/bank link or supplementing the SSM. See *supra* Part I (arguing factors specific to Europe call for centralized banking there).

234. See *supra* notes 196–197 and accompanying text (discussing Franco/German college preference).

235. See SRM Proposal, *supra* note 21, at 98–99 tbl.1 (providing calculations comparing Single Resolution Board and FDIC).

(and resolutions) are far more common for smaller banks, which do not present systemic risks.²³⁶ 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 for 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 an 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,²³⁷ 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 SRB 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

236. Over the 2007–2014 period, which included the heart of the financial crisis, approximately 520 banks or thrifts failed in the United States. FDIC Failures and Assistance Transactions, FDIC's Historical Statistics on Banking, <https://www2.fdic.gov/hsob/SelectRpt.asp?EntryTyp=30&Header=1> (last visited Mar. 13, 2015) (set "State" to "United States"; set "Effective Date(s)" to 2007 and 2014; click "Produce Report" button). 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.

237. This is the so-called "Minimum Requirement for Own Funds and Eligible Liabilities" (MREL). BRRD, *supra* note 8, art. 45, at 271–77; Eur. Banking Auth., Consultation Paper: Draft Regulatory Technical Standards on Criteria for Determining the Minimum Requirement for Own Funds and Eligible Liabilities Under Directive 2014/59/EU, at 6–14 (Nov. 28, 2014), available at <https://www.eba.europa.eu/-/eba-consults-on-criteria-for-determining-the-minimum-requirement-for-own-funds-and-eligible-liabilities-mrel-> (on file with the *Columbia Law Review*) (describing background and rationale of MREL).

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.²³⁸ 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.²³⁹ This is very important to assure the ongoing, nondisrupted operation of important financial activity that is organized in legally and contractually complex forms. Avoiding bankruptcy of 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.²⁴⁰ 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 bail-inable 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 United States, 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.²⁴¹

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. The set-up of the fund needs to negate the suggestion that taxpayer support will sustain the losses of a failing bank, and instead show that the fund is designed to 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.

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

239. For a more detailed discussion of this argument, see Jeffrey N. Gordon & Wolf-Georg Ringe, *Bank Resolution in Europe: The Unfinished Agenda of Structural Reform* (ECGI Working Paper Series in Law, Paper No. 282, Jan. 2015), <http://ssrn.com/abstract=2548251> (on file with the *Columbia Law Review*).

240. See *supra* Part III (describing how FDIC's resolution plan would help avoid subsidiary bankruptcy).

241. See *supra* text accompanying notes 90–92 (discussing how this procedure would unfold under U.S. SPOE approach).

The Single Bank Resolution Fund meets these criteria in principle, but it is, as explained, insufficient in its target size. In the United States, the Treasury provides a substantial credit line to the FDIC, which has repayment priority on the assets of the resolved institution.²⁴² 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 United States²⁴³ 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.²⁴⁴ In light of potentially massive liquidity needs in connection with the resolution of a large financial institution, this setup for the Fund will not provide a credible financial backstop.²⁴⁵ 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 from the ECB.²⁴⁶ As a monetary authority, not a fiscal authority, the ECB is not designed to bear losses (and should not be). However, though the bail-inable debt feature of our resolution proposal is meant to provide loss absorbency that could be extended to cover ECB advances, the Single Bank Resolution Fund can provide an additional backstop. Specifically, the necessary liquidity support should come through an ECB facility that is capitalized with the Single Bank Resolution Fund. This would put the Fund in a first-loss position, much as various Federal Reserve facilities in the fall of 2008 were capitalized with TARP funds.²⁴⁷ If the ECB nevertheless

242. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(n)(6), 124 Stat. 1376, 1507 (2010) (codified at 12 U.S.C. § 5390(n)(6) (2012)) (limiting maximum obligation for an institution to 10% of consolidated assets and 90% of fair market value of the assets post-resolution); *id.* § 204, 124 Stat. at 1454–56 (codified at 12 U.S.C. § 5384(d)) (describing repayment priorities). The FDIC guarantees of Bridgeco debt are not subject to explicit limit.

243. See *supra* text accompanying notes 41–46 (describing FDIC authority under OLA).

244. See SRM Regulation, *supra* note 9, art. 74, at 79 (giving Fund access to capital markets); Chris Mallon et al., EU Banking Union: Political Agreement Reached on Single Resolution Mechanism, Skadden, Arps, Slate, Meagher & Flom LLP 2–3 (Apr. 10, 2014), http://www.skadden.com/sites/default/files/publications/EU_Banking_Union_Political_Agreement_Reached_on_Single_Resolution_Mechanism.pdf (on file with the *Columbia Law Review*) (noting Fund's borrowing ability).

245. Cf. Int'l Monetary Fund, Cross-Border Bank Resolution: Recent Developments 10 (June 2, 2014), available at <http://www.imf.org/external/np/pp/eng/2014/060214.pdf> (on file with the *Columbia Law Review*) (“[SPOE] requires . . . the capacity and willingness to provide liquidity support in resolution . . .”).

246. See *infra* text accompanying notes 273–275 (suggesting improvements to liquidity aspect of framework).

247. See Bd. of Governors of the Fed. Reserve Sys., Quarterly Report on Federal Reserve Balance Sheet Developments 17–18 (Mar. 2013), available at http://www.federalreserve.gov/monetarypolicy/files/quarterly_balance_sheet_developments_report_201303.pdf (on file with the *Columbia Law Review*) (noting use of TARP funds in lending facilities).

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.²⁴⁸

* * *

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's 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.²⁴⁹ 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-inable debt is structurally, rather than contractually, subordinated to runnable debt at the operating subsidiary level. The SRB could thus resolve the 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, €100,000 is the current prescription;²⁵⁰ the (once envisaged) centralized E.U. Deposit Guarantee Scheme would probably have come out similarly. Capped deposit insurance would not

248. See *infra* Part VI.B.1 (discussing funding and liquidity aspect of proposal). 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 a 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.

249. Obviously, Member States would continue to provide deposit insurance on their level.

250. Directive 2014/49/EU, *supra* note 223, art. 6, § 1, at 160; see also *supra* notes 222–223 (discussing deposit guarantee schemes in Europe).

protect the large deposits of nonfinancial firms, wealthy individuals, or interbank loans; nor would it protect short-term credit issuances sold on the money market. Since such claims may well constitute the bulk of “runnable” bank liabilities for large financial institutions, a significant run risk would remain even with deposit insurance. By contrast, the self-insurance approach is not capped, assuming sufficient bail-inable debt has been required. Further, deposit insurance suffers from well-known weaknesses such as creating moral hazard in bank risk-taking and encouraging lax monitoring by depositors.²⁵¹ In comparison, 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 we discussed 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 IGA have been adopted successfully.²⁵² As things stand now, it is likely that the E.U. will fulfill (or can fulfill with only minor amendments) the first and second principles, centralization and broad discretion. The SRM Regulation provides the SRB as a centralized body,²⁵³ independent from the ECB, and relatively independent from the Member States’ resolution authorities.²⁵⁴ The Board will exercise responsibility to large banks only,

251. See Franklin Allen et al., *Deposit Insurance and Risk Taking*, 27 *Oxford Rev. Econ. Pol’y* 464, 468–71 (2011) (reviewing these weaknesses); Charles W. Calomiris, *Is Deposit Insurance Necessary? A Historical Perspective*, 50 *J. Econ. Hist.* 283, 293–95 (1990) (noting “problems of moral hazard and adverse selection” associated with deposit insurance).

252. See *supra* Part V.C.2 (discussing adoption of the SRM and the IGA).

253. Our compromise “capital call” solution, developed above, could be introduced by an amendment to the SRM Regulation, if deemed necessary.

254. SRM Regulation, *supra* note 9, arts. 42–48, at 65–67. In particular, note the independence enshrined in Article 47. *Id.* art. 47, at 67; see also Yves Mersch, Member, Exec. Bd. of the European Cent. Bank, *Speech at Finanzplatztag: The European Banking Union—First Steps on a Long March* (Feb. 27, 2013), http://www.ecb.europa.eu/press/key/date/2013/html/sp130227_1.en.html (on file with the *Columbia Law Review*) [hereinafter Mersch, *First Steps*] (noting SRM “should under no circumstances be placed with the ECB”).

but that would correspond to our focus on SIFIs.²⁵⁵ Though the Board may cooperate with and hand over some of its day-to-day work to national resolution authorities (analogous to the SSM), that would be satisfactory as long as the ultimate responsibility for and final decision of resolution lies with an E.U. body.²⁵⁶

Secondly, as to the resolution powers, the competences of the future SRM are modeled after the powers included in the BRRD.²⁵⁷ This directive has been praised for its strong support for bail-in powers.²⁵⁸ Moreover, it provides a robust and credible statutory mechanism to write down debt. The intrajurisdictional 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.²⁵⁹ As to bonds subject to a non-E.U. jurisdiction, the BRRD follows the preferred “hybrid” approach.²⁶⁰ 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.²⁶¹

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.²⁶² Whereas political economy considerations suggest that policy-

255. 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 9, arts. 2, 7, at 21, 26–27 (providing for scope of entities under authority of SRB).

256. According to the SRM Regulation, national authorities carry out the decisions by the SRB and may be specifically ordered to implement SRB decisions. See *id.* art. 18, § 9, at 43 (“The Board shall ensure that the necessary resolution action is taken to carry out the resolution scheme by the relevant national resolution authorities.”); *id.* art. 29, at 56–57 (placing national resolution authorities under direction of the Board). Even outside its scope, the SRB may ultimately take over responsibility from noncomplying national resolution authorities. See *id.* Art. 7, § 4(b), at 27.

257. SRM Regulation, *supra* note 9, arts. 23–29, at 50–57 (referring often to BRRD in outlining resolution scheme and various tools); see Mersch, *Banking Union*, *supra* note 185 (“The set-up of the SRM depends on the swift adoption of the Bank Recovery and Resolution Directive, containing a harmonised toolkit of resolution powers.”).

258. See Thomas Huertas & María J. Nieto, *A Game Changer: The EU Banking Recovery and Resolution Directive*, *VoxEu* (Sept. 19, 2013), <http://www.voxeu.org/article/banking-recovery-and-resolution-directive> (on file with the *Columbia Law Review*) (praising bail-in powers as shifting burdens from taxpayers to investors); see also Freshfields Bruckhaus Deringer, *Key Points from the EU Recovery and Resolution Directive 2* (Mar. 2013), http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/RRP/EU%20Directive%20key%20points.pdf (on file with the *Columbia Law Review*) (noting wide “scope of liabilities subject to the bail-in tool”).

259. See, on such legal problems for national bail-in tools, Chris Bates & Simon Gleeson, *Legal Aspects of Bank Bail-ins*, 5 *L. & Fin. Mkts. Rev.* 264, 269–70 (2011).

260. See *id.* at 270 (“[T]he most robust approach would be a hybrid approach.”).

261. BRRD, *supra* note 8, art. 44.

262. See Wim Fonteyne et al., *Crisis Management and Resolution for a European Banking System* 61 (Int’l Monetary Fund, Working Paper No. WP/10/70, Mar. 2010), <http://www.imf.org/external/pubs/ft/wp/2010/wp1070.pdf> (on file with the *Columbia*

makers struggle to justify new funding financed by the taxpayer, voters may respond more favorably to resolution funding that comes directly from the financial industry. As we have seen above,²⁶³ 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.²⁶⁴ The plan is to build up the Fund over several years to a target level of 1% of covered deposits in the banking system.²⁶⁵ On the basis of 2011 data, this would correspond to roughly €55 billion.²⁶⁶ 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.²⁶⁷ 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.²⁶⁸

We do not believe that the target size of €55 billion is sufficient for the SRM to efficiently resolve a large failed financial institution.²⁶⁹ 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 €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.²⁷⁰ Funds on that scale will

Law Review) (“[T]he cost-effective resolution of a failing bank is likely to require significant gross financing.”). 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? 17–27* (London Sch. of Econ. & Political Sci. Fin. Mkts. Grp., Special Paper No. 209, May 2012), <http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP209.pdf> (on file with the *Columbia Law Review*).

263. See *supra* Part V.B.2 (discussing emergence of BRRD).

264. See Mersch, *First Steps*, *supra* note 254 (proposing this method of funding for the Fund). Some aspects of the Fund are regulated in the SRM Regulation, *supra* note 9, arts. 67–79, at 76–81. The other aspects are detailed in the separate intergovernmental agreement. IGA, *supra* note 210.

265. SRM Regulation, *supra* note 9, art. 69, § 1, at 77.

266. SRM Proposal, *supra* note 21, at 14–15.

267. SRM Regulation, *supra* note 9, art. 71, at 78 (“Where the available financial means are not sufficient to cover the losses, costs or other expenses incurred by the use of the Fund in resolution actions, extraordinary *ex-post* contributions from the institutions authorised in the territories of participating Member States shall be raised, in order to cover the additional amounts.”); see also *id.* ¶ 78, at 15 (noting in some circumstances Fund may raise *ex post* contributions).

268. *Id.* arts. 73–74, at 79.

269. 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*, *EU Observer* (Sept. 24, 2013, 9:28 AM), <http://euobserver.com/economic/121545> (on file with the *Columbia Law Review*).

270. See Mats Persson & Raoul Ruparel, *The Eurozone Banking Union: A Game of Two Halves*, *OpenEurope* 11 (2012), <http://archive.openeurope.org.uk/Content/Documents/Pdfs/bankinguniontwohalves.pdf> (on file with the *Columbia Law Review*).

not be covered by a fund that is made up of annual contributions. A central bank is the only credible funder.²⁷¹ 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.²⁷² Unsurprisingly, Jack Lew, U.S. Secretary of the Treasury, openly has criticized the planned resolution fund as being insufficiently small.²⁷³

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 ECB, 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.²⁷⁴ To

(“We estimate, in a ‘business as usual’ scenario, a resolution fund to be at least €500bn to be convincing.”).

271. See *id.* (“[T]he 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.”).

272. The following has been described as a “major lesson[.]” learned from the U.S. experience:

[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.

Anthony Saunders, Regulatory Experience in the US and Its Lessons for European Banking Union 7 (Nov. 2013) (unpublished manuscript), available at <http://ssrn.com/abstract=2353545> (on file with the *Columbia Law Review*).

273. James Fontanella-Khan, European Parliament Challenges Plan for €55bn Bank Rescue Fund, *Fin. Times* (Jan. 16, 2014, 4:50 PM), <http://www.ft.com/intl/cms/s/0/7c1d0dda-7ec0-11e3-8642-00144feabdc0.html> (on file with the *Columbia Law Review*), quotes Mr. Lew as saying: “We don’t think it’s big enough. We don’t think it’s fast enough.”

274. 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.

SRM Proposal, *supra* note 21, at 13. Contrast, for example, the position of the European Banking Federation (EBF):

[T]he 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

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 argued previously, the strong level of bail-inable 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. In the unlikely event of losses, the ECB would recoup funds from the financial industry, similar to the SRM approach for the replenishment of the Resolution Fund.²⁷⁵

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.²⁷⁶ 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.²⁷⁷ Under the final framework, the ESM will now only serve as a transitional backstop until the Fund has reached its full target size.²⁷⁸ Apart from the ECB's much greater clout, the use of ECB liquidity rather than the ESM would have the additional advantage that the use of ESM funds is subject to decisionmaking by the Eurozone Finance Ministers, and the support

€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.

Eur. Banking Fed'n, EBF Positioning on the Principles Underlying the Single Resolution Mechanism 2 (Sept. 17, 2013), available at <http://www.ebf-fbe.eu/uploads/EBF%20Position%20on%20Single%20Resolution%20Mechanism%20v7%20final.pdf> (on file with the *Columbia Law Review*).

275. See SRM Regulation, *supra* note 9, art. 71, at 78 (describing ability of board to assess ex post levies on banks to recoup losses).

276. See Constâncio, *supra* note 39 (“[T]he creation of a common backstop is already underway with the on-going discussions on direct bank recapitalisation by the European Stability Mechanism (ESM).”). Constâncio further stated: “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 Asmussen, *supra* note 22, at 3 (“The first backstop for any capital needs will of course be the market, and for the time being national budgets and the existing ESM facilities will form the second and third line of defence.”).

277. See Euro Area Summit Statement, *supra* note 152, at 1 (“When an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly.”).

278. See Statement of Eurogroup and ECOFIN Ministers on the SRM Backstop, *supra* note 217 (“In the transition period, bridge financing will be available . . . from the ESM in line with agreed procedures.”).

of (most members of) this group is necessary to provide funds in any given case.²⁷⁹ 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 not, however, 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-inable 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.²⁸⁰

The first of these two elements, the level of bail-inable 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

279. See The Treaty Establishing the European Stability Mechanism, Mar. 25, 2011, T/ESM 2012-LT/en [hereinafter ESM Treaty], available at <http://www.esm.europa.eu/pdf/ESM%20Treaty%20consolidated%2003-02-2015.pdf> (on file with the *Columbia Law Review*).

280. See *supra* Part VI.B.1 (proposing new funding model that would minimize systemic distress costs).

plus subordinated term debt) scaled to at least twice the amount of required equity capital on both risk-weighted and leverage measures.²⁸¹ 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.²⁸² 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 reduce 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 BRRD. The BRRD already includes a provision that requires banks to “meet, at all times, a minimum requirement for own funds and eligible liabilities” (MREL).²⁸³ The EBA is to draft technical standards for the calculation of these required liabilities, but ultimately the Member States will fix the required figures.²⁸⁴ Presumably the ECB will monitor compliance with the E.U. standard as part of its supervisory duties to assure that each SIFI maintains a sufficient amount of unsecured term debt subject to bail-in powers.²⁸⁵

The structural reform of E.U. G-SIBs is not now on the agenda but needs to be. Systemically important European banks, typically organized

281. FSB, Adequacy of Loss-Absorbing Capacity, *supra* note 108, at 6–8.

282. *Id.* at 13. The threshold limits were based on calculation of losses during the recent financial crisis in an earlier consultation document. See FSB Steering Committee Memo, *supra* note 112, app. at 26–31.

Some might question why TLAC should consist of term debt, structurally or contractually subordinated, rather than equity, since equity is unambiguously loss-absorbing whereas debt is loss-absorbing only through operation of law. There are at least three reasons. First, term debt will be cheaper than equity, both because of clientele effects as well as the tax preference for debt. Some financial intermediaries that can hold a bank's term debt may be unable or unwilling to hold equity either because of practical portfolio needs (matching payout obligations with term liabilities) or legal reasons (constraints on holding equity vs. debt). The tax preference for debt is a separate (private) cost-reducer. Second, debt and equity will trade differently in ways that will provide regulators and other observers with useful signals. Changes in market prices unrelated to interest-rates and credit default swap spreads will reflect useful assessments by market participants of the bank's solvency. Third, bail-in of term debt will effect an ownership change; existing shareholders are replaced by post-conversion shareholders; presumably new directors are installed. This is a more dramatic “resolution” than just the dismissal and replacement of senior managers following a regulator's determination that the equity has fallen below a target level and may give current equity holders stronger incentives to monitor against excessive risk-taking.

283. BRRD, *supra* note 8, art. 45, § 1, at 271.

284. BRRD, *supra* note 8, art. 45, § 6, at 272–73.

285. See a similar comment by British Bankers' Ass'n (BBA), BBA Briefing: European Commission's Draft Recovery and Resolution Directive 4 (Aug. 2012), https://www.bba.org.uk/wp-content/uploads/2014/01/BBA01-401138-v1-BBA_Briefing_-_Recovery_Resolution_Directive-2.pdf (on file with the *Columbia Law Review*) (“[W]e suggest the resolution authority should be under a duty to ensure that each institution maintains a sufficient amount of bail-inable liabilities.”).

as “universal banks,”²⁸⁶ have a complex organizational structure in which various financial services are provided by divisions of the bank or through subsidiaries of the bank.²⁸⁷ Furthermore, as recent research suggests, the divergence and the complexity of most E.U. banks’ structure is such that it is virtually impossible to even depict their organizational structure.²⁸⁸ Putting an operating bank or some other operating financial entity through a resolution procedure will have unpredictable effects on the solvency of its subsidiaries and other affiliates and will have unpredictable effects on the claims of various credit suppliers, counterparties, and customers of the bank or affiliated financial firm.²⁸⁹ 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 (or entities) that are put in resolution? Since the bail-in debt is issued by an operating subsidiary, its loss-absorbing quality relative to

286. On the European universal banking model, see Jordi Canals, *Universal Banking: International Comparisons and Theoretical Perspectives* 6–11 (1997). The typical U.S. “holding company” group model is not popular on the European side of the Atlantic. Liikanen Report, *supra* note 12, at 137; see also Inst. of Int’l Fin., *Making Resolution Robust—Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions* 52 (2012), available at <https://www.iif.com/file/5160/download?token=tKH8xs-E> (on file with the *Columbia Law Review*) (noting holding company model “is not uncommon in the United States”); Bob Penn, *Single Point of Entry Resolution: A Milestone for Regulators: A Millstone for Banks?*, Allen & Overy, <http://www.allenoverly.com/publications/en-gb/lrrfs/uk/Pages/Single-point-of-entry-resolution.aspx> (on file with the *Columbia Law Review*) (last visited Mar. 12, 2015) (“Outside of the U.S., many banking groups do not have bank holding companies . . .”).

287. See James R. Barth et al., *Banking Structure, Regulation, and Supervision in 1993 and 2013: Comparisons Across Countries and Over Time*, 13 *J. Int’l Bus. & L.* 231, 251–54 tbl.4 (2014) (illustrating differences in bank structure across jurisdictions); James R. Barth et al., *Commercial Banking Structure, Regulation, and Performance: An International Comparison* tbls.5, 6a, 6b (Office of the Comptroller of the Currency, OCC Working Paper No. 97-6, 1997), www.occ.gov/publications/publications-by-type/economics-working-papers/1999-1993/working-paper-1997-6.html (click “Tables”) (on file with the *Columbia Law Review*) (reviewing bank regulations across various jurisdictions); World Bank, *Bank Regulation and Supervision* (2011), <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20345037~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html> (on file with the *Columbia Law Review*) (last updated 2012) (providing database to survey banks and regulatory agencies across many different countries); see also Richard J. Herring & Anthony M. Santomero, *The Corporate Structure of Financial Conglomerates*, 4 *J. Fin. Services Res.* 471, 481–89 (1990) (comparing various models of corporate structure); Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety and Soundness*, in *The Oxford Handbook of Banking* 195, 217–21 (Allen N. Berger et al. eds., 1st ed. 2010) (describing implications of banks’ complex corporate structures for stability).

288. See Liikanen Report, *supra* note 12, at 52 (discussing complexity of European banking institutions).

289. Cf. text accompanying notes 84–106 (discussing difficulty of Lehman bankruptcy because of complexity of structure).

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 (SPOE) system like the FDIC has fashioned for the United States. This approach, which pivots off a holding company structure, has a number of distinct advantages.²⁹⁰ First, SPOE resolution is more transparent and credible, as the bail-inable 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.²⁹¹ 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. An SPOE resolution offers the promise of minimizing overall creditor losses, which in turn will reduce the level of 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

290. In most recent policy initiatives, SPOE is given preference over the competing "Multiple Points of Entry." See, e.g., FINMA, *supra* note 4, at 8 (noting multiple-point-of-entry bail-in "would not be viable due to the lack of decentralised funding and the fact that the foreign subsidiaries do not have sufficient and appropriate liabilities outside the confines of the group to be used in the bail-in"); Gruenberg, Remarks to the Volcker Alliance Program, *supra* note 5, at 5 (arguing SPOE is a "viable strategy"); FDIC & Bank of England, *supra* note 6, at 1 ¶ 3 (noting multiple-points-of-entry strategy will occasionally be more feasible); European Parliament, Directorate Gen. for Internal Policies, Banking Union: The Single Resolution Mechanism 56 (Feb. 2013), <http://www.europarl.europa.eu/document/activities/cont/201304/20130422ATT64861/20130422ATT64861EN.pdf> (on file with the *Columbia Law Review*) (concluding SPOE is a much stronger strategy). For a helpful overview on "regulatory inputs so far," see Scope Ratings, Holding Companies: The Right Vehicle for European Banks' SPE Resolution? 4–5 (2014), available at <http://www.scooperatings.com/study/download?id=c2da6224-fa08-491c-aed2-93fa2de5eebe&q=1> (on file with the *Columbia Law Review*).

291. See European Parliament, Directorate Gen. for Internal Policies, *supra* note 290, at 13 (noting that more recently, "an increasing number of EU Member States . . . [have] force[d] subordinated creditors of failing banks to incur losses").

Structural Measures Regulation,²⁹² a reworking of structural reform proposals initially made in the Liikanen Report in 2012.²⁹³ 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.²⁹⁴ 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.²⁹⁵

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.²⁹⁶ On the other hand, if

292. Eur. Comm’n, 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) [hereinafter Eur. Comm’n, Structural Measures Proposal].

293. Liikanen Report, supra note 12, at 99–107 (outlining proposal for structural reforms). The Liikanen Report itself followed the U.K. ring-fencing proposal made in the Independent Commission on Banking Final Report (September 2011), commonly called the “Vickers Report,” after its chair. Indep. Comm’n on Banking, Final Report (2011), available at <http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmtsanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf> (on file with the *Columbia Law Review*).

294. See supra notes 136, 170 and accompanying text (explaining how living-wills requirements obligate banks to plan for failure).

295. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms Amending Directive 2002/87/EC and Repealing Directives 2006/48/EC and 2006/49/EC, 2013 O.J. (L 176) 338 (CRD IV); Regulation (EU) No 575/2013 of the European Parliament and the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation (EU) No 648/2012, 2013 O.J. (L 176) 1 (CRR).

296. In other words, SIFIs will not be interested in “opting in” into an 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 increase 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.

mandatory legislation is not possible, incentives may work. Switzerland could serve as an example in this context. 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.²⁹⁷ Once the new structure is in place, Credit Suisse plans to issue ample bail-inable debt from its group holding company, in order to facilitate the SPOE approach.²⁹⁸ Following new regulation in the U.K., British banks are also beginning to issue debt at the holding company level.²⁹⁹

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).³⁰⁰ 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 the SPOE strategy 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

297. James Shotter, *Credit Suisse to Overhaul Structure*, *Fin. Times* (Nov. 21, 2013, 10:16 AM), <http://www.ft.com/intl/cms/s/0/45d5a706-527d-11e3-8586-00144feabdc0.html> [hereinafter Shotter, *Credit Suisse*] (on file with the *Columbia Law Review*); James Shotter, *Swiss Bank Creditors Face Bail-in Risk*, *Fin. Times* (Aug. 8, 2013, 1:37 A.M.), <http://www.ft.com/intl/cms/s/0/48ab28a0-ff6e-11e2-919a-00144feab7de.html> (on file with the *Columbia Law Review*). According to rating agency Fitch, it is likely that other European banks are under pressure to follow the example. Shotter, *Credit Suisse*, *supra*; see also James Shotter, *UBS Plans Dividend as Part of Overhaul to Ease a Crisis Break-up*, *Fin. Times* (May 6, 2014, 2:29 PM), <http://www.ft.com/intl/cms/s/0/7c5ffa50-d4d8-11e3-8f77-00144feabdc0.html> (on file with the *Columbia Law Review*) ("UBS is to overhaul its legal structure to make it easier to break up the bank in a crisis, in a move designed to lower its capital requirements and enable it to pay a special dividend.").

298. Shotter, *Credit Suisse*, *supra* note 297.

299. Sam Fleming, *Banks Address "Too Big to Fail" Question with Debt Shift*, *Fin. Times* (Dec. 26, 2013, 12:20 PM), <http://www.ft.com/cms/s/0/df877896-6c7e-11e3-ad36-00144feabdc0.html> (on file with the *Columbia Law Review*).

300. On the CRD IV implementation, see Memorandum from Eur. Comm'n on Capital Requirements—CRD IV/CRR—Frequently Asked Questions (July 16, 2013), http://europa.eu/rapid/press-release_MEMO-13-690_en.pdf (on file with the *Columbia Law Review*).

their structure of operation would entail significant costs.³⁰¹ 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 resolutions 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 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.³⁰²

(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.³⁰³ The SPOE 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 to the multiple-point-of-entry approach. The Swiss banking watchdog FINMA has recently expressed its preference for an SPOE system, as have the German BaFin, and the Bank of England and the FDIC in a joint statement.³⁰⁴ The alternative MPOE approach would require cooperation and joint action

301. See Penn, *supra* note 286 (“There is also a transitional cost in terms of the higher risk premium for new holding company debt.”).

302. See *supra* note 103 and accompanying text (describing this simulation).

303. Barnier, The EU and US, *supra* note 1.

304. See *supra* note 290 (citing approval of SPOE approach by various authorities).

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.³⁰⁵ 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 United States through intermediate holding companies.³⁰⁶ We find 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 toward the domestic operation of foreign banks would disappear. For example, the requirement to establish an IHC could then be abandoned.³⁰⁷

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.³⁰⁸

Our central argument is that the E.U. 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.

305. William C. Dudley, President & Chief Exec. Officer, Fed. Reserve Bank of N.Y., Remarks at the Tenth Asia-Pacific High Level Meeting on Banking Supervision: Global Financial Stability—the Road Ahead (Feb. 26, 2014), <http://www.newyorkfed.org/newsevents/speeches/2014/dudl40226.html> (on file with the *Columbia Law Review*).

306. 12 C.F.R. § 252.153 (2012); see also Fed. Reserve Sys., Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 13,498 (Mar. 11, 2014); Tarullo, Regulating Large Foreign Banking Organizations, *supra* note 7 (explaining IHCs “must meet the risk-based and leverage capital standards generally applicable to bank holding companies under U.S. law”).

307. 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. ring-fencing requirements, provided that a sufficiently robust group-level resolution strategy between the foreign country and the E.U. exists. See Eur. Comm’n, Structural Measures Proposal, *supra* note 292, art. 4, § 2, at 23.

308. Geoffrey Miller, Presentation at the 2012 Transatlantic Corporate Governance Dialogue: America’s Dual Banking System: Lessons for Europe? (Dec. 17, 2012), available at <http://www.ecgi.org/tcgd/2012/presentations.php> (on file with the *Columbia Law Review*); Saunders, *supra* note 272, at 15 (“[T]he US is a useful laboratory to examine the benefits and costs of different approaches to the three ‘legs’ of European bank union, i.e., supervision, deposit insurance and restructuring/resolution.”).

European SIFIs should instead “self-insure”; that is, they should hold sufficient bail-inable 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; second, that the organizational structure of the financial institution will permit such a debt conversion without putting core financial constituents through bankruptcy; and third, 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 TLAC proposals. Together, these measures would facilitate an 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.”³⁰⁹

309. FDIC & Bank of Eng., *supra* note 6, at ii.

