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THESIS

“Addressing the Current Banking Crisis via Resolution Mechanisms: The American and European Paradigm”

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INTRODUCTION

The last five years the turmoil of the global financial markets has always been a op priority issue ion the political agenda. Even though, the characteristics in which the latter burst out in Europe and overseas are not exactly identical, however, a minimum common set of traits can be pointed out. The financial sector by nature is a very volatile and fragile one and the cycles of economic growth almost necessarily are followed by the ones of retreat. It is especially the high level of interdependence between the financial markets across the globe, and within each one of them among its "champion players", that turn a localized problem to a general one, with grave consequences to the whole sector.

The above, in conjunction with the importance of financial markets and especially the banking's, in real economy and its growth potential, renders the sanity of the banking industry one of the top priorities of the legislator, in an international, regional and national level. In the aftermath of the financial breakdown, the G-20 leaders came to an agreement about the appropriate strategic measures that should be taken in the world's largest economies, in order to hedge the impact of the current crisis and prevent a forthcoming one, as well.

In both side of the Atlantic, this strategy played a primordial role in the financial reform process. Despite, though, the common "input", the "output" was not identical. This discrepancy is due to structural, historical and economic reasons that characterize the two sides of the Atlantic. This observation was the spring board of the paper at issue, which develops as follow: In the first chapter the special key features of the banking sector that renders it so vulnerable to contagion and collapse are described (IIa). Then, it is the necessity of special resolution regimes, instead of ordinary insolvency procedures, as a response to the previously mentioned fragility of the banking sector, that is being outlined (IIb). In the third part (III), a chronicle of the US financial distress is reported, as well as the regulatory response to it, under the name "Dodd-Frank Act", being pointed out the contribution of the latter to the threat of the banking institutions' interconnectedness. After that, the European initiative to deal with the relevant banking distress, under the means of a Directive of the European Council and the Parliament is analyzed, which when compared to the American one introduces a real "novum" in the existing legal framework (under IV). Finally, the differences between the two reforms are explained, on the basis of the political and economic structure divergence that characterizes the two sides of the Atlantic and some core suggestions for the European case are educed.

II a. BANKING'S MARKET KEY FEATURES

1. TOO BIG (TO BE LEFT) TO FAIL INSTITUTIONS

The "too big to fail" concern was highlighted more fiercely than ever before with the emergence of the current global fiscal crisis. It was in fact the absence of a robust and *ex ante* endorsed rulebook about dealing with failed or failing such credit institutions that aggravated, if not triggered, the aforementioned crisis.

The main elements that synthesize the core of the "too big to fail" problem and perplex the policy-making in the banking sector are three. First, because of these institutions' magnitude in the financial sector and also their importance for the real economy, regulatory authorities do not easily opt for a “too big to fail” credit institution's regular bankruptcy procedure. Thus, these institutions tend to enjoy an “immunity” from being failed, and due to this fact they exacerbate systemic risk by not having any serious incentive for prudent risk management[1]. As a result of their aforementioned importance they create a massive contingent liability for governments, which can in certain cases jeopardize the supporting country's public finance[2].

Second, “too big to fail” institutions, as of their nature, have the potential to distort competition. They enjoy state-originated benefits due to their market position. Namely, according to Moody's, the 50 largest banks in 2009 benefited from an average three-notch advantage in their credit ratings, which has been understood to be at least partly related to official support. US banks with assets of more than $100 billion can fund themselves for more than 70 basis points cheaper than smaller banks[3].

Third, from an institutional point of view, the operation of “too big to fail” institutions can provoke sentiments of distrust and reduced accountability towards the whole economic system, as citizens that are concurrently economic agents too, perceive that “too big to fail” institutions are privately-owned in life, but socially financed in death.

2. INTERCONNECTEDNESS AND CONTAGION

The importance of financial interconnectedness for financial stability has been

[1] Institute for International Finance (IIF), Systemic Risk and Systemically Important Firms: An Integrated Approach, Washington: Institute for International Finance, May 2010.

[2] *Gary Stern, Ron Feldman*, “Too Big To Fail: The Hazards of Bank Bailouts”, Washington: Brookings Institution, 2004)

[3] BIS (Bank for International Settlements), 80th Annual Report, Basel: Bank for International Settlements, June 2010).

illustrated rather dramatically during the recent global financial crisis. Indeed, there is a growing consensus that the size of an institution alone is not the only (or even the main) consideration in assessing spillover risk[4]

Identification of systemically important institutions also requires an assessment of the nature and extent of their interconnectedness. Interconnectedness arises from actual—and perceived—*complex webs of contract relationships across financial institutions.*

Financial interconnectedness could have opposing effects on financial stability. On the one hand, linkages may act as channels to propagate shocks to the whole system, that is, they act as "shock transmitters." On the other hand, through these linkages, shocks can be shared and absorbed by others, that is, financial linkages may act as "shock absorbers."

Policymakers are, of course, most concerned with the downside of interconnectedness. Systemic (or spillover) risk arises when the failure or weakness of one or multiple financial institutions or infrastructures disrupts financial services and imposes costs on the economy as a whole. The failure or weakness of multiple financial institutions may arise through a variety of mechanisms[5]. Direct bilateral exposures across institutions are the most direct transmission mechanisms of shocks within a financial network. However, indirect linkages may arise from exposure to common risk factors such as the adoption of similar business models, common

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[4] See supra, note 3.
[5]For an overview of how interconnectedness threats unfold see *Cetorelli and Goldberg*, "Banking globalization, monetary transmission, and the lending channel", NBER Working Paper, no 14101, June 2008, *De Haas and Van Lelyveld* : "Internal capital markets and lending by multinational bank subsidiaries", Journal of Financial Intermediation, no 19, pp 1–25 (2010) *, Hal S. Scott and Anna Gelpern*, International Finance: Transactions, Policy and Regulation pp. 61673-174, 16th ed., Foundation Press,(2009).

accounting practices across financial institutions, the market perception of financial institutions' coincidence of fortunes, and other factors like fire sales and informational contagion that might be as important as direct exposures.

Commonly, interconnectedness is further classified into two categories: asset interconnectedness and liability interconnectedness, the first being the concern that the failure of one financial institution will directly cause the collapse of other financial institutions that have direct credit exposures to the first failed institution. Liability interconnectedness on the other hand, is the idea that one institution that is a source of short-term funding to other institutions will stop funding those institutions, thus causing the failure of the other institutions[6].

In conjunction with the above, contagion involves run behavior whereby funding is withdrawn from banks and other financial institutions as a result of a fear of widespread impending failure. The special feature that distinguishes contagion (in any format, market segment, or economic arena) from other major causes of systemic instability in the financial system is the possibility for contagious runs to propagate among institutions and in markets indiscriminately. Contagion is indiscriminate when it afflicts healthy, solvent institutions and markets rather than only dysfunctional or insolvent ones. Financial institutions are vulnerable to contagion because they depend on short-term borrowing to fund their longer- term investment activity, e.g., loans in the case of banks and finance companies. If investors in short-term debt instruments suddenly become unwilling to extend funding continuously to the financial system, these institutions might fail.

[6] *Hal Scott, Anna Gelpern*, supra note 5

There are four main linkages through which contagion between financial institutions typically spreads. First, there are interbank deposits, whether from loans or from correspondent accounts used to process payments. However, limitation of interbank deposits may be feasible with respect to placements by one bank with another because the amount of credit extended is usually fixed for a given term. Indeed, it appears that the chain reaction risk arising from bilateral credit exposures is quite low: Losses would not exceed one percent of total commercial banking assets as long as loss rates are kept to historically observed levels[7]. Second, a chain reaction of bank failures can occur through net settlement payment systems[8]. If one bank fails to settle its position in a net settlement system for large value payments, other banks that do not get paid may, in turn, fail[9].

Third, because of the lack of information in the market about the actual causes that triggered the financial or/and liquidity collapse imitative runs can cause consecutive bank collapses. When one bank fails, depositors in other banks, particularly those whose deposits are uninsured, may assume that their banks may also fail and so withdraw their funds, exposing these banks to a liquidity crisis and ultimately to failure[10].

Lastly, and especially prominent in the current crisis, a chain reaction of bank failures can occur as a result of counterparty risk on derivative transactions, such as credit

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[7] *Cr. Furfine*, Interbank Exposures: Quantifying the Risk of Contagion, Journal of Money, Credit and Banking, Blackwell Publishing,, vol. 35, p.111-128 (2003).
[8] For a definition see *Ch. Gortsos*, Introduction to International Financial Law (translation from the Greek title), Nomiki Vivliothiki, 2011, p. 32
[9] *Hal S. Scott*, supra note 5, at 174
[10] *Hal Scott*, id at 174

default swaps (CDSs)[11]. Here the concern is that if institution A fails to settle its derivative position with institution B, both A and B will fail. If B in turn cannot settle its positions, other institutions will also fail. This risk proved potentially significant in the failure of the hedge fund Long Term Capital Management in 1998[12] Concerns of this type also underlay JPMorgan Chase's assisted acquisition of Bear Stearns and the injection of federal funds into AIG[13].

What makes contagion in the banking sector special is that runs on credit institutions can happen indiscriminately. Contagion is indiscriminate when it afflicts healthy institutions, rather than dysfunctional and/or insolvent ones. Financial institutions are vulnerable to contagion because they depend on short-term borrowing to fund their longer-term investment activity, e.g., loans in the case of banks and finance companies. If investors in short-term debt instruments suddenly become unwilling to extend funding continuously to the financial system, these institutions might fail[14].

3. MORAL HAZARD

Moral hazard arises when an actor does not bear all of the consequences of his actions. It is particularly acute when he can profit by taking risks that he does not fully bear. In contemporary financial economies the separation of asset's management from the asset's ownership is the cornerstone of financial transactions, enabling, on the one hand, the direction of business affairs by

[11] See *Ch. Gortsos,* supra note 8, p. 11. Also see *Hal S. Scott*, "Do We Really Need a Systemic Regulator?", Editorial of Wall Street Jou,rnal, Dec.10, 2009, at A21).
[12] The President's Working Group on Financial Markets and Hedge Funds, "Hedge Funds, Leverage and the Lessons of Long - Term Capital Management", vol. 19 (1999).
[13] *R. Sidel , D. Bermann & K. Pelly*, "J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis", Wall street Journal , 17th March 2008, at A1; See also *Scott* supra note 8
[14] See T*ed Temzelides,* "Are Bank Runs Contagious?" Federal Reserve Bank of Philadelphia Business Review, Nov.-Dec 1997, pp. 3-14, available at http://www.philadelphiafed.org/research-and-data/publications/business-review/1997/november-december/brnd97tt.pdf

well-suited for this purpose executives, setting the premises of the so-called moral hazard enactment, on the other hand.

Besides credit institutions themselves, asset managers who profit from the gains earned using other face a moral hazard. Since they do not bear the full cost of a loss of capital and since higher returns are correlated with higher risk, an asset manager has the incentive to take additional risk in order to earn additional returns[15]. This is a form of agency cost inherent in the asset manager relationship. The asset manager relationship is the primary building block of modern financial markets. Both the firms themselves, such as LTCM, Bear, Lehman, AIG, and WaMu, and the individuals who make up these firms are situated within an asset manager relationship. They all face moral hazard.

There are two types of moral hazard, or better financial system's moral hazard can be expressed in two forms of business comportment. Apart from the above-mentioned excessive risk-taking, there is the underestimation of the risk taken in strategic investment decisions. The subprime crisis in the US that in a meanwhile caused the financial collapse of numerous institutions is a characteristic example of how underestimated though highly yielding collateral, such as mortgage loans, can cause a financial turmoil. More precisely, it was the rating agencies and not the directory personnel of the investment institutions that understated the risk of such securities. And so long as markets were willing to purchase securities based on agency ratings, investment firms were motivated to push as many deals as possible through the pipeline. Again, on balance, it was in the investment firm's interest to understate the

[15] See *J. Dow*, “What Is Systemic Risk? Moral Hazard, Initial Shocks, and Propagation”, Monetary and Economic Studies, December 2000, at 16–17

riskiness of the underlying assets. The less perceived risk, the easier it was to obtain the required rating.

II b. THE NEED OF A RESOLUTION SCHEME

All the abovementioned features suggest that the banking sector is a very fragile and unstable industrial sector whose failure's repercussions have a very costly reflex on national budgets. This is the very reason that explains why it is the legislator's or better the regulator's preoccupation to set up strategies that would address failure in an effective and fair manner, minimizing the economic risks for those who do are not directly involved with the ailing institution's business, namely the tax payers.

The primary goal of resolution procedures has historically been to provide a restructuring of financial institutions in a way that ensures continuation of essential business lines, with minimum disruption and the preservation of franchise value and low cost to the public. But from the perspective of systemic risk regulation, the protection of short-term creditors (whether or not insured) should also be a key objective of these procedures to minimize the incentives for contagious runs[16].

Resolution strategies in Europe and the US include among others: (1) issuing contingent capital to enhance loss absorption; (2) introducing a special commissioner at the failing institution in order to set up promptly a recovery strategy (2) employing creditor bail-ins in insolvency proceedings to force loss onto debt holders without requiring a disruptive judicial or prolonged administrative proceeding; (3) ring-fencing impaired assets through good-bank/bad-bank structures; (4) instituting a

[16] *H. Scott* "The Reduction of Systemic Risk in the U.S. Financial System", Harvard Journal of Law & Public Policy, vol. 33, p. 672 (2010)

publicly financed “bridge bank”; and (5) use of the Orderly Liquidation Authority to resolve systemically important non-bank financial institutions, under the of context Dodd-Frank Act, in the US.

<u>1. The debate: special regimes of resolution or improved insolvency procedures?</u>

The debate related to the optimal trail of mitigating financial losses in the case of a credit institution's failure has to do, on the one hand, with the widespread fear that ‘ordinary’ insolvency law regimes would not provide sufficient shock absorption for financial institution creditors, despite the special carve-outs that they enjoy from many traditional insolvency regimes. In the eyes of many commentators, these fears were given credence by the Lehman bankruptcy, which very nearly brought about a financial meltdown.

On the other hand, the very reason the US authorities permitted Lehman to fail was the unpleasantness of the other alternative, namely the ad hoc provision of public funds to ‘bail out’ troubled financial institutions. Yet in the winter of 2008-9 governments saw themselves as having little alternative but to make such bailouts on a gigantic scale. Whilst most citizens do not understand the complexities of the financial system, every voter can grasp the moral hazard problems and distributional inequity associated with government handouts for the financial sector.

One of the most urgent policy questions emerging from the crisis was therefore how to improve upon the tools available to resolve the distress of financial institutions. The policy debate can crudely be characterized as determining which is the lesser of two evils. In one camp stand those who are pessimistic about ordinary bankruptcy law’s performance, and who consequently advocate a special 'resolution' mechanism for financial firms[17].

These proposals take as their starting point an existing model: the Federal Deposit Insurance Corporation (FDIC) receivership regime for troubled banks in the US. The FDIC, which manages the insurance fund for consumer depositors in US banks, monitors the health of deposit-taking institutions subject to its regime, and steps in preemptively to take over a troubled bank[18]. There typically follows a rapidly-arranged sale of 'good' assets and a slower, but orderly, wind-down of 'bad' assets, as it will be analyzed below. Whilst the objective of this process is simply to preserve the position of depositors—or more accurately, of the FDIC fund which is subrogated to their claims—it is said to have the serendipitous consequence of minimizing consequent shocks to the financial system. Thus, under this special regulatory regime, deposits are immuned and the stability of the financial system is preserved, through the avoidance of sudden run on banks.

In the other camp are those who are pessimistic about the ability of a resolution mechanism to be able to scale up to deal with the largest financial institutions, and thereby avoid the peril of ad hoc bailouts. They are correspondingly optimistic that 'tweaking' ordinary bankruptcy laws can enable financial institution failure to be resolved more smoothly[19]**.** The reforms that have been, or are being, introduced in many of the major economies affected by the crisis, perhaps unsurprisingly, reflect a mixture of these policy prescriptions. The United Kingdom for instance, which did

[17] See eg, *Ed. R. Morrison,* 'Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?' Temple Law Review, Vol.82 , 2010
[18] See generally, *R. Bliss* and *G. Kaufman*, "US Corporate and Bank Insolvency Regimes: A Comparison and Evaluation", Virginia Law and Business Review, Vol. 143, N. 2, 2007
[19] *K Ayotte* and *D. Skeel*, "Bankruptcy or Bailouts", Journal of Corporation Law, Vol. 469, N. 35, 2010

not have any sort of pre-existing resolution or special insolvency regime for banks, has pursued a twin-track reform strategy. For deposit-taking institutions, the Banking Act 2009 introduced a special resolution regime modelled on the FDIC receivership process for insured depositary institutions in the US[20].

For non-deposit taking financial institutions, the UK's reform strategy focuses on improvements to insolvency law. Revisions to the ordinary insolvency laws are to be introduced to streamline the treatment of failed investment banks[21] and the already-existing (special) insolvency regime for insurance companies may be modified further[22]. In the UK, therefore, the choice between resorting to either a special resolution strategy or the insolvency procedure, as renewed, is *ex ante* determined in a great scale by the nature of business the ailing institution pursues (acceptance or not of deposits). However, the government retains a wide power to supplement this with *ad hoc* financial support -bailouts- for troubled financial institutions where there is a threat to financial stability.

It is as a result, the special features that the banking market is characterized of that renders the choice between ordinary insolvency procedures and special ones harsh. Starting from their capital structure, banks incur highly liquid liabilities in the form of deposits, repo loans and commercial paper. Their assets, by contrast, consist of long term loans and securities that may be difficult to sell or borrow against on short notice, resulting in a 'maturity mismatch'[23]. This renders banks and financial institutions particularly vulnerable to the loss of public confidence. Any suggestion,

[20] See generally, *P. Brierley*, "The UK Special Resolution Regime for Failing Banks in an International Context", Bank of England Financial Stability Paper No 5, July 2009
[21] HM Treasury, Establishing Resolution Arrangements for Investment Banks, December 2009
[22] HM Treasury, Strengthening the Administration Regime for Insurers: A Consultation, March 2010
[23] *Chr. Gortsos*, supra note 8, p. 32

even a rumor, may lead to a run on the bank. Due to significant inter-bank exposures arising from inter-bank deposits and loans and any one bank's role in payment and settlement systems one bank's failure may have damaging repercussions for the economic system as a whole. These problems are amplified when a bank is large in relation to its home country's GDP or so interconnected that its failure would potentially bring down other institutions within the same market.

And as commercial banks perform vital financial services, in particular the taking of deposits from households and firms, the extension of credit to individuals and businesses, and the processing of payments, there is no wonder why regulators are generally reluctant to allow banks to be wound down in normal insolvency proceedings.

<u>2. The G20 response to the crisis</u>

Following the outbreak of the financial crisis a G-20 summit has held on 14-15 November 2008 in Washington D.C. in order to coordinate in an international level the efforts against the financial crisis and to strengthen economic growth. The five key objectives the leaders agreed upon were:

- a common understanding of the root causes of the global crisis;
- a review of the actions countries had taken and would take in the future to address the immediate crisis and strengthen growth;
- an agreement on common principles for reforming their financial markets;
- a launch of an action plan to implement those principles and
- a request to the ministers to develop further specific recommendations that would be reviewed by leaders at a subsequent summit; and finally the

reaffirmation of the G-20 leaders commitment to free market principles.

Following this Summit of Washington, it was London on April 2nd 2009 that held the G-20 Summit on Financial Markets and the Global Economy. Once again the world's largest economies leaders expressed their commitment to the active reform of the global financial system and announced their shared goal to "to start the process of reform so as to manage globalization as a force for good in the medium term.". More specifically they declared their dedication in:

- Engaging concerted action to counter falling demand and fragile confidence (although different countries have different room for man oeuvre on monetary policy);
- Developing joint actions to prevent further contagion and support vulnerable emerging and developing markets;
- Working together to address the flaws in the financial and supervisory architecture that crisis has exposed;
- Strengthening cross-border co-ordination of financial regulation and international financial institutions like the Financial Stability Board (FSB) and the International Monetary Fund (IMF);
- Agreeing to boost world trade and reject protectionism as a way on moving towards more stable and secure global commodities markets;
- Reaffirming their shared commitment to meet the Millennium Development Goals[24]

The G20 leaders also pledged to establish the Financial Stability Board (FSB) "with a

[24] Press Release, Great Britain Cabinet Office, available at http://webarchive.nationalarchives.gov.uk/20110218163433/webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/managingtheglobaleconomy_081208.pdf

strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission that will collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them"[25]. Accordingly, the G-20 leaders asked the Financial Stability Board to develop a policy framework that would "address the systemic and moral hazard risks associated with systemically important financial institutions (SIFIs)". One of the cornerstones of this policy framework is to develop a resolution regime that would make banks, including SIFIs, 'safe to fail' in the sense that they could be resolved without taxpayer support to the bank's solvency and without causing significant disruption to the financial system. In October 2011 the Financial Stability Board set out the key attributes for such a resolution framework. This included a recommendation that countries establish special resolution regimes for banks and that such resolution regimes include bail-in as one of the stabilization options available to the resolution authority. Apart from the bail-in provision, the FSB proposal envisages for the resolution authorities to be competent to "(i) Remove and replace the senior management and directors and recover monies from responsible persons, including claw-back of variable remuneration;

(ii) Appoint an administrator to take control of and manage the affected firm with the objective of restoring the firm, or parts of its business, to ongoing and sustainable viability;

(iii) Operate and resolve the firm, including powers to terminate contracts, continue or assign contracts, purchase or sell assets, write down debt and take any other action necessary to restructure or wind down the firm's operations;

(iv) Ensure continuity of essential services and functions by requiring other

[25] London Summit- Leaders' Declaration, available on https://www.imf.org/external/np/sec/pr/2009/pdf/g20_040209.pdf

companies in the same group to continue to provide essential services to the entity in resolution, any successor or an acquiring entity; ensuring that the residual entity in resolution can temporarily provide such services to a successor or an acquiring entity; or procuring necessary services from unaffiliated third parties;

(v) Override rights of shareholders of the firm in resolution, including requirements for approval by shareholders of particular transactions, in order to permit a merger, acquisition, sale of substantial business operations, recapitalization or other measures to restructure and dispose of the firm's business or its liabilities and assets;

(vi) Transfer or sell assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, to a solvent third party, notwithstanding any requirements for consent or novation that would otherwise apply ;

(vii) Establish a temporary bridge institution to take over and continue operating certain critical functions and viable operations of a failed firm

(viii) Establish a separate asset management vehicle (for example, as a subsidiary of the distressed firm, an entity with a separate charter, or as a trust or asset management company) and transfer to the vehicle for management and run-down non-performing loans or difficult-to-value assets;

(ix) Carry out bail-in within resolution as a means to achieve or help achieve continuity of essential functions either (i) by recapitalizing the entity hitherto providing these functions that is no longer viable, or, alternatively, (ii) by capitalizing a newly established entity or bridge institution to which these functions have been transferred following closure of the non-viable firm (the residual business of which would then be wound up and the firm liquidated) (see Key Attribute 3.5);

(x) Temporarily stay the exercise of early termination rights that may otherwise be triggered upon entry of a firm into resolution or in connection with the use of resolution powers (see Key Attribute 4.3 and Annex IV);

(xi) Impose a moratorium with a suspension of payments to unsecured creditors and customers (except for payments and property transfers to central counterparties (CCPs) and those entered into the payment, clearing and settlements systems) and a stay on creditor actions to attach assets or otherwise collect money or property from the firm, while protecting the enforcement of eligible netting and collateral agreements; and

(xii) Effect the closure and orderly wind-down (liquidation) of the whole or part of a failing firm with timely payout or transfer of insured deposits and prompt (for example, within seven days) access to transaction accounts and to segregated client funds)"[26].

The aforementioned directions, though of non-binding nature in a strict legal language, have though an implicit obligatory essence for the international and regional regulators, as they are vested with political legitimization. Accordingly, both the US government and the European Union's competent authorities formed an implementation regulatory context that follows the requirements of the FSB's best practice guide, almost by letter. 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 a fallback position of host authorities to take independent action if necessary to protect financial stability in the host jurisdiction. The political endorsement that the Key Attributes obtained was depicted in the most notably way of

[26] FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, available at: http://www.financialstabilityboard.org/publications/r_111104cc.pdf

formal declaration at the G20 Summit 2011 in Cannes[27].

In the forthcoming chapters, the emergence of the financial crisis and its root causes, as well as its evolution in time will be reviewed in order to understand the regulatory response to it and to assess its suitability to trouble-dealing financial institutions in distress.

[27] Cannes G20 Summit Final Declaration – Building Our Common Future: Renewed Collective Action for the Benefit of All, November 4, 2011, available at http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html

III. THE 2008 FINANCIAL COLLAPSE

a. CHRONICLE

1. Bear Sterns

The financial institutions' collapse domino was initiated in America as of March 2008 with Bear Stearns, the most highly leveraged of the five large investment banks with an approximate 33:1debt-to-equity ratio[28]. Moreover, Bear was considered to have the largest exposure to mortgage-related assets; the bank had already taken $1.9 billion in write- downs related to its ownership of these types of assets in the fourth quarter of 2008.

In June 2007 the federal government decided the facilitate its business acquisition by JPMorgan[29] This rescue decision paved the way for the rest institution-failures to come, even though it was not followed literatim. However, this first deal established a number of principles that reflected the governments position on the distress-handling issue. The first element underlying the government's mindset on crises resolution is the adoption of the "too big (to be left) to fail" doctrine, considering that the failure of such large and/or interconnected credit institutions that could imperil the system's soundness, must be avoided.

Second, the loss adsorption should involve shareholders of the ailing institution first, rather than its creditors, in a clear effort to signal its commitment to fight against moral hazard. Third, the government insisted that market solutions be largely foreclosed for the sake of achieving orderly ones, in conjunction with its amplification of powers, through stretching the law's letter (para 13 of the Federal Reserve Act)[30]. The government's ultimate purpose was to conclude the deal as quickly

[28]Bear Stearns Cos., Annual Report (Form 10-K), exhibit 13 (Financial Report), at 52 (Jan. 29 2008) available on http://www.sec.gov/Archives/edgar/data/777001/000091412108000077/0000914121-08-000077.txt
[29] *K. Kelly*, "Fear, Rumors Touched Off Fatal Run on Bear Stearns", Wall Street Journal, May 28, 2008, at A1
[30]Stating that in unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal Reserve bank . . . to discount for any partnership, or corporation, notes, drafts, and bills of exchange when ... individual, indorsed or otherwise secured to the

as possible, in order to avoid unpredictable side effects that a purported delay or ambiguity of its commitment could bring about.

Briefly, the Stear Bearn's fall, that set a precedent for the forthcoming-ones, evolved quite quickly. It began by the refusal of a large investment bank to repurchase a $ 2 billion loan from the Bern's[31]. Rumors of a financial institution's imminent collapse would become reality through a self-fulfilling feedback loop as market participants lost confidence in the unfortunate institution, demanding collateral, withdrawing assets, and refusing to do business with the suspect institution. During this period, the SEC concluded that Bear Stearns was adequately capitalized[32]. However, Bern's liquidity position began to fall considerably as its liquid reserves had dropped from $18.3 billion the week before to $5.9 billion, and it owed Citigroup $2.4 billion[33].

On Thursday, March 13, Bear concluded that without outside assistance it would have to file bankruptcy the next day[34]. In the course of the Thursday night, the Federal Reserve Bank of New York (New York Federal Reserve) decided to guarantee a twenty-eight-day loan from JPMorgan to Bear in the amount of $30 billion[35].

This action also set a precedent: the loan agreement was concluded by the government through a Federal Reserve institution, using the vague authority that the§ 13 of the Federal Reserve Act

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satisfaction of the Federal Reserve bank: Provided, that before discounting ... the Federal Reserve Bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.

[31] R. Boyd, The Last Days of Bear Stearns, Fortune Magazine, Apr. 14, 2008, at 89

[32] Press Release, SEC, Chairman Cox Letter to Basel Committee in Support of New Guidance on Liquidity Management (Mar. 20, 2008), available on http://sec.gov/news/press/2008/2008-48.htm

[33]See *Kelly*, supra note 28

[34] See Hearing Before the S. Joint Economic Comm., 110th Cong. (2008) (statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, available on http://jec.senate.gov/index.cfm?FuseAction=Hearings.HearingsCalendar&ContentRecord_id=0af929fa-0f03-d201-bdb3-2e0cd4eece87&Region_id=&Issue_id

[35] See Bear Stearns Cos., Current Report (Form 8-K) (Mar. 16, 2008), available on http://www.sec.gov/Archives/edgar/data/777001/000091412108000249/be12284854- 8k.txt ; see also Hearing Before the Senate Commission on Banking, Housing and Urban Affairs, 110th Cong. (2008) (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York), available on http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=ec013d8f-fe1e-4fb6-a514-ab93be32ad38&Witness_ID=b428e0eb-d844-4add-9d85-8fab78ba065a

conferred upon it. This exceptional authority was last invoked to the benefit of nonbanks in the Great Depression[36] and it provides to the Federal Reserve the right to make loans to, as the Federal Reserve interpreted it during the crisis, any financial institution in distress. These low-rate loans are contracted with the aforementioned institutions, under the sole condition that the Federal's Reserve Board decides that the financial circumstances are indeed "unusual and exigent". The recipient should, in turn, commit itself to the return of the amount due to the Federal Reserve, as agreed[37] Moreover, it was accepted that the Federal Reserve's discretionary decisions on this subject matter would effectively be excluded from judicial review. While no court *expressis verbis* denied its authority to put on the test the comformity of these decisions to other statutes or/and the Constitution, that Federal Reserve decisions are unreviewable as a matter of law and courts have steered clear of substantively reviewing both monetary policy decisions and bank financial assistance. In *Raichle v. Federal Reserve Bank*, Judge Augustus Hand concluded that there was nothing inappropriate with a legally constituted bank making loans to other banks and setting interest rates for those loans (52 12 U.S.C. § 343 (2006)).

Bear Sterns was finally sold to JP Morgan for $ 2 billion[38]**.** What is important to note is that, given the conjuncture, the government strived for some long-cherished reform of the financial regulatory system. First, in March 31, 2008, Secretary Paulson released a report recommending administrative and legislative changes to government regulation of finance. The recommendations—the so-called Paulson Blueprint—plumped for enhanced powers for bank regulation, to be placed into the hands of the Federal Reserve as well as the Treasury, and for the regulatory supervision apparatus of the

[36] Press Release, Fed. Reserve Bank of New York, Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 24, 2008), http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html; see also *I. Greg*, "Central Bank Offers Loans to Brokers, Cuts Key Rate", Wall Street Journal, 17th March 2008, at A1
[37] 51 12 U.S.C. § 343. The Federal Reserve and Treasury Secretary have since suggested that this security requirement actually constrains the flexibility of the central bank in opening the discount window—but since the collateral requirement is left up to the Federal Reserve's discretion, these claims seem like simple efforts to argue for a limitation on the power of the bank where there is none. See, e.g., Posting of David Zaring to Conglomerate, http://www.theconglomerate.org/2008/10/must-the-fed-ta.html.
[38]Bear Stearns Cos., Current Report, June 2, 2008, available on http://www.sec.gov/Archives/edgar/data/777001/000091412108000468/0000914121-08-000468-index.htm

government to be consolidated by, among other things, merging the Commodity Futures Trading Commission with the Security Exchange Commission[39]. The report did not result in any immediate congressional act.

Second, on July 24 2008, the government passed the Housing and Economic Recovery Act of 2008 ("HERA")[40] an attempt to address the housing crisis. HERA provided, in theory, $300 billion in aid to subprime housing buyers (if they could qualify for it) and also set the Government's Sponsored Enterprises ("GSEs") as principal actors in engineering a housing recovery[41]. The bill increased the regulatory oversight of the GSEs and expanded the conservatorship powers of the federal government over the entities[42].

2. Lehman Brothers and the Sale of Merrill Lynch

During the weekend of September 13th 2008, Lehman suffered from the same self-fulfilling feedback loops as Bear. On September 10 2008, Lehman had pre-announced quarterly earnings: a loss of $3.9 billion for that quarter and gross asset write-downs of $7.8 billion[43]. Lehman also announced on that day plans to hive off its troubled commercial-real-estate-related and other assets into a separate "bad" bank[44].

The plan had been largely criticized as insufficient[45]. Rumors began to circulate of Lehman's

[39] See U.S. Department of Treasure, Blueprint of a Modernized Financial Regulatory Structure (2008), available at http://www.treas.gov/press/releases/reports/Blueprint.pdf
[40] Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008) (to be codified at 42 U.S.C. § 4511)
[41] Id. § 1311
[42] Id.
[43] Lehman Bros. Holdings, Inc., Current Report (Form 8-K), exhibit 99.1 (Press Release, Lehman Brothers Announces Preliminary Third Quarter Results and Strategic Restructuring), at 5 (Sept. 10, 2008), http://sec.gov/Archives/edgar/data/806085/000110465908057829/a08-22764_2ex99d1.htm
[44] Id. at 3. Lehman intended to spin off $25 billion to $30 billion of its commercial real estate portfolio into a separate publicly traded company, Real Estate Investments Global, in the first quarter of 2009
[45] *R. Smith*, 'Lehman's Revamp Plan Draws Doubters: Analysts Wonder If Fixes Can Occur in Time to Be of Help", Wall Street Journal, 11 September 2008, at C1

inability to survive[46]. These rumors quickly created their own feedback loop as customers began to pull assets from Lehman and demand collateral on counterparty trades as they became concerned for Lehman's survival. By September 13, Lehman's liquidity position had significantly deteriorated, and the company was facing a loan call by JPMorgan[47]. Lehman was the next financial institution faced with insolvency if it could not find a buyer or obtain government backing.

Moreover, Merrill Lynch & Co. had its own problems emerging at this time; after Lehman, Merrill was perceived as the next at risk of the five investment banks. In light of the market turmoil and higher leverage ratios of these investment banks when compared to more-regulated bank holding companies, market participants were fearful of doing business and investing in these institutions. Over a weekend Merrill agreed to be acquired in an approximately $50 billion transaction by Bank of America[48].

After this acquisition, Barclays was the sole willing bidder for Lehman's. However, Barclays was thrown out of the race when its own British regulator, the Financial Services Authority, refused to approve an acquisition[49]. Perhaps because they felt that the government would actually act and they could still free ride on such government conduct, the major financial institutions also refused to assist Lehman directly and instead put in a $70 billion facility to backstop trading when Lehman filed for bankruptcy[50]. On Monday, September 15, 2008, Lehman's holding company filed for Chapter 11. At this point, it is worth mentioning that most of Lehman's subsidiaries did not file for bankruptcy. The next day, Lehman agreed to sell its U.S. broker deal operation minus certain

[46] See *J. B. Bruno*, "Lehman Plunges on Concerns About Capital Levels", Associated Press, 9 September 2008 ("The steep decline in Lehman's shares began shortly after Dow Jones Newswires reported that the head of South Korea's financial regulator said talks about a possible investment had ended.")

[47] *C. Mollenkamp*, "The Two Faces of Lehman's Fall: Private Talks of Raising Capital Belied Firm's Public Optimism", Wall Street Journal, October. 6 2008, at A1. On September 11, JPMorgan demanded from Lehman $5 billion in additional collateral in easy-to-sell securities to cover lending positions that JPMorgan's clients had with Lehman. Id

[48] See *W. Cohan*, 'House of Cards: A Tale of Hubris and Wretched Excess on Wall Street", 2009.

[49] Id

[50] See *C. Mollenkamp*, "Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash: Fed Will Expand Its Lending Arsenal in a Bid to Calm Markets; Moves Cap a Momentous Weekend for American Finance", Wall Street Journal., 15 September, 2008, at A1

troubled commercial-real-estate-related assets to Barclays for a fire-sale price of $250 million.

Many observers would accuse the government of making a mistake in failing to bail out Lehman, leaving its bondholders without recourse, the credit insurance that it had underwritten meaningless, and its significant issued commercial paper worthless[51]. Regardless of whether Lehman should have been allowed to fail, it is still unclear whether the government realized the extent of Lehman's obligations. On the other hand, the drastic market reactions that flowed from Lehman's failure ultimately drove the government to adopt a more comprehensive approach to the crisis.

The government was clearly hamstrung here by the failure to have the power to simply seize Lehman. However, given that the Federal Reserve had previously interpreted (and would later interpret) its statutory authority to have broad reach to make loans in the context of the Bear Stearns matter, it is arguable that the government may not have been able to seize Lehman but the Federal Reserve could loan it money. Instead, it appears that the first was restricted from acting politically and wanted to make a statement, as deal makers do, about its willingness to bail out all financial institutions.

In the wake of the Lehman bankruptcy and Merrill's agreement to be acquired by Bank of America, the investment-banking model was shaky at best. In a short while, the final two independent investment banks regulated by the SEC, Goldman Sachs & Co. and Morgan Stanley, Inc., left the agency's regulation to become bank holding companies, overseen by the Federal Reserve—and potentially protected by that apparently more capable agency[52].

These two investment banks were pursuing a path toward stability by acquiring bank deposits

[51] The finance minister of France, for example, criticized the government for letting such an important global financial player default on its obligations.
[52] http://dealbook.blogs.nytimes.com/2008/09/21/goldman-morgan-to-become-bank-holding-companies/

(even though that bank deposits are also a form of short-term funding). Nonetheless, the market perception was that this model was more reliable than one which relied upon short-term prime brokerage deposits and repo lending for liquidity. The SEC's program overseeing investment banks like Bear Stearns and Lehman was quietly shuttered, meaning that any pretence that the SEC could make at performing banking-style supervision of the capitalization of investment banks ended[53]. As the SEC chair would testify before Congress that "*...The supervisory program was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate of the CSE program, and weakened its effectiveness*"[54].

After the failure of Lehman and near failure of the other investment banks contributed to the quick decline in the availability of short-term credit, unprecedented problems in the money market sector of the financial industry, and a knock-on effect on a number of other banks, the Treasury and Federal Reserve announced that a comprehensive solution to the financial crisis would now be required, one that would necessitate the imprimatur of Congress.

In June 2009, President Obama introduced a proposal for a "sweeping overhaul of the United States financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression"[55]**.** The law at hand[56] was nicknamed after Barney Frank and Chris Dodd, Chairman of the House's Financial Services Committee and of the Senate's Banking Committee, respectively, due to their involvement with the bill.

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53 Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), http://www.sec.gov/news/press/2008/2008-230.htm

54 137 Id

55 President's Barak Obama speech on June 17th 2009 at the White House, Office of the Press Secretary, available on http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/

56 whose long title is "Wall Street Reoform and Consumer Protection Act; an act to promote he financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes"

Major components of his original proposal include:

- The consolidation of regulatory agencies, elimination of the national thrift charter, and new oversight council to evaluate systemic risk;
- Comprehensive regulation of financial markets, including increased transparency of derivatives (bringing them onto exchanges);
- Consumer protection reforms including a new consumer protection agency and uniform standards as well as strengthened investor protection;
- Tools for financial crises, including a resolution regime complementing the existing Federal Deposit Insurance Corporation (FDIC) authority to allow an orderly winding down of failed firms, and including a proposal that the Federal Reserve receive authorization from the Treasury for extensions of credit in "unusual or exigent circumstances";
- Proposals concerning the tightening-up of credit rating agencies regulation as well as improved accounting.

The main focus among the aforementioned proposed regulatory initiatives will be the on the resolution of financial crises, the improved authorities of the Treasury, the Federal Deposit Insurance Corporation (FDIC) and thee Treasury and the Federal Reserve ("Fed") and the inauguration of an "orderly liquidation authority".

<u>b. The existing during the 2008 crisis, regulatory framework</u>

The FDIC's core business since its 1933 establishment as an independent government agency has been the protection of insured depositors at banks through the provision of deposit insurance. In furtherance of that role, it monitors banks against the risk of failure and intervenes in cases of failed or failing banks as appropriate. Hence, he FDIC's resolution authority was built for "banks", not for complex and systemically important financial institutions. Upon a determination by the bank's supervisor that the depository institution has failed or is failing, the FDIC steps in as either conservator or receiver[57]. The failing point is determined by the bank's insolvency either in its balance sheet or going concern sense or if its nearing insolvency with no prospects for becoming adequately capitalized. As receiver, the FDIC has the option of liquidating the bank's assets and simply paying off the insured depositors.

Instead, the FDIC generally engineers a “purchase and assumption” transaction: it purchases “bad” assets at a premium and arranges for a third party, generally a stronger bank, to purchase “good” assets and assume the insured deposits and certain other liabilities of the failing bank, aided by FDIC financial support[58]. The transaction commonly takes the form of a “merger” governed by the Federal Deposit Insurance Act rather than state law.

A purchase and assumption move can preserve the going concern value of the failing bank, which can promptly reopen under the purchaser's name. The provisioned structure gives the FDIC significant discretion to disfavor particular creditor claims by not including them in the transferred liabilities. The non-transferred creditors will be left with recourse to the receivership only, which will have been depleted by the assisted assumption[59].

In most bank resolution cases, the FDIC steps in as receiver. Less commonly, the FDIC acts as a special governor of the institution (or conservator) and operates a bank with the objective of restoring it to solvency. Historically, the FDIC has also had the power to provide “open bank” assistance, which avoids an adverse finding and commonly leaves management in place.

During a wave of bank failures in the 1980s, the FDIC liberally used its open bank assistance

[57] 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.).
[58] *R. Manning*, “Note, Creditors' Remedies Against the FDIC as Receiver of a Failed National Bank, Texas Law Review, vol. 1429, n. 64, 1986
[59] See supra note 57

powers to resolve failing banks, particularly the larger ones, choice that was largely accepted by the shareholders. In the most salient cases, this had the effect of minimizing loss-sharing with uninsured depositors, other creditors and the shareholders. Congress responded with a provision in the Federal "Deposit Insurance Corporation Improvement Act" ("FDICIA") in 1991 that required the FDIC to resolve cases at the "least cost". This was intended to limit FDIC assistance to cases where it was necessary to protect the deposit fund and where such assistance was the least costly resolution method for the Deposit Insurance Fund[60].

There was an important carve-out to the least cost rule: it did not apply to cases of systemic financial distress where the FDIC, the Secretary of the Treasury, and the Board of Governors agreed that adherence to the rule "would have serious adverse effects on economic conditions or financial stability." (12 U.S.C. § 1823(c)(4)(G)(ii)). As part of its general anti-bailout program, Dodd-Frank now limits the FDIC's capacity to provide other than "least costly" assistance to cases in which the FDIC had been installed as receiver and the assistance was used to wind down the institution[61].

c. Dodd-Frank Act and the FDIC Resolution Authority

The FDIC received important new resolution authority for failing non-bank financial institutions, under the name "Orderly Liquidation Authority," in Title II of Dodd-Frank.. Upon an appropriate determination by the Secretary of the Treasury, following recommendations by the Fed and the FDIC, regarding the impact of a particular financial firm's impending failure on "financial stability in the United States[62]", the FDIC is to step in as receiver, preempting the role of a bankruptcy court.

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[60] See the FDIC Report "Evolution of the FDIC's resolution practices", chapter 3, available at http://www.fdic.gov/bank/historical/managing/history1-03.pdf

[61] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 1106(b), 124 Stat. 1376, 2125 (to be codified at 12 U.S.C. § 5613) (amending § 13(c)(4)(G) of the Federal Deposit Insurance Act, 12 U.S.C. § 1823(c)(4)(G))

[62] § 203(b). The Secretary also needs to make various other determinations, including that other available resolution methods (for example, bankruptcy) would be inadequate, that "no viable private sector alternative is available," and that the proposed resolution would "avoid or mitigate...adverse effects" on "claims or interests of creditors, counterparties and shareholders of the [resolved] financial company and other market participants," taking into account the cost to Treasury and the potential to "increase excessive risk taking on the part of creditors, counterparties, and shareholders."Id. The broad range of factors that the Secretary should consider seems aimed at broadening the

(116, Id. § 202(c)(2)).

This new authority is similar to the FDIC's powers with respect to a failing bank, with important limitations. The FDIC's mission is the "orderly liquidation" of the financial firm, not a conservatorship or open bank assistance[63]. This liquidation procedure requires that the intervention be necessary for "financial stability," not "for preserving the covered financial company." The liquidation must be structured to impose any losses on unsecured creditors and shareholders (who are paid last), and the management and board members "responsible for the failed condition" of the firm must be removed[64].

The FDIC cannot take any "equity interest" in the firm. Nevertheless, it has broad authority to provide different forms of financing to facilitate the firm's liquidation, which includes extending credit, purchasing assets, and assuming or guaranteeing obligations. The FDIC can also establish a "bridge financial company," presumably to protect the viable business and sound assets of a failing financial firm pending a subsequent sale. (§ 206(6)). Even though the FDIC cannot take on equity interests, it can provide operating funds "in lieu of capital" to a bridge financial company and can provide financing to facilitate a subsequent sale. In effect, the FDIC will provide a special kind of "debtor in possession" financing to protect the financial system while the failing firm is wound down or sold via the bridge company mechanism.

As for the funding resource, Dodd-Frank provides for an "Orderly Liquidation Fund," supplied by Treasury borrowings. (§ 210(n)). This Fund is not capped and requires no legislative action for unlimited borrowing, though it is subject to debt ceiling constraints. The FDIC also has the

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resolution strategies

[63] See *D. Polk*, Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010, at 27-34 (July 21, 2010), available at http://www.davispolk.com/files/Publication/efb9442899114472b5dd006e9c6185bb/Presentation/PublicationAttachment/efd835f6-2014-4a48-832d-00aa2a4e3fdd/070910_Financial_Reform_Summary.pdf

[64] Individuals are also subject to liability for negligence, § 210(f)

authority to guarantee any obligations of the failing company that were issued during the receivership. (§ 204(d). The Fund, including disbursements on guarantees, will be repaid through the proceeds of asset sales and other dispositions, as well as authorized recoveries.

Under Dodd-Frank, an FDIC receivership displaces not only bankruptcy but also other potential sources of government financial assistance for a failing firm. More specifically, the Act eliminates the Fed's emergency authority to lend to specific firms (capital injections). The Fed's section 13(3) emergency lending authority is limited to "broadly available" facilities rather than "single and specific" borrowers; its lending must aim to provide "liquidity to the financial system, and not to aid a failing financial company"; and its loans may not be made to "insolvent" borrowers (§ 1101(a)). Moreover, any such Fed program requires the prior approval of the Secretary of the Treasury (§ 1101(a)(6)).

d. What makes FDIC's renewed authority special

In order to understand the importance of the Dodd-Frank Act legacy we have to examine closer the structure of "banks" in the US, especially the systemically important ones. A systemically important financial firm in the U.S. will almost invariably be organized through a holding company structure in which the principal asset of parent company ("Topco" as it very commonly is called), is 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, investment banking and assets management through various investment advisors.. All of these activities will be organized as direct or indirect subsidiaries of the "Topco" parent. Some of the subsidiaries will be organized in the U.S.; others outside the U.S. The subsidiaries are likely to have complex financial arrangements with one another, entailing the intra-organizational transfer of funds and collateral. The subsidiaries will have different counterparty relationships with set-off and liquidation of collateral provisions.

The FDIC's new Orderly Liquidation Authority is of "single point of entry" ("SPOE") meaning that, in the event of financial distress that goes beyond the SIFI's capacity to address it internally, the FDIC is to 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[65].

So, for example, if a large bank subsidiary that suffers a large write-downing its loan book or takes a massive loss on a derivatives position that would normally (see before the enactment of Dodd-Frank) render "Topco" insolvent on a consolidated balance sheet basis, under the SPOE, the parent company can continue operating. The new receivership transfers the assets of "Topco", most particularly its ownership interest in its operating subsidiaries, to a new financial holding company, a "bridge" entity (also known "Bridgeco"). In general, "Topco's" unsecured and subordinated liabilities become claims against the receivership, which retains the equity claims against "Bridgeco".

The FDIC estimates the extent of the losses, which it apportions among equity holders and the unsecured and subordinated creditors of "Topco" in accordance with their priority. Equity holders will almost assuredly be eliminated and some fraction of the unsecured debt will be written off. The remaining "Topco" unsecured debt is converted into equity claims and unsecured liabilities of Bridgeco, which is now fully capitalized. "Bridgeco" downstreams equity to restore solvency to the banking subsidiary, reflected by the write-down of holding company loans to the bank. As this process is unfolding, the FDIC can supply liquidity to "Bridgeco", either through a direct cash infusion from the "Orderly Liquidation Fund," generated through a drawdown on a Treasury line of credit, or through the guarantee of new debt obligations issued by "Bridgeco", full faith and credit

[65] For an overview of the SPOE, see the Federal Register's Notices, available on http://www.gpo.gov/fdsys/pkg/FR-2013-12-18/pdf/2013-30057.pdf

obligations of the U.S[66].

The upshot of this approach is that the holding company – the shareholders and debtholders of "Topco" – bear the losses of the operating subsidiaries. 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. Besides the long term creditors and shareholders of "Topco" cannot run in the face of impending financial distress because of the nature of their commitment. Because the subsidiaries' businesses are not disrupted – because the systemic shock is contained – the ultimate creditor losses will be much less. This the FDIC regards as the lesson of Lehman Brothers. The losses were far greater than the intrinsic asset write-downs. Rather, most of the losses occurred because of value destructivity in the disorderly bankruptcy: fire sale liquidations and lost going concern and franchise value. To be sure, the SPOE strategy depends upon a layer of unsecured debt in the liability structure of "Topco", but the claim is that in expectation of a well-managed resolution process, losses can be contained to the point so that a reasonable level of unsecured debt (plus capital) can cover the losses[67].

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 foreign subsidiary ("Subco") as necessary to preserve "Subco's" solvency, and if the FDIC can flow liquidity support

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[66] See the Deputy Governor of Bank of England Paul Tucker's Speech, Resolution and Future of Finance (May 20, 2013), available at http://www.bankofengland.co.uk/publications/Pages/speeches/2013/658.aspx. Among others, he quotes: ""Single-point-of-entry resolution involves working downwards from the top company (Topco) in the group in an exercise that resolves the group as a whole, wherever its problems began. Think of it this way. Losses in subsidiaries are first transferred within the group to the Topco. If Topco is bankrupt as a result, the group needs resolving. Bailin can then be applied to the Topco's capital structure: writing off the equity and, most likely, subordinated debt; and writing down and partially converting into equity the senior (bonded) debt issued by Topco. Those bondholders become the new owners."

[67] See Annex 2 "Guidance on Developing Resolution Strategies and Operational Resolution Plans", Financial Stability Board Recovery and Resolution Planning: Make the Key Attributes Requirements Operational (Consultative Document, Nov. 2012), , available at http://www.financialstabilityboard.org/publications/r_121102.pdf

through "Bridgeco" to foreign "Subco", then "Subco" remains a solvent and functional entity throughout the resolution of the SIFI of which it is apart. The approach and its advantages are described in a joint FDIC-Bank of England paper that contemplates cooperation among two major regulators in the resolution of cross-border firms in their jurisdictions[68] :

"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."

Conclusion of the Second part

To sum up, financial institutions are unlikely to issue sufficient unsecured term debt without regulatory prodding. Capital, not loss absorbency through unsecured term debt, has been the focus of Basel. 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[69]. Other countries are exploring similar strategies: Switzerland, for example, allows banks to lower the overall amount of regulatory capital they are required to hold by making their businesses easier to separate in a crisis[70].

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[68] FDIC and Bank of England, Resolving Globally Active, Systemically Important, Financial Institutions Par. 49 (December 10, 2012), available at <http://www.fdic.gov/about/srac/2012/gsifi.pdf

[69] See Janet L. Yellen, Regulatory Landscapes: A U.S. Perspective (June 3, 2013): "In consultation with the Federal Deposit Insurance Corporation, the Federal Reserve is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of long-term unsecured debt outstanding. Such a requirement could enhance the prospects for an orderly SIFI resolution. Switzerland, the United Kingdom, and the European Union are moving forward on similar requirements, and it may be useful to work toward an international agreement on minimum total loss absorbency requirements for global SIFIs", available at http://www.federalreserve.gov/newsevents/speech/yellen20130602a.htm

[70] J. Shotter, "Credit Suisse to overhaul structure", Financial Times, November 21, 2013.

The crucial advantage of the SPOE strategy is that it offers a credible path to the resolution of large financial institutions without reliance on deposit insurance guarantees either to fund the transaction or to mitigate the risk of destructive depositor runs. The depository subsidiary will be protected by the debt layer at the holding company level, and, implicitly, by the administrator’s determination to make the SPOE approach, once undertaken, succeed.

In the subsequent chapter, the European Union's reflexes will be illustrated in detail, in order to suggest the strengths and weaknesses of both regulatory regimes and to come to a conclusion about their potential to effectively and in a promptly manner mitigate an upcoming crisis. In contrast to the American context, the European one concerns the existence of multiple nation-states, in the territory of whom often operate large cross-border institutions. The alleviation of these institutions' distress will be the core challenge of the Union's regulator.

a. THE EUROPEAN RESPONSE TO FINANCIAL TURMOIL

The Union's reaction to the crisis was not coherent, centralized or even well coordinated on the outset, due to the absence of any similar situation since the Union's foundation, and therefore the absence of an apt regulatory regime. We could roughly point out the following stages of crisis dealing:

- The first reaction were simple, straightforward bail-out programs, led the individual Member States, and typically uncoordinated. There was almost no E.U. level involvement at this stage
- This was subsequently and slowly replaced by national resolution regimes – again, States adopted their own regimes, at different speed and with different priorities.
- Thirdly, efforts were made to coordinate national resolution regimes by means of a European harmonization directive, which harmonizes the national regimes, but essentially leave resolution power on the State level. This is the (proposed) E.U. Resolution Directive, as it will be analyzed forthwith.

b. THE 2014/59/EU DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ESTABLISHING A FRAMEWORK FOR THE RECOVERY AND RESOLUTION OF CREDIT INSTITUTIONS AND INVESTMENT FIRMS

On the 15th of April 2014 the European Parliament adopted the Bank Recovery and Resolution Directive ("BRRD"), proposed by the Commission on June 2012. On 6 June 2012, the Commission published its long awaited Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms[71]. This Proposal constituted the first step of a comprehensive agenda for establishing a general

[71] COM(2012) 280/3, available on

framework for ailing financial institutions outlined in the Commission's Communication of October 2010[72]. In the medium and long term, the Commission plans to examine the need for further harmonization of bank insolvency regimes.

Whereas in the United States a special bank insolvency law has long been available to deal with commercial (deposit taking) banks in distress[73], most European jurisdiction were lacking such a special regime. When the global financial crisis fully hit in 2008 the only alternative were bank bailouts resulting in huge exposure for taxpayers. Given the degree of integration and interconnectedness of financial markets within the EU[74] and the prevalence of EU wide banking groups, the adoption of a harmonized EU wide regime appears to be essential for the proper functioning of the internal market. In the absence of effective preventive measures and resolution tools and powers banks will de facto operate under an implied state guarantee. This may have significant implications for concentration and competition across the EU and may impede the free movement of capital by deterring investors from acquiring securities in institutions no longer supported by an implied state guarantee.

Under the Reform at issue, the envisaged EU framework rests on 'three pillars': (I) preparatory and preventive measures; (ii) early intervention; and (iii) resolution tools and powers[75]. It largely draws

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http://ec.europa.eu/internal_market/bank/docs/crisismanagement/2012_eu_framework/COM_2012_280_en.pdf. Currently, the envisaged date for implementation is 31 December 2014 with application from 1 January 2015. The application of the bail-in tool, in particular, is postponed until 1 January 2018, Art 115(1) of the Proposal

[72] 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, COM(2010) 579 final, available on http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf

[73] *R Bliss and G Kaufman*, 'US Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation' Federal Reserve Bank of Chicago Working Paper 2006

[74] ECB, "Financial Integration in Europe" (April 2012), noting a marked deterioration of integration in recent years caused by the financial crisis

[75] The Proposal also provides a framework for dealing with resolutions that involve third countries, in particular through the conclusion of agreements with third countries regarding the means of cooperation between resolution authorities; the recognition of third country resolution proceedings, the resolution of Union branches of third country institutions and the cooperation with third country authorities (Arts 84-89)

on past experiences[76] and reflects an emerging international consensus[77]. The resolution tools and powers form the heart of the Reform

'Resolution' in that sense is the restructuring of an institution in order to ensure the continuity of its essential functions, to preserve financial stability and to restore the viability of all or part of that institution. (art 2(1) in conjunction with 31(2)). These objectives can only be achieved where the regime allows for early, quick, broad and decisive actions to be taken by resolution authorities as soon as financial trouble is on the horizon.

1.Scope of Application & General Preconditions

The Directive applies to credit institutions, that is, commercial and universal banks, as well as investment firms and certain bank holding companies (23 Art. 1) More specifically, in order to ensure consistency with existing Union legislation in the area of financial services as well as the greatest possible level of financial stability across the spectrum of institutions, the resolution regime should apply to institutions subject to the prudential requirements laid down in Regulation 575/2013/EU of the European Parliament and of the Council[78] and Directive 2013/36/EU of the European Parliament and of the Council[79]. The regime should also apply to financial holding companies, mixed financial holding companies provided for in Directive 2002/87/EC of the European Parliament and of the Council[80] mixed-activity holding companies and financial institutions, when the latter are subsidiaries of an institution or of a financial holding company, a mixed financial holding company or a mixed-activity holding company and are covered by the

[76] IMF and World Bank, "An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency" (April 17, 2009), available on https://www.imf.org/external/np/pp/eng/2009/041709.pdf
[77] Mainly the FSB Key Attributes
[78] Regulation 575/2013/EU of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation 648/2012/EU
[79] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on the 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
[80] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council

supervision of the parent undertaking on a consolidated basis.

Investment banks have been included on the basis that their failure may endanger financial stability and cause damage to the financial system as a whole[81]. The scope is not limited to systemically important financial institutions. This is because in view of the Commission systemic relevance is difficult to predict ex ante and the failure of a number of small banks may equally cause significant market disruption[82] The Directive does not provide for a single European resolution authority; rather, the designation of resolution authorities is left to the Member States, provided that the resolution authority (or authorities) is a public authority, equipped with the necessary resources and infrastructure and the resolution function is sufficiently independent from the supervisory function in order to avoid a conflict of interest (Art. 3 (3)).

2. Resolution Tools

National resolution authorities must have at their disposal the following resolution tools (Art 37 (3)):

(i) the sale of business tool

(ii) the bridge institution tool

(iii) the asset separation tool[83] and

(iv) the bail-in tool.

Apart from the bail-in tool, all resolution tools envisage a transfer of an institution's business, or part thereof, to a separate entity. The residual part is to be wound up under normal insolvency proceedings, having regard to any possible need of the transferee entity for continued support of the residual institution in order to carry out the activities that were transferred (Art. 31 (6)). National

[81] See Explanatory Memorandum 4.4.1
[82] Explanatory Memorandum, 4.3
[83] Resolution authorities may apply the asset separation tool only together with another resolution tool (preamble para 66)

laws on avoidance of transactions are suspended (29 Art. 37 (8)). In line with the minimum harmonization character of the Directive, Member States are not prevented from conferring upon resolution authorities additional powers exercisable where an institution meets the conditions for resolution, provided that those additional powers do not pose obstacles to effective group resolution and are consistent with resolution objectives and general resolution principles (30 Art 37 (9)). This minimum harmonization clause is, however, rather complex in its implementation and will probably give rise to difficult questions on several aspects of the resolution regime.

When applying resolution tools and exercising resolution powers, resolution authorities shall 'have regard to the resolution objectives (Art. 31 (1)). These are (Art. 31 (2)) (i) to ensure the continuity of critical functions; (ii) to avoid significant adverse effects on financial stability (preventing contagion, including to market infrastructure and by maintaining market discipline); (iii) to protect public funds by minimizing reliance on extraordinary public financial support; (iv) to protect depositors covered by Directive 2014/49/EU and investors covered by Directive 97/9/EC; (v) to protect client funds and client assets.

These objectives are of equal significance and must be balanced in each case depending on the circumstances. (33 Art. 31 (3)) Moreover, resolution authorities must take all appropriate measures to ensure that the resolution action is taken in accordance with general resolution principles.(34 Art. 34 (1)) These principles are:

(ii) shareholders bear first losses;

(ii) creditors bear losses after the shareholders and in accordance with the order of priority established by the Directive;

(iii) senior management is to be replaced and senior managers are to bear losses commensurate with their individual responsibility for the institution's failure, except in extraordinary circumstances where the maintenance of responsible management is necessary for the accomplishment of the resolution objectives;

(iv) management body and senior management of the institution under resolution shall provide all necessary assistance for the achievement of the resolution objectives;

(v) natural and legal persons are made liable, subject to Member State law, under civil or criminal law for their responsibility for the failure of the institution;

(vi) except where otherwise provided in this Directive, creditors of the same class are treated in an equitable manner;

(vii) no creditor shall incur greater losses than would have been incurred if the institution had been wound up under normal insolvency proceedings;

(viii) covered deposits are fully protected; and

(ix) resolution action is taken in accordance with the safeguards in this Directive.

However, the general principal that no creditor will bear greater losses when compared to those suffered under normal insolvency procedure is quite problematic, as it is not the order of priority under the Directive may deviate significantly from priority under national insolvency(-ies) law, necessitating complex and difficult valuations and rendering the resolution process ambigue and slower.

<u>3. Conditions for resolution (Art. 32, 33 of the Directive)</u>

Article 32 and 33 of the Directive set out the conditions for resolution for credit institutions and investment firms, and for groups of companies, respectively. In respect of a credit institution or investment firm, resolution action may be taken if (I) the competent authority determines that the institution is failing or likely to fail; (ii) there is no reasonable prospect that in the absence of a resolution action the failure of the institution could be prevented within a reasonable timeframe; and (iii) a resolution action is necessary in the public interest (67 Art 32 (1)).

As for (i), an institution is deemed failing or likely to fail, if it is in breach or will be in breach, in the near future, of the capital requirements for continuing authorization in a way that would justify the withdrawal of the authorization by the competent authority because the institution has incurred or is likely to incur losses that will deplete all or substantially all of its own funds (Art 32 (4)(a)). Own funds are defined with reference to Arts 56-66 Directive 2006/48/EC[84] and basically comprise common equity, retained earnings and certain reserves. Thus, own funds will be depleted if an institution's net assets are equal to or lower than its subscribed share capital and the reserves to be included for that purpose.

An institution will also be deemed to be failing, or likely to fail, if its assets are, or will in the near future be, less than its liabilities; or if it is, or will in the near future be, unable to pay its obligations as they fall due (71 Art. 32 (4)(b,c)). Moreover, the institution is deemed to be failing when it requires extraordinary public financial support. (72 Art.32 (4)(d)). The form of state aid provided must not be one of the following in order to qualify for the Directive's requirements;

financial stability, the extraordinary public financial support takes any of

the following forms (Art. 34 (4)(d)(i)):

(i) a State guarantee to back liquidity facilities provided by central banks according to the central banks' conditions;

(ii) a State guarantee of newly issued liabilities; or

(iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution.

In each of the cases mentioned in points (d)(i), (ii) and (iii), the guarantee or equivalent measures referred to therein shall be confined to solvent institutions and shall be conditional on final approval under the Union State aid framework.

[84] Art 57 Directive 2006/48/EC, with Arts 22, 23 Directive 86/635/EEC

As for (iii), a resolution action will be in the public interest if it achieves, and is proportionate to, one or more of the resolution objectives, and winding up of the institution pursuant to normal insolvency proceedings would not meet those objectives to the same extent[85].

In the group context, the resolution conditions must be met, in principle, with regard to both individual institutions and subsidiaries and their parent companies (74 Art. 33). Only exceptionally may resolution action be taken in respect of a parent company that does not itself meet the resolution conditions where this is necessary for the resolution of subsidiary institutions or for the group as a whole.

4. Sale of business tool (Art. 38 & subs.)

The sale of business tool seeks to achieve a quick and easy transfer of the business or part thereof to a private sector buyer or buyers in order to maintain critical functions and to rescue the viable parts. For that purpose, resolution authorities shall have the power to transfer the shares of an institution under resolution, or all or some of its assets, rights or liabilities to a private sector purchaser or purchasers, that is not a bridge institution, (art. 38 (1)) provided they are appropriately authorized to carry out the transferred business. In order to not unnecessarily delay the transfer, it requires neither the consent of the shareholders of the institution nor of any third party other than the purchaser. The procedural requirements under company or securities laws are suspended. The transfer is to be made on 'commercial terms' with the net proceeds going to the residual entity, in case of a partial transfer, or to the shareholders who have been divested of their rights, and in accordance with the Union's state aid framework. (art. 38 (2)).

Reasonable steps must be taken by resolution authorities in order to obtain commercial terms for the

[85] Reminded that resolution objectives are (i) to ensure the continuity of critical functions; (ii) to avoid significant adverse effects on financial stability (preventing contagion, maintaining market discipline); (iii) to protect public funds by minimising reliance on extraordinary public financial support; (iv) to protect depositors and investors by Directive 2014/49/EU investors covered by Directive 97/9/EC; and (vi) to protect client funds and client assets.)

transfer on the basis of the fair and realistic valuation carried out in accordance with Art 36 (Art. 38 (3)). In particular, unless doing so would undermine the resolution objectives, resolution authorities are required to market the institution or its assets or liabilities in a way that is transparent and fair with a view to maximizing the sale price (Art. 38 (2)(a). An auction in a strict sense does not seem to be required since resolution authorities have the discretion to solicit particular potential purchasers.

Shareholders and creditors are protected by the 'no-worse-off-principle'. Shareholders and creditors whose interests have not been transferred (or have been written down or converted to equity) must receive at least as much as they would have received if the institution had been wound up under normal insolvency proceedings[86] immediately before the transfer (or write down or conversion), as the case may be. Where they have received less, the difference is to be paid by the resolution authority.

In order to apply the sale of business tool, and the other resolution tools, effectively, resolution authorities are granted an extensive list of resolution powers. These include the power to take control of an institution and to exercise all the rights of the shareholders (Art. 63(b)); to remove or replace senior management (art. 63 (i)); to transfer equity and debt securities as well as other assets, rights and liabilities (Art. 63 (c,d)); to write down or convert to equity capital instruments and eligible liabilities, to cancel debt and equity instruments, to issue new debt, equity or hybrid securities including contingent convertible bonds ('coco' bonds), or alter their maturity (Art. 63 (h,i,j), the power to convert eligible liabilities of an institution under resolution into ordinary shares or other instruments of ownership of that institution or entity (Art. 63 (f)). Exercise of any of these powers is not subject to the requirements of approval of concerned parties that would normally apply. The transfer may take effect free from any encumbrances or third party rights. Moreover, resolution authorities may remove pre-emptive rights, securities may be delisted and contracts

[86] according to the general principle no (vii) of the resolution framework, as exposed above

modified or cancelled (Art. 63 (k)). Resolution authorities also have the power to impose a temporary automatic stay by suspending certain obligations, and termination rights under financial contracts, until midnight the following business day (Art. 71 (1)), as well as the enforcement of security interests, as long as necessary in order to achieve the resolution objectives (Art. 70 (1)).

Partial transfers are subject to the safeguards provided for in Articles 66, 73, 76 and 80, for security arrangements. These provisions seek to prevent the separation of assets and liabilities that are inextricably linked in particular with regard to security arrangements, title transfer collateral arrangements, set-off and netting arrangements and structured finance. Whether these safeguards will be effective in practice is as yet an open question.

The purchaser succeeds the institution under resolution to the extent of the transfer in respect of rights to provide services and establishment pursuant to Directives 2013/36/EU and/or 2014/65/EU. Moreover, the transferee may be treated as the successor of the institution under resolution for all legal purposes including pending legal proceedings relating to any financial instrument (Art. 38 (11,12)). In order to ensure an uninterrupted continuation of critical functions, resolution authorities may require the residual institution or other institutions within the same group of companies to provide the necessary services and facilities to the recipient entity. However, shareholders and creditors who are left behind do not have any rights in relation to the assets and liabilities that have been transferred (Art. 38 (13)).

The sale of business tool has proved to be extremely useful in the course of the resolution of failing commercial banks in the United States. Where the Federal Deposit Insurance Corporation (FDIC) is appointed as receiver it may, by way of a “purchase and assumption” transaction, as it is called overseas, transfer all or some of the assets of a troubled bank to a healthy institution with the latter assuming some or all of the banks liabilities, in particular its insured deposits. Given that insured and uninsured domestic deposits rank ahead of unsecured creditors and the FDIC is substituted for the insured creditors it is often the major creditor of the residual bank and unsecured creditors (other than depositors) will usually have to bear significant losses[87]. Under the Directive it would be possible to transfer, for instance, deposits and current accounts to a willing buyer. However, under the 'no-creditor-worse-off' principle, general unsecured creditors may be entitled to considerable compensation from the resolution authorities. This is likely to render resolution more expensive; and the necessary valuation will inevitable slow down the resolution process and make it less effective.

In the past, partial transfers to a private sector purchaser (or a bridge bank) were used effectively mainly in respect of small and medium sized banks[88]. By contrast, the application of this tool in respect of large and complex banks and banking groups may face extraordinary difficulties, resulting from a mismatch of legal and operational structures[89]. Disentangling these functions whilst at the same time maintaining their efficacy will be difficult and time consuming. These problems can, however, be alleviated by effective recovery and resolution planning as envisaged under the Directive (Art. 5 and subs. of the Directive).

5. Bridge Institution Tool (Article 40 & subs.)

Where no private sector buyer is readily available resolution authorities may have resort to the bridge institution tool. In exercise of the bridge institution tool, resolution authorities transfer all or specified assets, rights or liabilities of an institution to a bridge institution (Art. 40 (1)(a&b)). The bridge institution is a legal entity wholly or partially owned by one or more public authorities, possibly the resolution authority, created for the purpose of carrying out some or all of the functions

[87] *R Hynes* and *S. Walt*, 'Why Banks are Not Allowed in Bankruptcy' available at http://ssrn.com/abstract=1522205
[88] *A van der Zwet*, 'Crisis Management Tools in the EU: What Do We Really Need?' DNB Occasional Studies Vol.9, No. 2 (2011)
[89]Id, supra note

of an institution under resolution (Art. 40 (2)).

The general resolution powers, in particular the transfer powers are available. However, following the transfer, the total value of liabilities transferred must not exceed the total value of the rights and assets transferred or provided from other sources. (Art. 40 (3)).A re-transfer from the bridge institution to the institution under resolution is possible only where the initial transfer instrument so provides, or where the assets and liabilities were not actually covered by the transfer instrument in the first place. (Art. 40 (7)). Similar to the sale of business tool, the bridge institution succeeds the institution in respect of freedom to provide services and establishment under Directives 2013/36/EU or 2014/65/EU. (Art. 40 (9)). Shareholders and creditors left behind do not have any claims against the bridge institution. The 'no-worse-off' principle, however, applies as well.

The resolution authority appoints the bridge institution's board of directors and determines their salaries and responsibilities. (Art. 41 (c)) The bridge bank must be duly authorised to carry out the respective activities and must comply with prudential requirements. It must be operated with a view to selling its business to a private sector buyer when market conditions are appropriate (Art. 41 (2)). Operations of the bridge institution are to be terminated when the bridge institution merges with another institution, when the majority of its capital is acquired by a third party, or when substantially all of its assets or liabilities have been assumed by a third party (Art. 41 (3)). If neither of these events occurs, the bridge institution is to be terminated after a period of two years, which is under certain circumstances, properly justified, extendable (Art. 41(5)(6)). In preparation of a sale the institution or its assets or liabilities must be marketed openly and transparently, and any sale should be made on commercial terms. Following a termination of operations the institution shall be wound up and liquidated, and any net proceeds shall benefit the institution under resolution (199 art. 41 (8)).

6. Asset Separation Tool (Art.42 & Subs.)

The asset separation tool consists of the power to transfer assets, rights and liabilities to an asset management vehicle, which is a legal entity wholly owned by one or more public authorities it has been created for the purpose of receiving some or all of the assets, rights and liabilities of one or more institutions under resolution or a bridge institution (Art. 42 (1,2)). This tool may only be used in respect of assets the liquidation of which under normal insolvency proceedings could have an adverse effect on the financial market, or such a transfer is necessary to ensure the proper functioning of the institution under resolution or bridge institution, or, finally, such a transfer is necessary to maximize liquidation proceeds (Art 42 (5)). Assets and liabilities are to be transferred for consideration on the basis of a fair valuation. The appointed asset manager shall manage the assets and liabilities with a view to maximizing their value through eventual sale or otherwise ensure an orderly wind down of the business.

This tool (as well as the bridge institution tool) may be used to insulate underperforming or toxic assets in a separate vehicle (bad bank) in order to cleanse a troubled bank's balance sheet. This however, is problematic from a strategic point of view, as the availability of this tool may increase the moral hazard problem for bank's management, as institutions do not have to worry so much about the riskiness of their assets. Consequently, under the Directive, the asset separation tool may be applied only in conjunction with one of the other tools. (preamble para 66**).** Shareholders and creditors left behind have no rights in relation to the asset management vehicle (Art. 42 (12))**.** The asset manager shall not be liable vis-à-vis the shareholders of the institution, other than in case of gross negligence or serious misconduct. (Art. 42 (13)).

The problem with both the bridge institution tool and the asset separation tool is that assets and liabilities are transferred for consideration and parked in a special vehicle in the more or less vague hope that market conditions will improve. In many cases this will only postpone the inevitable, to write down the 'bad bank' assets possibly yielding only a minimal return.

7. Bail-In Tool (Art. 43 subs.)

In addition to traditional resolution tools, the Directive provides for a 'bail-in' tool for eligible liabilities, in addition to the power to write down capital instruments. Bail-in offers, in the view of the Commission, a resolution tool that would significantly enhance the ability of authorities to resolve large and complex ("too-big-to-fail") financial institutions where other resolution tools might prove insufficient because there is no private sector buyer readily available and even if it were, this would only increase concentration and the size of remaining institutions, thus exacerbating the "too-big-to-fail" problem[90]. Winding down may not be an option if the critical functions provided cannot be readily substituted by other market players[91]. In these cases, bail-in constitutes a tool for imposing losses on existing investors and for recapitalizing an institution without the injection of taxpayer money.

Bail-in, in contrast to other loss-absorbing mechanisms, such as contingent capital or contingent convertible bonds ("Coco's") does not occur automatically upon a certain trigger event. Rather, it is dependent on the exercise of discretion on the part of the resolution authority. Under the bail-in tool, all equity would be written off and all subordinated liabilities would be written off or converted into equity, as the case may be, as soon as the institution meets certain trigger conditions and the resolution authority exercises the bail-in tool. Initially the Commission considered that the mechanism could be based on mandatory contractual terms for write down or conversion to be

[90] 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 COM(2010) 579 final; DG Internal Market and Services, Working Document: Technical Details of a Possible EI Framework for Bank Recovery and Resolution on http://ec.europa.eu/internal_market/consultations/2011/crisis_management_en.htm); Discussion paper on the debt write-down tool – bail-in (http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bail_in_en.pdf

[91] Commission Staff Working Document, Impact Assessment accompanying the document Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms SWD(2012) 166/3 final, available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_ass_en.pdf

included in a proportion of the debt issued by financial institutions[92].Subsequently it favoured a solution based on a statutory power of resolution authorities to exercise the bail-in tool in either a going concern scenario, to absorb losses and recapitalize the entity, or in a liquidation scenario to wind the institution down.

Pursuant to the Directive, the bail-in tool consists of the application of the resolution powers specified in Art 63: to write down or convert capital instruments into shares; to reduce, if necessary to zero, the principal or outstanding amount due in respect of eligible liabilities; to convert eligible liabilities into ordinary shares; to cancel shares and debt securities; to require an institution under resolution to issue new shares or other capital instruments including preference shares and coco bonds; to require the conversion of debt instruments which contain a contractual term for conversion subject to the conditions for write down specified in Art 59 of the Directive.

These powers may be used to either (i) to recapitalise an institution in order to restore its ability to comply with the conditions for authorisation and to carry on the activities for which it is authorised under the respective Directive (*open bank scenario*) or (ii) to capitalise a bridge institution by converting to equity, or reducing, the amount of debt transferred to it from the institution under resolution (*closed bank scenario*); (Art. 42 (2) (a) &(b) respectively). In both scenarios the conditions for resolution specified in Art 32 must be met nad the bail tool must be induced in accordance with the resolution objectives specified in Article 31, as well as with the resolution principles specified in Article 34 (Art. 43 (2)). This is explicitly provided for in the open bank scenario; it follows for the closed bank scenario from the fact that the bridge institution tool itself is subject to the conditions for resolution. In the closed bank scenario, application of the bail-in tool seems to be straightforward: transferred debt is reduced or converted to the extent necessary to adequately

[92] 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 COM(2010) 579 final, 11

capitalize the bridge institution.

Exercise of the bail-in tool in the open bank scenario seems to be more complex. Here, the bail-in tool may be exercised only if there is a realistic prospect that the application of bail-in in conjunction with other measures implemented in accordance with a business reorganization plan by an administrator appointed for that purpose will achieve, not only the relevant resolution objectives, but will restore the institution to financial soundness and long term viability. (Art. 43 (3)). Where these conditions are not fulfilled, resolution authorities may use any of the other resolution tools and the bail-in tool in order to capitalize a bridge institution (only).

Read in conjunction with Art 31(5), this seems to limit the ambit of the application of the bail-in tool in the open bank scenario considerably, since where the sale of business tool, bridge institution tool or asset separation tool is exercised to transfer part of an institution, the residual entity must be liquidated under normal insolvency proceedings. It is not clear whether application of a resolution tool can be part of the required business reorganization plan. If not, it would not be possible, for instance, to apply the bail-in tool to an institution in order to reduce its debt and then apply the sale of business tool to transfer its business or part thereof to a private purchaser; such a transfer would be possible only after the recapitalization on the basis of the business reorganization plan had failed.

Given that, for a bank in distress, fast and decisive action will be of the essence, the regime outlined in the Directive seems to be quite unsatisfactory. Under the Directive the bail-in trigger is the determination by the resolution authority that the general conditions for resolution have been met, in particular, that losses have been, or will be, incurred that reduce own funds to virtually zero, and that resolution is in the public interest. This trigger is problematic for a number of reasons. The general conditions are rather vague and open textured. Rational people may draw different conclusions on the basis of the facts presented to them, in particular in term of the valuation of an institution's assets in difficult times[93]. This will make anticipation of whether and when bail-in will occur rather difficult. Market participants may have a hard time determining the risk associated with bail-in bonds and pricing them accordingly.

Moreover, the reliance on losses that reduce own funds to (almost) zero sets the trigger rather late in the day when the prevention of a terminal decline may no longer be possible. The valuation problem and a general reluctance to interfere with investors' rights may add further impetus for delay. Prior to the determination by the resolution authority, speculators may attack an institution by buying up its "bail-inable" debt and shorting its shares when it comes under pressure and a bail-in becomes more likely. Shorting the stock may potentially accelerate a decline of share prices leading to a 'death spiral' of the institution triggering bail-in and conversion of bail-inable debt to under-valued shares[94]. In order to prevent this, holders of bail-in bonds would have to be prevented from shorting the institution's shares. But this could be easily circumvented through synthetic shorts using derivatives. Even if it was possible to prevent shorting, bail-in bonds may become very unattractive for many investors[95].

8. Eligible Liabilities

The bail-in tool is very broad in its scope in order to ensure efficient application and to avoid circumvention. It applies to all liabilities of an institution that are not excluded. (Art. 44(1)). Excluded liabilities are only: (Art. 44(2))

- covered deposits,
- secured liabilities including covered bonds and liabilities in the form of financial instruments used for hedging purposes which form an integral part of the cover pool and

[93] *M Flannery*, 'Stabilizing Large Financial Institutions with Contingent Capital Certificates' Working Paper 2009, University of Florida, at 12

[94] This problem may be alleviated by carefully calibrating the trigger conditions and the terms of conversion, M Flannery, 'Stabilizing Large Financial Institutions with Contingent Capital Certificates' Working Paper, University of Florida, at 19-20

[95] Price Waterhouse Coopers, "Basel III and beyond The trillion dollar question: can bail-in capital bail out the banking industry?" November 2011, available at www.pwc.com/banking

which according to national law are secured in a way similar to covered bonds

- liabilities arising from the holding of client assets or client money or from the institution acting as fiduciary;
- short term liabilities with a maturity less than one month and
- certain liabilities owed to employees, commercial and trade creditors, and tax and social security claims provided they are treated as preferential under national insolvency law.

Resolution authorities may exclude liabilities arising from derivatives contracts if this is necessary to ensure that the provision of vital functions is being maintained and the stability of the financial system is preserved (249 Art. 43(3)). Where derivatives are not excluded and the transaction is subject to a netting agreement, the bail-in tool is applied on a net basis in accordance with the agreement.

The exclusion of certain liabilities from the scope of the bail-in tool constitutes a deviation from the ranking of creditors under national insolvency laws, where insured depositors, short term creditors, and trade creditors usually rank pari passu with general unsecured creditors. This is most relevant for insured depositors as their preferred status would facilitate the separation and transfer of critical functions – deposit taking and current accounts – to a private sector purchaser or a bridge bank.

However, due to the 'no-creditor-worse-off' principle, the exclusion of insured deposits from bail-in does not really introduce insured depositor preference. If the institution were to be wound up under normal insolvency law unsecured creditors and depositors would share in the proceeds of the pool of assets available for distributions. Consequently, the bail-in, in resolution, of unsecured creditors would trigger the safeguard provisions of Art 65(1)(b) of the Proposal, resulting in potential payouts to these creditors from the resolution authority. This would render resolution more expensive. The necessary valuation is likely to slow down the process, significantly reducing its effectiveness. This delineation of the scope of the bail-in tool means that basically all unsecured debt with a maturity of one month or more will be bail-inable.

In addition to this, problematic is the risk of contagion. A large share of debt instruments is held by other financial institutions, which may not be able to hedge against the risk through CDS or other hedging instruments. Applying the bail-in tool in respect of one institution may have a significant effect on other banks' balance sheets. Simultaneously, the market for bail-inable debt may dry up making it even more difficult for other institutions to raise capital through new issues. The problem could be mitigated by limitations on cross-holdings of bail-in bonds, which is not currently envisaged in the Directive[96]

9. Minimum requirement

In order to prevent banks from shifting their liabilities into exempt debts there is a need to establish a minimum requirement for eligible liabilities. The Directive has opted against setting a statutory minimum centrally; rather, resolution authorities may determine the required minimum on a case by case basis depending on the risks associated with a specific institution (256 Art. 45(1)). Institutions are required to maintain at all times a sufficient aggregate amount of own funds and eligible liabilities expressed as a percentage of total liabilities of the institution that do not qualify as own funds (Art. 45(4)).

The minimum aggregate amount depends on the need to ensure that the institution can be resolved through the application of resolution tools, in particular with a view to restoring an institution's Common Equity Tier 1 ratio to a level necessary to sustain sufficient market confidence in the institution and enable it to continue to comply with the conditions for authorization and to carry on the activities it is authorized for (Art 45(6)). In principle, institutions must comply with the

[96] IMF Staff Discussion Note, From Bail-out to Bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions, SDN/12/03 (April 24, 2012), 22, available at https://www.imf.org/external/pubs/ft/sdn/2012/sdn1203.pdf

minimum aggregate amount on an individual basis. However, subject to certain conditions, the minimum aggregate amount may be applied on a consolidated basis for groups subject to consolidated supervision (Art. 45(8)). The setting and verification of whether institutions maintain the minimum aggregate amount through the resolution authorities is conceived as part of developing and maintaining resolution plans. There is a clear risk that different resolution authorities may apply different standards for determining the required minimum aggregate amount. In order to mitigate divergences, resolution authorities report the minimum amounts determined for each institution to EBA which in turn reports to the Commission**.** (Art. 45(16 and subs.)) The Commission is further called upon to specify the relevant criteria for determining the minimum aggregate amount through delegated acts.

10, Implementation of the bail-in tool

In order to apply the bail-in tool, resolution authorities must first establish, on the basis of a fair and reasonable valuation in accordance with Art 30, the aggregate amount by which eligible liabilities should be reduced or converted. Where the bail-in tool is applied in the open bank scenario, the aggregate amount thus established must be sufficient to restore the Common Equity Tier 1 capital ratio of the institution, to sustain sufficient market confidence in it and to allow it to continue to comply with the conditions for authorization and to carry on the activities for which it was authorized. The reference to sufficient market confidence seems to impose a near impossible assessment and requirement. After all, the institution is in resolution. Given the fact that even perfectly healthy banks may be subject to a run, it is difficult to see how such market confidence could ever be restored prior to the institution emerging from resolution.

In application of the bail-in tool, existing shares in an institution are either cancelled or 'severely diluted' by converting eligible liabilities into shares at an appropriate rate of conversion. The conversion rate of debt to equity may be different for different classes of debt, as long as the conversion rate represents adequate compensation for the affected creditors and the conversion rate for senior creditors is higher than that for subordinated creditors where that is appropriate in light of priorities under national insolvency law.

Article 48 establishes the hierarchy for exercising the bail-in tool. Common Equity Tier 1 instruments are written down first in proportion to the losses and up to their capacity with the relevant shares being cancelled. If, and only if, this is insufficient to arrive at the aggregate amount, resolution authorities reduce to zero the principal amount of Additional Tier 1 instruments that are liabilities (perpetual subordinated debt) and Tier 2 instruments (subordinated debt with a remaining maturity of at least five years). If, and only if, this is still insufficient to arrive at the aggregate amount, resolution authorities reduce the principal amount of subordinated debt that is not Additional Tier 1 or Tier 2 capital (subordinated debt with maturity of five years and less) to the extent necessary. Only if this is still insufficient, may the outstanding senior eligible debt be reduced to the extent necessary to arrive at the aggregate amount. When applying the write down or conversion powers, resolution authorities shall allocate the losses equally between shares or other instruments of ownership and eligible liabilities of the same rank by reducing the principal amount of, or outstanding amount payable in respect of, those shares or other instruments of ownership and eligible liabilities to the same extent pro rata to their value (art.48 (2)).

In the open bank scenario application of the bail-in tool would not be the end of the resolution process. Rather, an administrator will be appointed with the objective of drawing up and implementing a 'business reorganization plan' (Art. 51 &52) setting out measures aimed at restoring the long term viability of the institution within a reasonable time scale. Possible measures are the reorganization and restructuring of activities, the withdrawal from loss-making activities, the sale of assets or of business lines. The resolution authorities assess the plan within one month from the date of submission and approve it if satisfied that the plan is likely to restore long-term viability.

As it claimed this procedure may prove quite lengthy and cumbersome, and as a result of a potential limited use in practice[97]. A bank in resolution is hardly in a position to inspire confidence in market participants. Moreover, time will usually be of the essence. Unless, a market develops for the financing of distressed banks and possibly a secondary market for trading in such debt, it will be extremely difficult for the administrator to obtain the necessary funding other than through the resolution fund or the taxpayer.

Also, the presence and conversion of contingent equity and bail-in bonds will not stop a liquidity crisis once it begins. Short-term creditors and repo counterparties will not be prevented from 'pulling out' merely because bond holders' interests have been converted to equity. Once a run for the exit begins it will continue in a self-fulfilling manner. This can be remedied only by setting the trigger for conversion so early that debt is eliminated before a liquidity crisis is likely to begin, taking into account that the conversion itself may be a signal to the market causing a self-fulfilling presumption of crisis. The balance sheet effect of the conversion would have to be so strong as to counterbalance this possible signaling effect.

CONCLUSION

Having already exposed the core elements of each financial reform regime, we could make some suggestions for the improvement of the European regulatory complex of the banking market, inspired by the American paradigm. Before doing so though, it would useful to point out some core differences between the American and the European reality.

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[97] *D. Duffie*, 'Contractual Methods for Out-of-Court Restructuring of Systemically Important Financial Institutions' in K Scott, G Shultz an J Taylor (eds) Ending Bailouts as We Know Them (Hoover Institution Press, 2009), available on http://media.hoover.org/sites/default/files/documents/EndingGovtBailouts.pdf

First of all, in the European Union, the historical and political underpinnings of the too big to fail institutions problem are very different. Because the continent is composed of independent, generally centralized nation-states with strong cross-border financial linkages, national governments have been encouraged to favor the emergence of a strong and autonomous national financial sector that could successfully compete with its neighbors. Thus, the inclination is generally to protect and foster 'national banking champions.' When these run into difficulties the inclination is to prevent their disappearance or foreign takeover by forcing domestic consolidation or, if this option is not available, by nationalization. This mindset and treatment from the part of national governments intensifies the linkages, which in most countries of the world do exist, between sovereigns and 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. European banks continue to hold large amounts of bonds from their home governments[98].

Overall, in the European Union it is observed a wider structural variety of financial institutions, meaning that the larger and stronger economies (France, Germany, Italy, the Netherlands, and Spain) are predominantly hosting domestically headquartered banks, whereas smaller countries, such as Belgium, Finland and ex communist countries have local subsidiaries of international banking firms. The United Kingdom is a category of its own with, inter alia, one large foreign-owned retail bank (Santander UK), along with very large wholesale activities of nondomestic, European, and non-European financial institutions in the city of London, which is largely accepted to be the financial heart of the continent, have gradually integrated over the past two decades (a development that has mostly happened independently from banking consolidation).

[98] *Al. Gallo* and others, "The Revolver – European banks: Still too big to fail", RBS Macro Credit Research, January 23, 2014, available at http://cfa.wpengine.netdnacdn.com/marketintegrity/files/2014/03/Alberto_Gallo_The_Revolver.pdf

Apart from the 'domestic champions' mindset, a second major difference between the United States and European Union is the attitude toward bank failures. It is often asserted that the United States is more tolerant of corporate insolvency than most European cultures, and that the US bankruptcy code, at least when applied to nonfinancial companies, is comparatively more protective of corporate executives and employees than most European counterparts. In the case of banking, this difference is compounded in the European (and especially, but not only, in the German) point of view by the memories of the last significant wave of bank defaults in Europe, which in 1931 played a prominent role in enabling the subsequent rise to power of Adolf Hitler's National Socialists. Thus, it is common among European policymakers to see bank failures as politically ominous disasters to be avoided at all costs, even in the case of relatively small banks. In this connection, the head of Germany's financial supervisory authority, BaFin, commented in early August 2007, in the very first stages of the financial crisis, that the bailout of IKB, a second-tier specialized bank that most observers would have thought far smaller than any reasonable TBTF threshold, was necessary to avoid "the worst financial crisis since 1931."

A third specific 'European' feature is linked to its welfare and/or social-democrat heritage, namely the importance of cooperatives and savings banks in several EU countries. The United States had a rough equivalent with the savings and loans (S&L) institutions and credit unions, but their importance and specificity have decreased in the last two decades, not least as a consequence of the S&L crisis of the 1980s. Many demutualisations and transformations into commercial bank entities have taken place in Italy, Sweden (with the formation of Swedbank), and the United Kingdom, but this segment remains prominent in Austria (Erste, Raiffeisen), Denmark (savings banks), Finland (OP-Pohjola), France (Banques Populaires-Caisses d'Épargne Groupe, Crédit Agricole, Crédit Mutuel), Germany (savings banks and Volksbanken), the Netherlands (Rabobank), and Spain (savings banks). In general, cooperative and savings banks have proved fairly resilient in financial crises, except when they diversified beyond their core retail business in which case they have often run into major difficulties. As they are not publicly listed, they typically disclose less financial information than listed peers; this in turn can be a contributing factor to market distrust, as has recently been the case, arguably, in both Germany and Spain.

Apart from the aforementioned differences that have their roots in the different organizational political system in America and Europe (federal and strengthened cooperation-in the financial sector- respectively), it is worthy to notice some further differences that derive from the abovementioned.

First, legislative proceedings are structurally slower in the European Union because of the complex interaction between the EU level and 27 sovereign states. For the overhaul of the financial regulatory system at issue to be achieved, the initiative was relied upon the European Commission, which was also charged with the refinement of its tedious technical aspects, whereas the final approval remained on national hands: the 27 ministers of finance under a qualified-majority rule, with the consent of the European Parliament.

Second, at the time of the Lehman Brothers collapse, the European Commission was in awaitance of its planned renewal in 2009, and this renewal was then further delayed for procedural reasons involving the adoption of the Lisbon Treaty. The new team, including the new commissioner for the internal market and services (who oversees most financial-services issues), only came in charge in early 2010. Third, priority was initially given to the necessary overhaul of the European Union's supervisory architecture. This is an innovative policy endeavor that will result in 2011 in the establishment of three supranational European supervisory authorities, with respective mandates over banks (European Banking Authority – EBA), securities and markets (European Securities and Markets Authority – ESMA) and insurance (European Insurance and Occupational Pensions Authority – EIOPA), as well as a European Systemic Risk Board to oversee macroprudential issues.

The corresponding legislation, based on a report published in February 2009 (Larosière, 2009), was finalised in September 2010.

This rather long delay is unsurprising given the political significance of the changes: the US equivalent is not the limited reorganisation of federal agencies included in the Dodd-Frank Act, but rather the establishment of federal financial authorities such as the Securities and Exchange Commission and the Federal Deposit Insurance Corporation in the 1930s, even though the European agencies will start with a more limited mandate that does not supersede all existing competencies of national supervisors at the level of EU member states. Fourth, and not least, the European Union remains in the midst of an unresolved major banking crisis, while in the United States the 'stress tests' of spring 2009 and subsequent recapitalisation managed to restore a sense of normality at the core of the national banking system, even though many smaller banks have failed since.

Given all the previously stated differences, some suggestions are to be highlighted for the European Union's case. First, the American paradigm teaches that the responses in order to be effective and timely must be centralized. The historical evolution of the FDIC in the system of U.S. banking regulation illustrates the importance of a central, unbiased and well-funded institution. In fact, the creation of the FDIC itself is a response to weak state-based insurance systems that could not prevent the bank failures of the Great Depression. This strengthens the case for a centralized E.U. resolution authority, given the huge number of banks operating cross-border in the E.U. today and the well-advanced integration of financial services in the E.U.

Second, it is the european banks' structural model that must change in order for them to be more resolvabe. Clearly he typical U.S. “holding company” group model is not popular on the European side of the Atlantic. But regulation can change the relevant incentives. Stimulated by regulatory incentives, Swiss banks are reported to be among the first European banks to currently change their organizational structure. Under Swiss rules, banks can lower their core capital by changing their legal structure to make the banking group more resolvable[99]. This has led both major banks, Credit Suisse and UBS, to adjust their organizational structure to something akin to the U.S. bank holding company structure.

These suggestions, if combined, could contribute to the unification of the western world's bank resolution regimes and would minimize the threaten of the cross-border operating, too interconnected to fail credit institutions, and thus, eliminating the systemic risk, to the extent of that being a matter of regulation.

[99] Finma, the Swiss Financial Market Supervisory Authority, has said it prefers the SPOE approach for cross-border banking resolution. See Finma position paper, "Resolution of global systemically important banks", August 7, 2013, available at http://www.finma.ch/e/finma/publikationen/Documents/pos-sanierung-abwicklung-20130807-e.pdf

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