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IN-DEPTH ANALYSIS

The different legal and operational structures of banking groups in the euro area, and their impact on banks' resolvability

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Provided at the request of the
Economic and Monetary Affairs Committee

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Abstract

This paper discusses the legal and operational structure of the 129 banking groups in the euro area, which meet the test of SSM significance. Following a brief consideration of some key definitional and theoretical aspects, the paper analyses the data available from those 129 groups under a tri-dimensional taxonomy (considering their institutional, organizational, and operational structure). Based upon such data and taxonomy, the paper poses a number of questions or issues that the Single Resolution Board might consider in their resolvability assessments in the light of the Bank Recovery and Resolution Directive and the SRM regulation. The paper outlines avenues for further research since greater clarity is needed to understand both legal and operational structures of banking groups in the euro area.

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

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LIST OF ABBREVIATIONS

| | |
|-------------|---|
| BBMM | Banking Business Model Monitor |
| BCC | Banche di Credito Cooperativo |
| BRRD | Bank Recovery and Resolution Directive |
| EBA | European Banking Authority |
| ECB | European Central Bank |
| ESFS | European System of Financial Supervision |
| ESM | European Stability Mechanism |
| EU | European Union |
| GDP | Gross Domestic Product |
| GSIB | Global Systemically Important Banks |
| HC | Holding Company |
| HR | Human Resources |
| ICBC | Industrial and Commercial Bank of China |
| MPE | Multiple Point of Entry |
| MREL | Minimum Requirements for Own Funds and Eligible Liabilities |
| N/A | Not Applicable |
| PLC | Public Limited Company |
| SHV | Shareholder Value |
| SNL | Financial database or S&P Global Market Intelligence |
| SPE | Single Point of Entry |
| SRB | Single Resolution Board |
| SRF | Single Resolution Fund |
| SRM | Single Resolution Mechanism |
| SSM | Single Supervisory Mechanism |
| STV | Stakeholder Value |
| TLAC | Total Loss Absorbing Capacity |
| UK | United Kingdom |
| US | United States |

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EXECUTIVE SUMMARY

This paper deals with the legal and operational structures of banking groups in the Eurozone in order to assess the impact of such structures upon banks' resolvability.

The very definition of banking group is contentious. At the EU level, the only clear reference to a "banking group" can be found in recital 48 of Directive No. 36 of 2013 which states that banking groups are comprised of several banking entities (parent undertakings, subsidiaries and branches), with diversified activities where parent undertakings control at least one subsidiary. Furthermore, banking groups vary their structure according to their business practices and their operations in different jurisdictions. The terms "group" and "conglomerate" can be used interchangeably.

Our preliminary analysis has focused on the 129 significant banking groups supervised by the ECB and provides an insight into the complexity and multidimensional nature of the supervision and monitoring of banking groups within the framework of the SSM. We consider the data available from those 129 groups under a tri-dimensional taxonomy, considering their institutional organizational, and operational structure.

In terms of the organisational dimension, more data and research are needed on the definition (i.e. holding companies), and on the number and granular balance sheet data on the branches and subsidiaries country by country. For the operational dimension, more data and research are needed on the core business lines and critical functions.

We discuss the framework for resolution and identify impediments to resolvability in accordance with the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) Regulation.

Since supervision and crisis management are part of a seamless process, the relationship between the SSM (as supervisor with some crisis management responsibilities such as early intervention and recovery plans) and the SRM is essential at the critical point of early intervention. This requires timely communication and exchange of information (pre-planning), as well as coordination between supervisory and resolution authorities.

The starting point of any possible resolution strategy planned ex ante would be the choice between a single point of entry (SPE) or a multiple point of entry (MPE). Already in the resolution plan the SRB will have to indicate which resolution tool, or combination thereof, to use. For instance, the authority would want to activate the bail in tool, the asset separation tool, the bridge institution or the sale of business tool. In practice, the Board will have to indicate «a detailed description of the different resolution strategies that could be applied according to the different possible scenarios and the applicable timescales» (art 8(9)(j) SRM Regulation).

To ensure the continuity of critical economic functions carried out by the group entities, where they can be easily separated in a timely manner or by other means, should be one of the key guiding principles in the resolvability assessment of banking groups.

1. INTRODUCTION – DEFINITIONAL ISSUES AND TEST OF SIGNIFICANCE

This paper was requested by the European Parliament under the supervision of its Economic Governance Support Unit.

Under EU law the SSM Regulation (Council Regulation EU No 1024/2013 of 15 October 2013) has clarified that the SSM supervises significant institutions. The test of significance is open-ended though some criteria are established in Article 6.4 of the SSM Regulation: if the balance sheet total exceeds either 20% of the GDP of its Member State or 30 billion Euros, if the entity is of significant relevance for the domestic economy, if the credit institution has received financial assistance from the ESFS and ESM. The procedures for classifying entities as ‘significant’ are outlined in Articles 43-44 of the SSM Framework Regulation (Regulation EU No. 468/2014 of the European Central Bank) adopted on 16 April 2014.

The list of significant institutions was first published in September 2014 in accordance with Article 49(1) of the SSM Framework Regulation. The latest list of 129 significant supervised entities was published in May 2016¹.

The jurisdictional scope of the SRM Regulation is aligned with the SSM Regulation, *i.e.* the institutions subject to the SSM supervision in the participating Member States are also subject to the SRM regulation. However, the SRM is not limited to the “significant” institutions, which are directly supervised by the ECB; “less significant” institutions shall also fall under the scope of the SRM. The SRM applies to the resolution of: 1) credit institutions; 2) parent undertakings established in one of the participating Member States, including financial holding companies and mixed financial holding companies when subject to consolidated supervision carried out by the ECB; 3) investment firms and financial institutions established in participating Member States when they are covered by the consolidated supervision of the parent undertaking carried out by the ECB.

The relationship between the SSM and the SRM can be controversial at the critical point of early intervention. Since early intervention is an SSM task the transition from early intervention and recovery plans to resolution plans is fundamental and a key variable in assessing resolvability.

According to Article 6a of the SRM Regulation, the SRB will be responsible for drawing up resolution plans and adopting resolution decisions for those institutions that are directly supervised by the ECB under the SSM Regulation, while the national resolution authorities will remain responsible for other entities, except where resolution scheme is expected to use the Single Resolution Fund (SRF). However, this does not prevent the SRB from intervening when it is “necessary to ensure consistent application of high resolution standards”. The SRB shall also have certain investigatory powers that it can exercise either directly or through the ECB or the national authorities. For example, the SRB is empowered: 1) to request information from the institutions subject to the SRM Regulation, their employees, and third parties to whom these entities outsourced functions or activities; 2) conduct all necessary investigations (including access to all necessary documents and records, and the possibility to obtain explanations from the employees); and 3) conduct on-site inspections. The SRB shall also have limited powers to penalize institutions to address infringements and non-compliance with the SRB decisions. In this regard the SRB can take decisions to either impose fines or periodic penalty payments.

¹ Available here

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/list_of_supervised_entities_20160531en.pdf?496fcf1d1a3add48ded49e7db0e9f3e6

2. BANKING GROUPS: WHAT THEY ARE AND HOW THEY OPERATE

International banking groups have grown in recent years as a result of the trend towards consolidation of the financial industry on the one hand, and the demise of geographic barriers on the other hand. The legal arrangements with regard to the supervision and crisis management (including resolution) of such groups or conglomerates present a number of challenges for regulators, supervisors and policy-makers. There is first the cross-sector dimension, i.e. the different lines of business (banking, securities, insurance) that will allow to distinguish a financial conglomerate from a banking group or conglomerate. But there is also the legal separateness and cross-jurisdiction dimension, since international financial conglomerates operate in different jurisdictions.

According to the Tripartite Group of Bank, Insurance and Securities Regulators, a financial conglomerate is defined as “any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors”. A financial conglomerate may be characterised primarily as a securities, insurance or a banking structure. The character would be determined by the sector represented at the holding company level and by the type of activity that constitutes the major business of the conglomerate.

A financial conglomerate involved primarily with banking would typically be one in which the parent company is either itself a banking institution under supervision, or is a financial holding company whose most dominant subsidiary is an authorised credit institution. If the major business activity is banking and no other services are provided in other financial sectors (i.e. insurance and/or securities) it will be a banking group (or conglomerate). The terms “group”² and “conglomerate”³ can be used interchangeably.

The evolution of several pan-European banking groups has given rise to new structures, management and strategic practices that have also led to new forms of systemic risk.⁴ It has also evidenced that despite the cross border nature of such groups, governments acted unilaterally, in a number of cases, such as Fortis⁵ or the Icelandic banks⁶.

In the EU, financial conglomerates are defined as large financial groups active in different financial sectors, often across borders.⁷ In 2002, the EU adopted the Financial Conglomerates Directive in an effort to tighten supervision of financial conglomerates and ensure international financial groups do not weaken the financial system.⁸ For the purposes of the Conglomerate Directive, a group or

² According to the Oxford Dictionary, a group is “a commercial organization consisting of several companies under common ownership”, available at <https://en.oxforddictionaries.com/definition/group>.

³ According to the Oxford Dictionary, conglomerate is “a thing consisting of a number of different and distinct parts or items that are grouped together” available at <https://en.oxforddictionaries.com/definition/conglomerate>.

⁴ BCBS, ‘Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring’ (Bank for International Settlements, October 2010); Bank for International Settlements, ‘Report and Recommendations of the Cross-border Bank Resolution Group’ (March 2010).

⁵ Sophie Limbos and Diana Phillips, ‘The Rise and Decline of a Belgian Banking Giant – Communication and Business Ethics in the Fortis Case’ (May 2010) University of Antwerp, Faculty of Applied Economics Working Paper 2010-009 available at: <http://anet.uantwerpen.be/docman/irua/fd1e2b/10770.pdf>.

⁶ Arnór Sighvatsson and Gunnar Gunnarson, ‘Iceland’s financial disaster and its fiscal impact’ in John Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds) *Managing Risk in the Financial System* (Edward Elgar, 2011) 133-135.

⁷ See http://ec.europa.eu/finance/financial-conglomerates/index_en.htm.

⁸ 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. Articles 1-2 of the Financial Conglomerates Directive have been amended by Directive 2011/89/EU in which “group” is defined as ‘a group of undertakings which consists of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries hold a participation, or undertakings linked to each other by a relationship.’

subgroup will be a financial conglomerate if at least 40% of its business is financial and at least 10%, or failing that six billion euros of its financial business, is in each of the insurance and the combined banking/investment sectors.⁹ The Conglomerate Directive details the further requirements for an organisation to be considered a financial conglomerate.¹⁰ Any conglomerate, headed by a group, which is industrial or commercial based and has a regulated financial entity working on behalf of that group is known as a mixed conglomerate.¹¹

According to Article 2(14) of the Conglomerate Directive, as amended by Directive 2011/89/EU, ‘financial conglomerate is a group or subgroup, where a regulated entity is at the head of the group or subgroup, or where at least one of the subsidiaries in that group or subgroup is a regulated entity’, and which falls into the following conditions:

- (1) where there is a regulated entity at the head of the group or subgroup: (a) that entity is a parent undertaking of an entity in the financial sector, an entity which holds a participation in an entity in the financial sector, or an entity linked with an entity in the financial sector by a relationship; (b) at least one of the entities in the group or subgroup is within the insurance sector and at least one is within the banking or investment services sector; and, (c) the consolidated or aggregated activities of the entities in the group or subgroup within the insurance sector and of the entities within the banking and investment services sector are both significant.
- (2) where there is no regulated entity at the head of the group or subgroup: (a) the group’s or subgroup’s activities occur mainly in the financial sector; (b) at least one of the entities in the group or subgroup is within the insurance sector and at least one is within the banking or investment services sector; and, (c) the consolidated or aggregated activities of the entities in the group or subgroup within the insurance sector and of the entities within the banking and investment services sector are both significant.

At the EU level, the only clear reference to a banking group can be found in recital 48 of Directive No. 36 of 2013 which states that banking groups are comprised of several banking entities (parent undertakings, subsidiaries and branches) with diversified activities where parent undertakings control at least one subsidiary.¹²

A financial conglomerate can be further organised under three basic organisational structures, which permit the combination of banking and non-banking activities. It is important to stress the difference between legal and functional separateness. The former implies separate legal entities with different management, accounting, boards of directors and capital while the latter derives from a regulatory or self-imposed restriction (Chinese walls) to restrain integrated provision of different financial services.

⁹ 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.

¹⁰ Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a Financial Conglomerate Directive 2002/87, article 3.

¹¹ European Commission, ‘Towards an EU Directive on the Prudential Supervision of Financial Conglomerates’, available at http://ec.europa.eu/internal_market/financial-conglomerates/docs/consult_en.pdf. Groupe Carrefour, a French retail outlet specialized in food retailing is an example of a mixed conglomerate.

¹² See recital 48 of the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

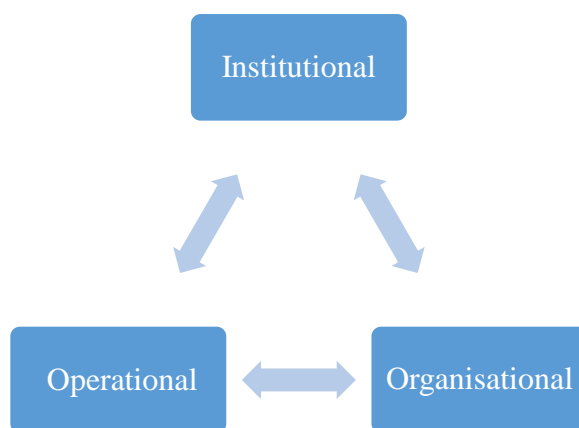
3. INSTITUTIONAL, ORGANIZATIONAL AND OPERATIONAL STRUCTURES OF THE BANKING GROUPS

In this section¹³ we conduct a preliminary analysis based on a tri-dimensional framework of the 129 banking institutions¹⁴ that comply with the significance test by the ECB. We first introduce the framework and then we describe each of the dimensions with the data collected for the 129 banks¹⁵.

3.1 Introduction of the tri-dimensional framework

We introduce the framework based on three dimensions that include the institutional, organisational and operational of a banking group operating in the EU.

Figure 1: A tri-dimensional analytical framework



Source: Ayadi and Ouchene (2016)

Each dimension corresponds to specific variables or criteria identification:

- Institutional refers to the ownership structure of the parent institution. This dimension is analysed based on the typology of ownership structure from the Banking Business Models Monitor (Ayadi *et al.*, 2015). There are five types of ownership structures that co-exist in the European banking market including commercial banks, which are typically shareholder-value (SHV) banks and cooperative, saving, public and nationalised banks which are typically stakeholder-value (STV) banks.
- Organisational refers to the global structure of each 129 banking groups. This structure includes the ultimate parent institution with its subsidiaries and/or branches (see Figure 2).
- Operational refers to the business model of the parent institution. This dimension is analysed based on the typology of the banks business model from the Banking Business Models Monitor (Ayadi *et al.* 2015). There are five models, which can be assimilated to the indicators that refer to the core business lines (which are assessed from an asset- liability or activity-funding mix perspectives) and matched with the critical functions as described by the EBA (2015). This dimension is analysed based on the number of subsidiaries and branches for the whole sample of 129 banking groups.

¹³ This section draws on Ayadi and Ouchene (2016).

¹⁴ The sample of 129 banking institutions supervised by the ECB is extracted from the ECB's list of supervised entities (ECB, 2016).

¹⁵ See Table 5 in Annex 2 for the breakdown of the 129 banking groups per size.

The preliminary analysis of the 129 systemic banking groups shows that the supervision and resolution of these banks is a complex and multidimensional process due to its systemic and multi-faceted nature. Our tri-dimensional framework provides a scheme to respond to the resolution challenge as rightly outlined by EBA (2015) when comparing the existing recovery plans of significant banking institutions.

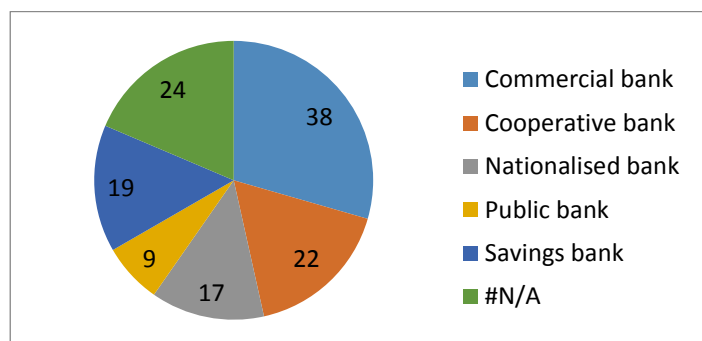
“[...] there was no consistency in the specific quantitative benchmarks, and most recovery plans did not indicate standards pre-defined market share to determine criticality. [...] The fact that the market for this type of service is often fragmented should also be taken into account. [...] As a consequence, the EBA recommends that specific quantitative benchmarks should not be included in the assessment of the criteria above [market share].” (EBA, 2015 p. 10).

“[...] the resolution authorities should take into account the institution’s business model and structure (i.e. the way an institution’s business is organised, including interconnections between businesses) [...]” (EBA, 2015 p. 15).

3.2 Description of the institutional, organizational and operational structures

In terms of ownership, the sample of 129 banking institutions is mainly composed of commercial banks (n=38) and cooperatives (n=22) as shown below in figure 2.

Figure 2: Ownership structure of 129 banking institutions supervised by ECB 16



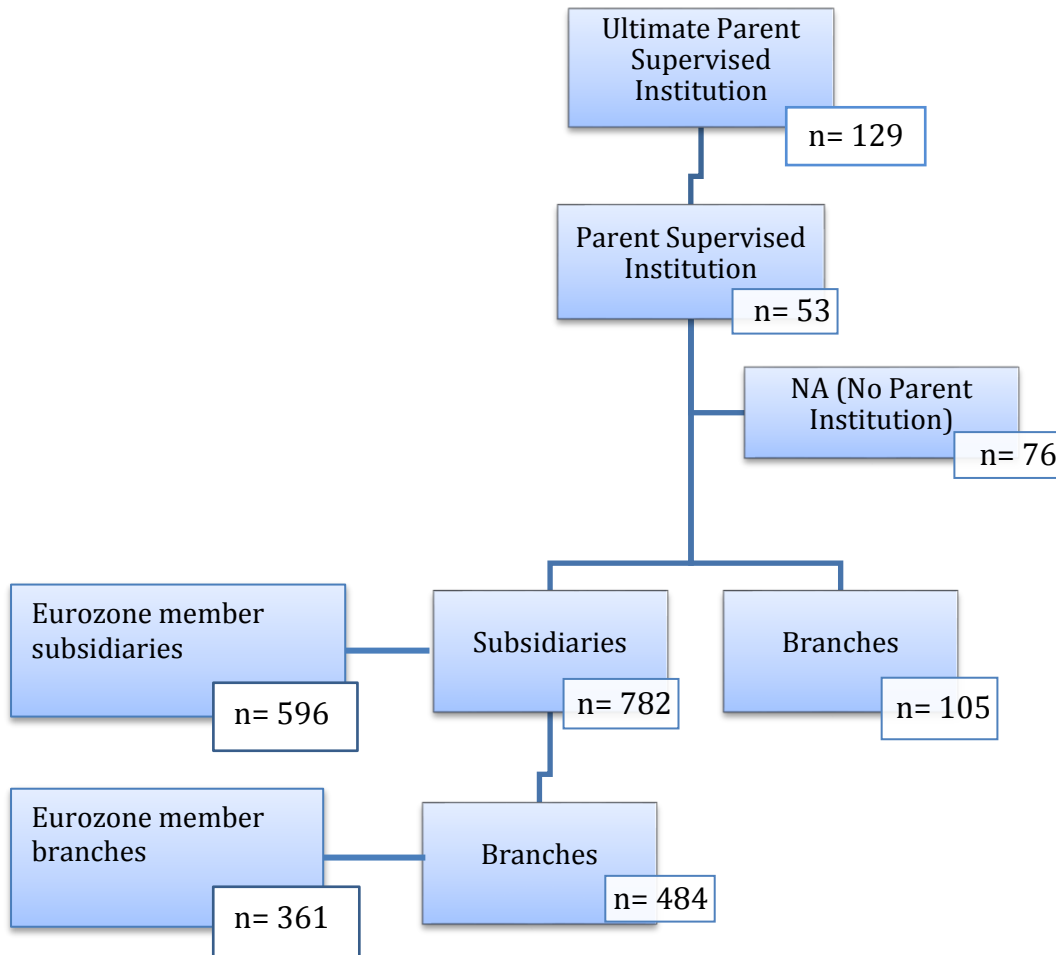
Source: Compilation from Ayadi and Ouchene (2016) based on data in Ayadi et al (2016)

From an organizational perspective, we have analysed the organisation of the 129 banking institutions based on two variables: number of subsidiaries and branches. The figure below shows the structure of the whole sample (n= 129). We have identified the countries of the subsidiaries (n=782) based on the number of ultimate parent institutions, the parent institutions and subsidiaries of the 129 banks’ sample. 596/782 subsidiaries are part of the Eurozone. These subsidiaries are located in 39 countries, which are either in or out of the Eurozone. Regarding the number of branches, there are 105/129 supervised banking institutions that have branches. In addition, if we look into the 782 subsidiaries, these have also their own branches (n=484). Of these branches, there are 361, which are part of the Eurozone¹⁷.

¹⁶ In this sample, there are 24 banking institutions which are missing data for these variables (represented by the symbol ‘#N/A’ in graphs).

¹⁷ Despite the availability of the variable ‘Number of branches’ in the SNL database, there is not enough available data on the country or region of these branches. This would require a further research in order to identify the host country and the adequate supervision authority.

Figure 3: Organisational structure of the 129 banking institutions



Source: Ayadi and Ouchene (2016)

In terms of the business models, we have used the definition and methodology of the BBMM Europe 2015 by Ayadi et al. (2016).

The Diversified retail (type 2) banks activities consist primarily of lending to customers, mainly using debt liabilities and customer deposits. Notwithstanding that the largest share of assets is allocated to customer loans, this category of bank obtained twice as much from trading activities than the other retail-oriented banks. They are relatively large in size and internationally active, as compared to the other retail-oriented banks.

The Diversified retail (type 1) banks combine lending to customers with a moderate percentage of trading activities (i.e. 31% on average) and they primarily use customer deposits. These banks are modest in size. The ownership structure is slightly tilted towards stakeholder value banks such as savings and cooperative banks.

The **focused retail banks** provide traditional services, such as customer loans and are funded by customer deposits. This is also reflected in their income, which consists mostly of net interest income and commission and fees, while trading income and other income are only minor components. The share of the banks that were identified as focused retail remained similar during the crises. These banks have an ownership structure that is slightly tilted towards stakeholder value banks (cooperative and savings banks).

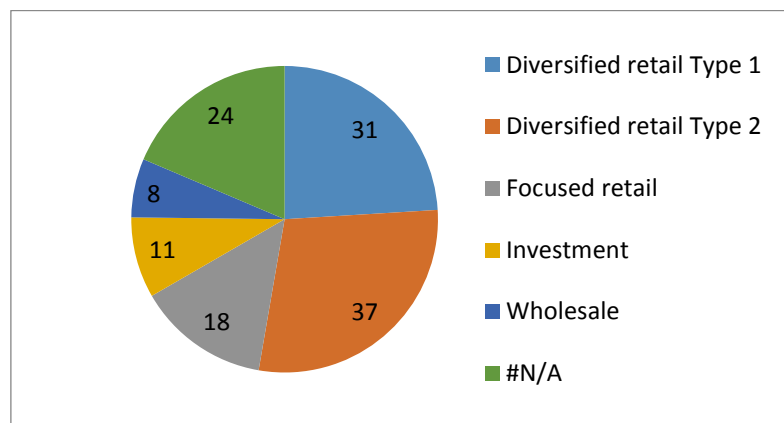
Wholesale banks engage in interbank lending and borrowing and are mainly categorised as shareholder value banks. However, they also include the central institutions of cooperative and savings banks that provide liquidity and other services to both local banks and public banks.

Investment-oriented banks engage in trading activities while relying on debt securities and derivatives for funding.

Source: Ayadi et al. (2016)

Figure 4 shows the type of business model according to the BBMM 2015 (Ayadi *et al.*, 2016).

Figure 4: Business model of 129 banking institutions



Source: Compilation from Ayadi and Ouchene (2016) based on data in Ayadi et al (2016)

As shown above, 37 supervised banks belong to the ‘Diversified retail Type 2’ and 31 supervised banks to the ‘Diversified retail type 1’. Followed by the other business models: ‘focused retail’ (18), ‘Investment’ (11) and ‘Wholesale’ (8).

When crossing and applying the three dimensions to the 129 banks, there are five broad models that can be identified based on the institutional structure which are broken down in 22 sub-models depending on their business models and organisational structure (See Figure 7 to 11 in Annex 2). One common denominator between all these models is the complexity of the overall structure. Banking groups that are commercial, which are typically shareholder value institutions and operationally investment oriented, are more involved in the capital markets where they serve critical functions such as in the bond market, secondary market and prime brokerage. These banks have thousands of branches in the eurozone. Others that are cooperatives and savings, which are typically stakeholder value banks and operationally retail banks, are very active in the real economy and retail markets. These banks have equally numerous branches as their commercial counterparts.

It is important to notice that all these banks regardless their ownership structure and business model are universal banks that combine at different percentages, retail, investment and, in some instances, insurance activities. These percentages evolve over time that makes their overall business model and hence their core business and the critical functions they serve move over time in case of external shocks or internal reorganisation.

4. RESOLVABILITY OF BANKING GROUPS

4.1 Resolvability assessment

This section considers the resolvability of banking groups, considering the tri-dimensional framework introduced and defined in Section 3.

A. Institutional Structure

Commercial private banking groups are typically organized using the legal form of public limited company (PLC) or société anonyme, with the main objective of profit maximization. However, in the light of the interests of other stakeholders beyond the interests of shareholders, notably depositors, there is a trend towards ring-fencing retail activities in a number of jurisdictions, including the UK, in order to facilitate the resolvability of banking groups. There is also a broader debate about the suitability of the PLC model for banking.

Cooperative banks have traditionally been local, mutual and in some instances not-for-profit organizations.¹⁸ However, this is changing as result of policy and legislative changes at the domestic level. For example Italy's recent reforms known as *la riforma del Credito Cooperativo*.¹⁹ Similar changes can be witnessed in the Netherlands where Rabobank Nederland reorganized its institutional structure becoming a single entity as result of the merger of 107 different legal entities and changed its legal name from Coöperatieve Centrale Raiffeisen-Boerenleenbank B.A. into Coöperatieve Rabobank U.A.²⁰ This illustrates a current trend towards consolidation and modernisation within cooperatives which aim to benefit from some of the features of commercial banking groups.

The case of nationalised banks (whether total or partial, permanent or temporary government ownership) and public banks – two other categories identified in section 3 and annex 2 – will not be further discussed in this section. We will not expand either on the category of 'saving banks' (which are often organized relying upon cooperative or mutual structure). These have a complex history in several Eurozone jurisdictions (like the Spanish 'cajas de ahorro' or the German 'Sparkassen') given their political and social considerations (which can also be impediments to resolvability).

B. Organizational Structures

As stated in section 3, the organisational criterion refers to the global structure of each of the 129 banking groups. This structure includes the ultimate parent institution with its subsidiaries and/or branches. This leads to a four-fold analysis, depending on where they operate (intra or outside the EU) and the reliance on branches or subsidiaries.

As acknowledged, the distinction between branches and subsidiaries is a legal one since branches are extensions of the same legal entity (the parent legal entity is the one that has legal personality) while subsidiaries are separate legal entities under the laws of the country of incorporation. This distinction has serious implications for resolvability purposes, as it does from the perspective of supervision (reliance on home authorities in the case of branches and host authorities in the case of subsidiaries). And like in the case of supervision, the trend towards consolidation is fundamental.

¹⁸ Under the 'genus' of cooperative banks there are credit unions, mutual savings banks, building societies and cooperatives.

¹⁹ Interesting examples can be drawn from ICCREA Group in Italy or Rabobank in the Netherlands. ICCREA Group is a network of 337 cooperative banks called Banche di Credito Cooperativo, Casse Rurali, and Casse Raiffeisen in Alto Adige (known as Banche di Credito Cooperativo or BCC). BCC, created a holding company to own the different lines of business and be able to raise capital from the markets.

²⁰ See Rabobank Nederland, Press Release, Rabobank General Assembly Approves new Cooperative Structure, dated 9 december 2015, https://www.rabobank.com/en/press/search/2015/20151209_governance.html.

If a banking group is organized through branches, it will present a more manageable structure for the purposes of resolution since it is a single entity. This notwithstanding, proper consideration must be given to the existence of branches deemed to be “significant” and the fact that large foreign groups may access the single market via the establishment of a branch²¹.

In these cases intra and extra-EU coordination might prove difficult. This might impose limitations if there is an attempt to resolve particular lines of business. If a separation or spin-off of certain lines of business within the operational structure (analysed below) is attempted, it might not be so simple for third parties to understand this attempt to divide between profit-making and loss-making entities resulting in unavoidable reputational costs.

As evidence has demonstrated, market participants are not always able to differentiate between profit-making or solvent entities and loss-making or insolvent legal entities.²² In a ‘subsidiaries’ model organizational structure, the resolvability of a banking group can result in a complex web of separate legal entities with or without crossed shareholdings.

The use of separate legal entities is convenient for the purposes of limiting the extent/degree of the expansion of liability across entities of the same group; however, the counter side of this is that it complicates the resolvability aspect since the banking group has to deal with a web of separate legal entities. To this end the choice between the multiple-point-of-entry (MPE) or single-point-of-entry (SPE) resolution strategies is crucial.

Substantial progress has been made at the EU level on domestic insolvency, but organisational complexity is still an unresolved issue if we are faced with a banking group simultaneously operating inside and outside the EU (e.g. Santander, UBS or Deutsche Bank). The latter opens fundamental coordination problems and can even generate conflicts with policies and priorities of different intra and extra-EU regulatory and supervisory agencies towards resolvability.

C. Operational Structure

When assessing the operational structures of banking groups, these can be classified in four to five additional sub-categories (i.e. besides the categorization outlined above between commercial v. cooperatives; branches v. subsidiaries; and, intra v. extra-EU) as was outlined previously:

- (1) Banking groups focused on investment activities (investment banking groups)
- (2) Banking groups focused on retail deposit taking activities (retail-focused banking groups)
- (3) Diversified banking groups types 1 and 2 combining both activities indicated before (deposit taking (Type 1) and market funded (Type 2) and investment banking or universal banking groups) and,
- (4) Wholesale banking groups.

From this analysis, there are a series of permutations that can be observed, for example, the resolvability of a (a) commercial, shareholder-value banking group that is organised via subsidiaries and is focused on investment bank activities with critical functions in the international financial systems (custody, international payment services, etc.) and operates intra and extra-EU is not the same as the resolvability of (b) a banking group which is a cooperative, stakeholders’ oriented, organised via branches and focused on domestic retail deposit taking activities.

²¹ The recent case in which ICBC being awarded a UK bank licence provides an example of the latter case

²² See Rosa M. Lastra and Rodrigo Olivares-Caminal, *Cross-Border Insolvency: The Case of Financial Conglomerates*, in John R. LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds.), *Financial Crisis Management and Bank Resolution*, Informa, 2009, pp. 276-277.

Rather than analysing each of the several possible scenarios—which are quite numerous (see annex 2- Figures 7 to 11 for all possibilities), it is more practical to derive some general principles: (1) diversification of the operational structures (or business structures) usually goes hand-in-hand with an increased number of subsidiaries; (2) mono-line operational structures add to vulnerabilities if there happens to be a shock in the specific sector of operations as there are no additional “buffers” that can absorb the shock, therefore exacerbating vulnerability (same can apply to retail and wholesale operational structures); (3) although diversified structures seem in principle to be less prone to risk, they can accelerate contagion from ‘ill’ businesses to ‘healthy’ activities of the banking group (e.g. case of Fortis that combined banking and insurance activities prior to the banking failure); and, (4) in wholesale scenarios, small events can gain a concerning magnitude quite fast due to the volume factor.

The operational structure can pose additional concerns since it does not necessarily mimic the institutional structure described above. Banks may be organised, inter alia, via hub-and-spoke²³ (or master-feeder) structures and/or via business lines running across different vehicles, and different operational business lines of the banking group resulting in an exacerbation of risk. For example, a banking group’s risk and liquidity management practices may be concentrated in one subsidiary but this subsidiary is interconnected to all or most of the other subsidiaries in the group. A similar situation can be encountered in the area of cross-group IT systems. The interconnectedness of the group is something, which is difficult to avoid, since economies of scale are what makes the business model of banking groups more profitable (with all their implied benefits) but can be a multiplier when addressing the resolvability of the group.

4.2 The legal framework

This section describes the legal framework pertaining to resolution under the BRRD and the SRM Regulation. Obstacles to the SRB’s ability to address impediments to resolvability are highlighted. Since the provisions applicable to resolvability in both texts are fundamentally similar, a parallel analysis of the two texts will be conducted only where there are considerable differences that may give rise to concerns. Where necessary, reference will also be made to EBA relevant guidelines on the matter²⁴.

Art 5 (1) SRM Regulation establishes the SRB as the relevant national resolution authority or the relevant group-level resolution authority for EU based cross border groups for the application of that SRM Regulation and of the BRRD (Directive 2014/59/EU).

The scope of the SRB is ample, even wider than the ECB supervisory remit. The SRB will have to adopt resolution decisions²⁵ for the entities referred to in Article 2²⁶ that are not part of a group and for groups: (i) which are considered to be significant in accordance with Article 6(4) of Regulation

²³ A hub-and-spoke structure is a common feature in investment structures where several non-core investment vehicles (“spokes”) pull their assets together by contributing to a central investment vehicle (“hub”). An important aspect of this structure is that each individual vehicle remains independent and individually managed.

²⁴ Specifically see EBA, *Guidelines on measures to reduce or remove impediments to resolvability*, EBA/GL/2014/11, 19 December, 2014; ID, *RTS on the content of resolution plans and the assessment of resolvability*, EBA RTS/2014/15, 19 December 2014; ID, *Comparative report on the approach to determining critical functions and core business lines in recovery plans*, on 6 March 2015.

²⁵ See article 8 of the SRB regulation.

²⁶ Article 2 of the SRB Regulation reads as follows: “This Regulation shall apply to the following entities: (a) credit institutions established in a participating Member State; (b) parent undertakings, including financial holding companies and mixed financial holding companies, established in a participating Member State, where they are subject to consolidated supervision carried out by the ECB in accordance with Article 4(1)(g) of Regulation (EU) No 1024/2013; (c) investment firms and financial institutions established in a participating Member State, where they are covered by the consolidated supervision of the parent undertaking carried out by the ECB in accordance with Article 4(1)(g) of Regulation (EU) No 1024/2013.”

(EU) No 1024/2013; or (ii) in relation to which the ECB has decided to exercise directly all of the relevant powers; and (b) *other cross-border groups* (emphasis added). These are defined as groups that have entities as referred to in Article 2 established in more than one participating Member State (Article 3 (24) SRM Regulation)²⁷.

The SRB may also at any time decide on its own initiative, after consulting the national resolution authority concerned, or upon request from the national resolution authority concerned, to exercise directly all of the relevant powers under the SRM Regulation also with regard to any entity or group which falls under the direct remit of national resolution authorities (Article 7(2), Article 7(4)(b) and (5) SRM Regulation).

The reason why it is important to consider the SRB remit is because, for those institutions not directly supervised by the ECB, coordination problems may arise among the national competent authorities and the SRB in assessing resolvability and its possible impediments.

In fact, the assessment of the resolvability of the group must be made by the SRB in consultation with the competent authorities, including the ECB, and the resolution authorities of non-participating Member States in which significant branches are located insofar as relevant to the significant branch. Such assessment should be carried out at the same time as the drawing up and updating of the group resolution plan²⁸.

The SRB shall also identify any material impediments to resolvability and, where necessary and proportionate, outline relevant actions for how those impediments could be addressed when drawing up and updating the resolution plan²⁹.

As resolution authority, the SRB also has discretionary powers to address impediments to resolvability. However, it is worth mentioning that actions to address impediments are to be taken by the competent authority rather than by the SRB. Also the relevant decision making process, which sees the involvement of the competent authority, the ECB and, where necessary, the macro-prudential authority, seems convoluted. Whilst this procedure is consistent with the Meroni doctrine and is in line with the specific allocation of competences among authorities, it may create again a coordination problem.

Actions to address impediments must be necessary and proportionate³⁰. Absent any definition in the Regulation, one may speculate that a measure is “necessary” if it is the best viable option against all the alternatives, whereas the assessment of proportionality should take into account the overall impact this may have on the group as a whole and possibly on market infrastructure. Paragraph 46 of the SRM Regulation limits the Board discretion to “what is necessary to simplify the structure and operations of the institutions solely to improve its resolvability” and that “action should not go beyond the minimum necessary to attain the objectives sought”.

For the purposes of Article 17 (5) BRRD³¹, EBA instead defines a measure as proportionate as follows:

²⁷ See also par. (22) of the SRB Regulation.

²⁸ See article 12(4) of the BRRD and article 10 of the SRB Regulation.

²⁹ See article 8(6) of the SRB Regulation. Group resolution plans are drawn up by group-level resolution authorities, together with the resolution authorities of subsidiaries and after consulting the resolution authorities of significant branches insofar as is relevant to the significant branch as established by art 12 (1) BRRD.

³⁰ See article 8(6) of the SRM Regulation.

³¹ Which indicates the possible measures the resolution authorities can impose on the entity to address impediments to resolvability.

“A measure is proportionate (...), if the overall benefits for making a liquidation in normal insolvency proceedings or resolution of the institution [are] feasible and credible and [if the overall benefits] for meeting the resolution objectives outweigh the overall costs and negative effects of removing the impediments to resolvability”³².

As for necessity, the EBA considers that:

“A measure is necessary to reach the intended goal if it is required to remove or materially reduce a substantive impediment to the feasible or credible implementation of the relevant resolution strategy, and if there are no less intrusive measures which are able to achieve the same objective to the same extent.”³³

Necessity and proportionality may be a further obstacle to group resolution as, depending on the level of intrusiveness, certain measures could be seen as disproportionate, hence be subject to appeal by the institution concerned. While the appeal does not automatically suspend the decision, it is unclear whether the institution will incur sanctions in case of non-compliance³⁴.

To ensure consistency across supervisory practices, EBA has issued a set of guidelines, which spell out further the list of possible measures that can be requested following Article 17 BRRD and the circumstances in which each measure can be applied³⁵. For our purposes, one key theme seems to emerge from those guidelines: the problem of dealing with cross border/third countries issues (applicable laws, recognition of resolution proceedings and obstacles to termination/novation/amendment of contracts).

Even if more research is needed on the degree of third country penetration of EU banking groups and of those single entities that fall under the SRB domain, it is reasonable to expect that the provision of some services to groups or sub-groups or entities that may be affected by EU resolution proceedings are located in non-EU countries.

4.3 Resolvability issues pertaining to banking groups

In what follows, we will give a bird’s eye view of impediments that are likely to appear in all or certain group structures. Annex 4 provides a table where specific examples are given: these are linked to a suggested course of action by the SRB to the evaluation of the necessity and proportionality requirement.

A group shall be deemed to be resolvable if it is feasible and credible for the resolution authorities to (1) either wind up group entities under normal insolvency proceedings or (2) to resolve group entities by applying resolution tools and powers to group entities³⁶.

On a pragmatist approach, (1) above can always be achieved as evidenced with the insolvency of Lehman Brothers. However, this does not necessarily always mean that it will be economically efficient or that it will be self-contained (and will not spread to other entities and eventually result in a systemic crisis, as also evidenced by the collapse of Lehman Brothers). Therefore, (2) would almost inevitable be the tool of choice of the resolution authorities due to the special nature of banks.

³² See EBA guidelines on impediments to resolvability supra 24 at p. 10.

³³ *Ibid.*

³⁴ See article 85 of the SRB regulations establishes that «Any natural or legal person, including resolution authorities, may appeal against a decision of the Board referred to in Article 10(10), Article 11, Article 12(1), Articles 38 to 41, Article 65(3), Article 71 and Article 90(3) which is addressed to that person, or which is of direct and individual concern to that person».

³⁵ EBA guidelines on impediments to resolvability supra 24.

³⁶ See article 16 of the BRRD and article 10 of the SRB Regulation.

According to Article 17, paragraph 5: “ ... resolution authorities shall have the power to take any of the following measures:

(g) require changes to legal or operational structures of the institution or any group entity, either directly or indirectly under its control, so as to reduce complexity in order to ensure that critical functions may be legally and operationally separated from other functions through the application of the resolution tools;

(h) require an institution or a parent undertaking to set up a parent financial holding company in a Member State or a Union parent financial holding company; ... ”

It seems that the required powers are vested to the resolution authorities to address any structural or operational impossibilities to resolve a group and maintain its critical functions. However, its implementation is not simple and can have risk management implications and a potential political cost. On the former, the main rationale for the emergence of several legal entities has mainly to do with reducing legal risk, which has been historically supported by the concept of separate legal entity in corporate law and liquidation or winding up in insolvency law. On the latter, i.e. the political cost, if substantial changes are required which, under the group’s view will deter its risk management or would have a financial impact on its return, can force the group to migrate its operations to a more favourable jurisdiction. In addition, a special remark should be made in regard to (h) above, since this would contribute towards a simpler resolvability of the group within the European Union but this still will not address the issue of coordination in the case of GSIBs.

SRB assessment of resolvability and possible impediments to resolvability is inextricably linked to the preferred resolution strategy. The starting point of any possible resolution strategy planned *ex ante* would be the choice between an SPE and a MPE. This is why a possible preferred resolution strategy is indicated in the annex below.

One of the guiding principles in resolvability assessment should be the need “to ensuring the continuity of critical functions carried out by the group entities, where they can be easily separated in a timely manner or by other means”. In their «Comparative report on the approach to determining critical functions and core business lines in recovery plans», EBA surveys the different definitions of critical functions³⁷. All of the different definitions identify a function as critical on the basis of its impact on financial markets, financial stability and the real economy, on their level of substitutability and as a proportion of total system capacity.

BRRD Annex C covers critical “operations”, rather than “functions” in the assessment of resolvability, however, absent any definition of critical operations in the Directive, it is likely to assume that the terms are used interchangeably.

EBA instead laments the lack of clarity in the BRRD definition and suggests that this should be better defined. Specifically EBA notes how in «critical function” the term ‘functions’ means activities, services and operations provided to third parties and should not be determined from a merely internal perspective oriented at the business and organisation of the institution». EBA also notes how the identification of critical functions is “intrinsically linked” to the “concept of the underlying services that are essential to the setting up of the deliverable services, relationships or operations to third parties”³⁸. Critical services are those underlying activities needed to provide one or more critical functions in fact.

³⁷ See EBA Comparative report on the approach to determining critical functions and core business lines in recovery plans, *supra* 24, page 7, in footnotes 3, 4 and 5.

³⁸ See EBA, Technical advice on the delegated acts on critical functions and core business lines, EBA/Op/2015/05, 6 March 2015, p. 6.

Against those definitional problems, banks seem to have identified critical functions mostly on the basis of their systemic importance and their substitutability. To this end, examples of critical functions are: retail and corporate deposits, retail and corporate lending, payments, clearing and settlements, derivatives, secondary market trading, debt capital markets and custody services.

Besides the lack of a clear definition of critical functions, the SRB may encounter several problems when addressing impediments to resolvability. These can be divided into 4 main groups: 1) the inability of the bank to correctly map them³⁹ which in turn may impact both the correct choice of resolution strategy and of possible alternative measures 2) the feasibility of substitutability due to possible legal and structural⁴⁰ obstacles; 3) legal obstacles pertaining to the provisions of those services to third countries parties; 4) obstacles pertaining to the underlying critical services which are vital to the delivery of those functions (such as IT services).

EBA has already expressed concerns on the ability of cross border banking groups to map their core business lines and critical functions⁴¹ mostly related on their identification on the basis of judgmental evaluation and qualitative considerations rather than being supported by quantitative information and objective and detailed analysis. Also EBA considers that in some cases banks may confuse critical functions with core business lines and there is no analysis of the relative importance of the function to different group entities.

Also, in deciding the preferred resolution strategy (SPE or MPE), consideration should be given to the extent to which critical functions are integrated within the banking group and the dependency of material entities onto these integrated functions. SPE may be preferable in case of high level of integration.

Further impediments to resolvability the SRB can face relate to:

- Effectiveness of bail in: in case of a highly integrated domestic commercial group it is likely to imagine that the resolution authority would like to adopt an SPE resolution strategy. In absence of a pure holding company (HC), there may be obstacles to the use of the bail in tool. In fact, the creation of a pure holding company in an SPE resolution scenario would in principle mitigate the impact of resolution proceedings over the liabilities of the operational subsidiaries because the HC will bear the “capital liabilities”, e.g. losses will be imposed on the HC capital. Further losses will then be borne by the HC unsecured term debt, which will be the one to be bailed in. This will further shield the operational subsidiaries because the HC debt would be structurally subordinated to credit claims against them. From this follows that in absence of a HC questions related to the subordination of TLAC may arise as well.
- Funding structure: the group funding structure will have to be carefully assessed against the SRB preferred resolution strategy and tools. For instance it has been noted⁴² that firms may make extensive use of structured notes with different structures and embedded derivatives. The correct evaluation of these can be difficult to make and bail in may not be possible. Another concern arises with the use of non-equity capital instruments by the operating firms⁴³ issued as TLAC or MREL. For them to achieve the intended objective, the issuing subsidiary may have to be put into resolution. This may be in contrast with an SPE strategy. Also, should this type of debt be issued by a subsidiary incorporated in a foreign jurisdiction, the powers of the SRB to bail it in may be

³⁹ Supervised entities have a duty to cooperate in the drafting of the resolution plans by providing resolution authorities all information necessary to draw up the plans, which will include a mapping of their critical functions. See article 8 of the SRB Regulation. A full list of necessary information is included in annex B of the BRRD.

⁴⁰ For instance when the infrastructures needed to carry out those services are too complex to unbundle.

⁴¹ See EBA criticisms at page 6 of the EBA comparative report on recovery planning supra 24.

⁴² See Andrew Gracie, TLAC and MREL: from design to implementation, 17 July 2015, available here <http://www.bankofengland.co.uk/publications/Pages/speeches/2015/834.aspx>.

⁴³ *Ibidem*, p 5.

uncertain. Finally, those groups, which operate mainly via subsidiaries, may not be able to disentangle easily their intra-group liabilities that may in turn hamper the self-sufficiency of a legal entity in a resolvability scenario. Also, this may create liquidity management problems. The SRB should require groups to disentangle the maze and to be able to attribute funding and liquidity strategy at individual entity level. As a consequence, the SRB should also require the existence of strong internal governance mechanism, which will allow the smooth functioning of the process. To tackle funding problems, in the US, resolution authorities may require the creation of a clean holding company⁴⁴, which will be banned from issuing short-term debt to external investors and from entering into derivatives and certain other types of financial contracts with external counterparties.

- **Maintaining critical functions in resolution:** as discussed above, in a highly integrated commercial group, the mapping and the provision of critical functions may be hampered during resolution, especially because companies which provide services essential to the provision of those functions may be located outside the group and they may even be located abroad. To ensure continuity, one solution for the SRB would be to require groups to create an in house model for the delivery of shared services, which is able to be insulated and to operate on a stand-alone basis. Where this is not possible there should be inter-affiliate contractual agreements, which guarantee the provision of those services in resolution.
- **Cash and liquidity management:** both domestic and international groups may adopt capital pooling strategies as cash and liquidity management. A cross border cash pool can take different structures (physical, notional or hybrid), different names (sweeping and notional), and forms (pooling per country or pooling per legal entity) but in essence it allows banks to concentrate in one locations the cash it holds in different countries, currencies and subsidiaries. However, in case of resolution it may be difficult to track down the original owners of the cash, *i.e.* the relevant entity, and the attributable amount. In preparing for resolvability, the SRB should require groups to map and reduce the level of cross border multiple cash sweeping arrangements.
- **Relationship with third parties:** under this broad heading, we include all those types of contracts (ranging from premises lease to repos), which may include acceleration/termination/cross default clauses that may be activated in case of event of default. The relevant impediments to resolvability are applicable to all types of groups, with an increased level of complexity and seriousness for those international investment focused groups. Whereas Article 71 of the BRRD deals with termination rights, its remit is not absolute. Many contracts fall outside its scope, for instance those concluded with counterparties located in a foreign (non EU) jurisdiction and those that are not directly linked to a crisis prevention measure or a crisis management measure such as rights to terminate arising from any other default, including failure to pay or deliver margin. The SRB should require banks to include specific clauses in those contracts.

It should also be marginally noted that in resolution, groups might face a HR problem under two perspectives: 1) the ability to retain key staff and 2) to comply with employment law in case of dismissal. The first case may be exacerbated when the key staff, while being formally employed by a specific legal entity, performs functions that are critical across the board. In all these cases SRB should require the inclusion of ad hoc provisions in the relevant contracts.

⁴⁴ See Board of Governors of the Federal Reserve System, Press Release dated 30 October 2015, available at <https://www.federalreserve.gov/newsevents/press/bcreg/20151030a.htm>.

5. CONCLUSIONS

This paper has discussed some key aspects related to the legal and operational structures of banking groups in the Eurozone in order to assess the impact of such structures upon banks' resolvability.

Our preliminary analysis has focused on the 129 significant banking groups supervised by the ECB and provides an insight into the complexity and multidimensional nature of the supervision and monitoring of banking groups within the framework of the SSM. We consider the data available from those 129 groups under a tri-dimensional taxonomy, considering their institutional organizational, and operational structure.

Based upon such data and taxonomy, the paper raises a number of questions or issues as well as impediments to resolvability that the Single Resolution Board might consider in their assessments in the light of the Bank Recovery and Resolution Directive and the SRM regulation.

The paper outlines avenues for further research since greater clarity is needed to understand both the legal and the operational structures of banking groups in the euro area and how such structures impact upon their resolvability bearing in mind the need to maintain the continuity of critical economic functions in resolution. Banking groups may also change or adapt their structure/s in the light of regulatory and legislative changes (e.g. ring-fencing).

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Figure 5: Differences between a Banking Group and a Mixed/Financial Conglomerate

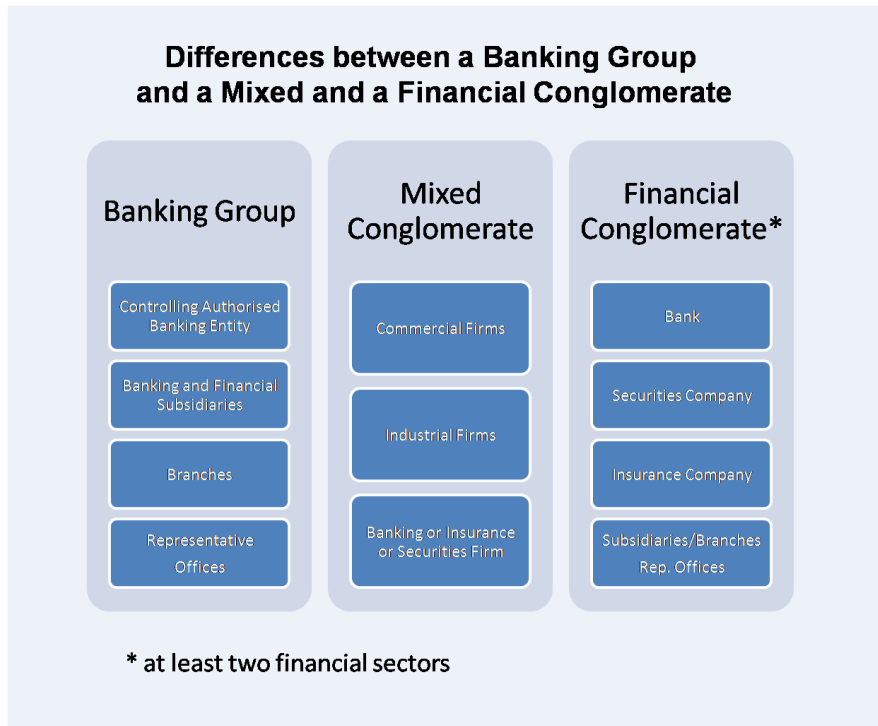
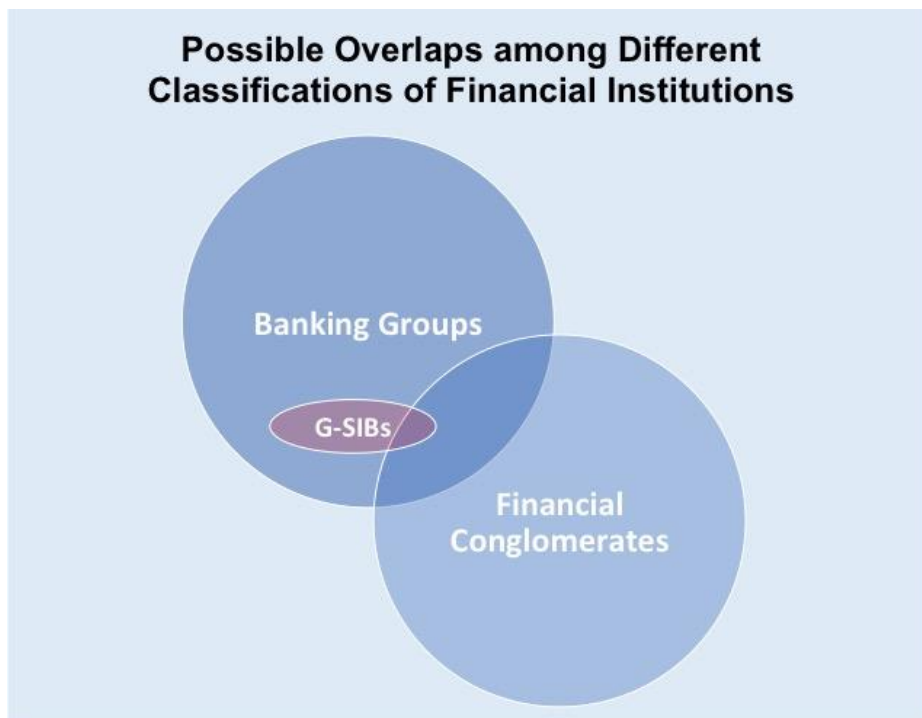


Figure 6: Possible Overlaps among Different Financial Institutions' Classifications



ANNEX 2

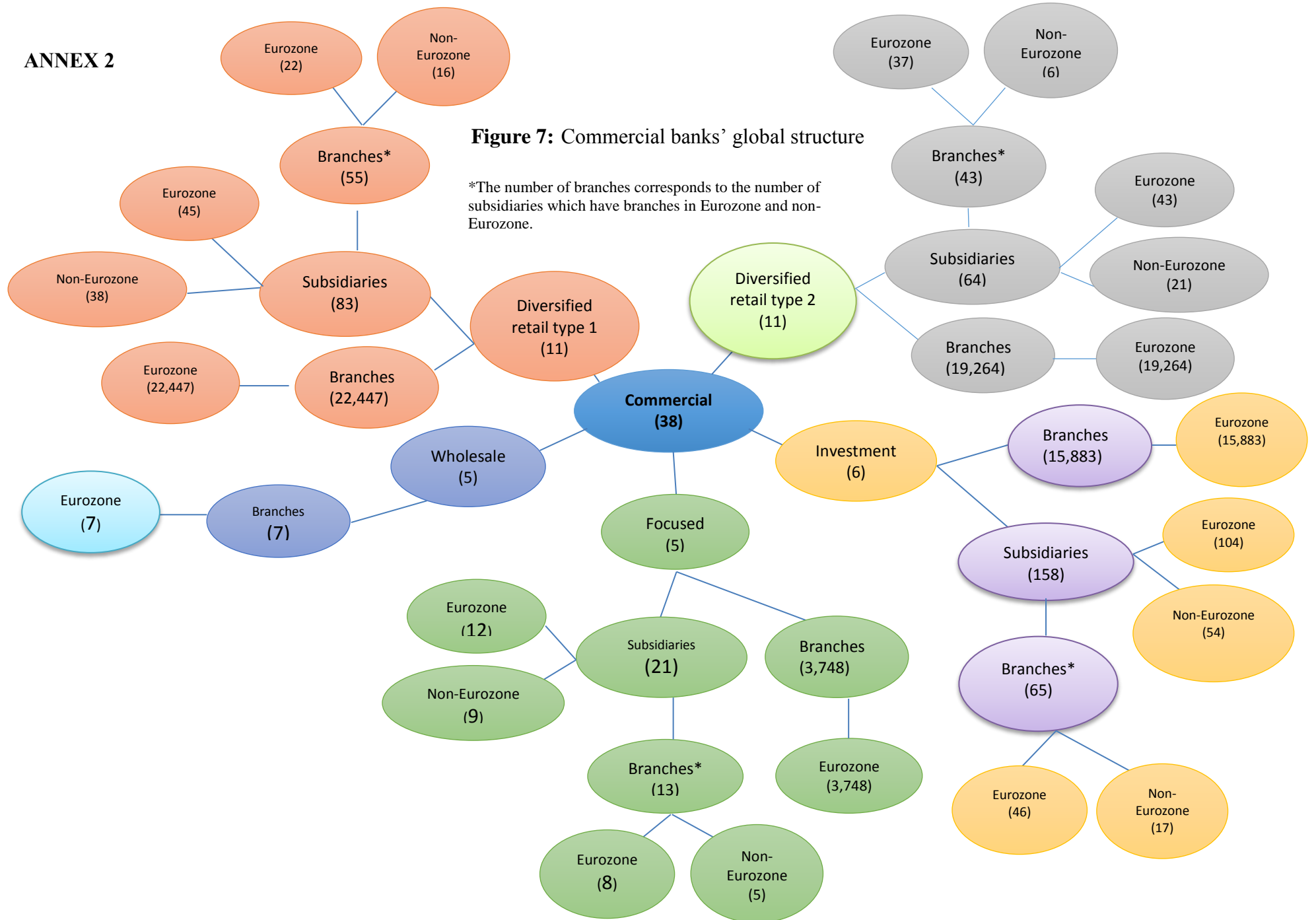
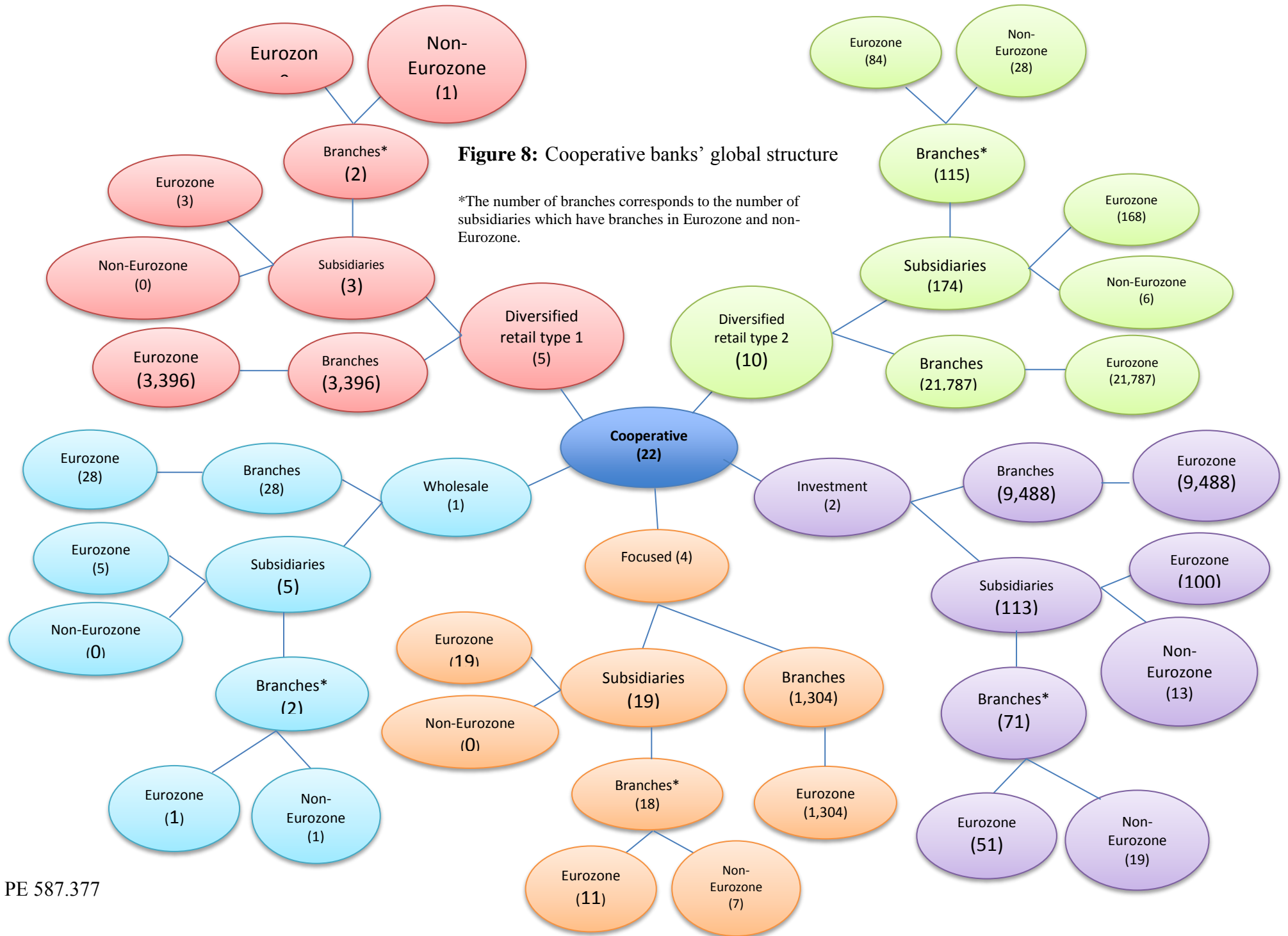
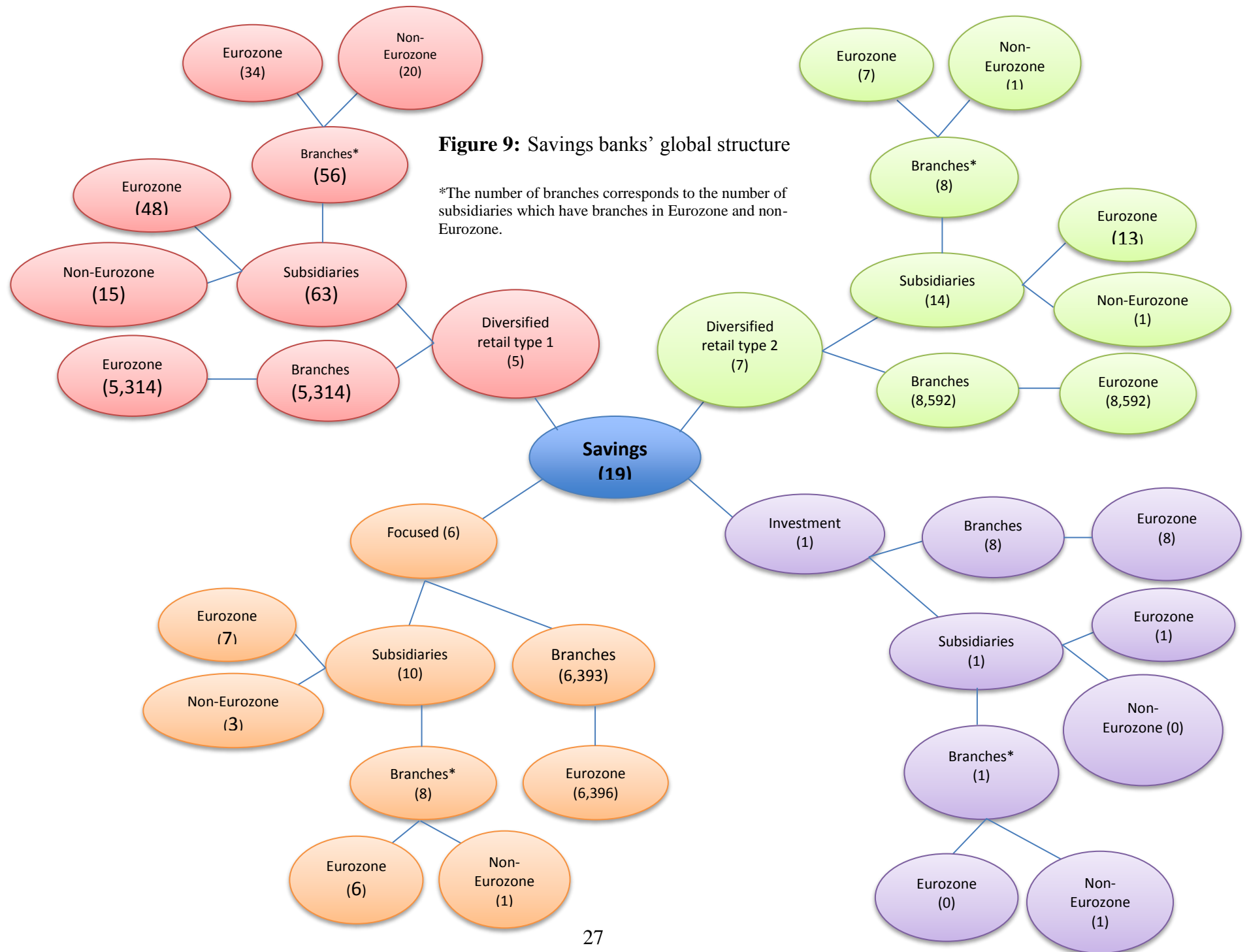


Figure 7: Commercial banks' global structure

*The number of branches corresponds to the number of subsidiaries which have branches in Eurozone and non-Eurozone.





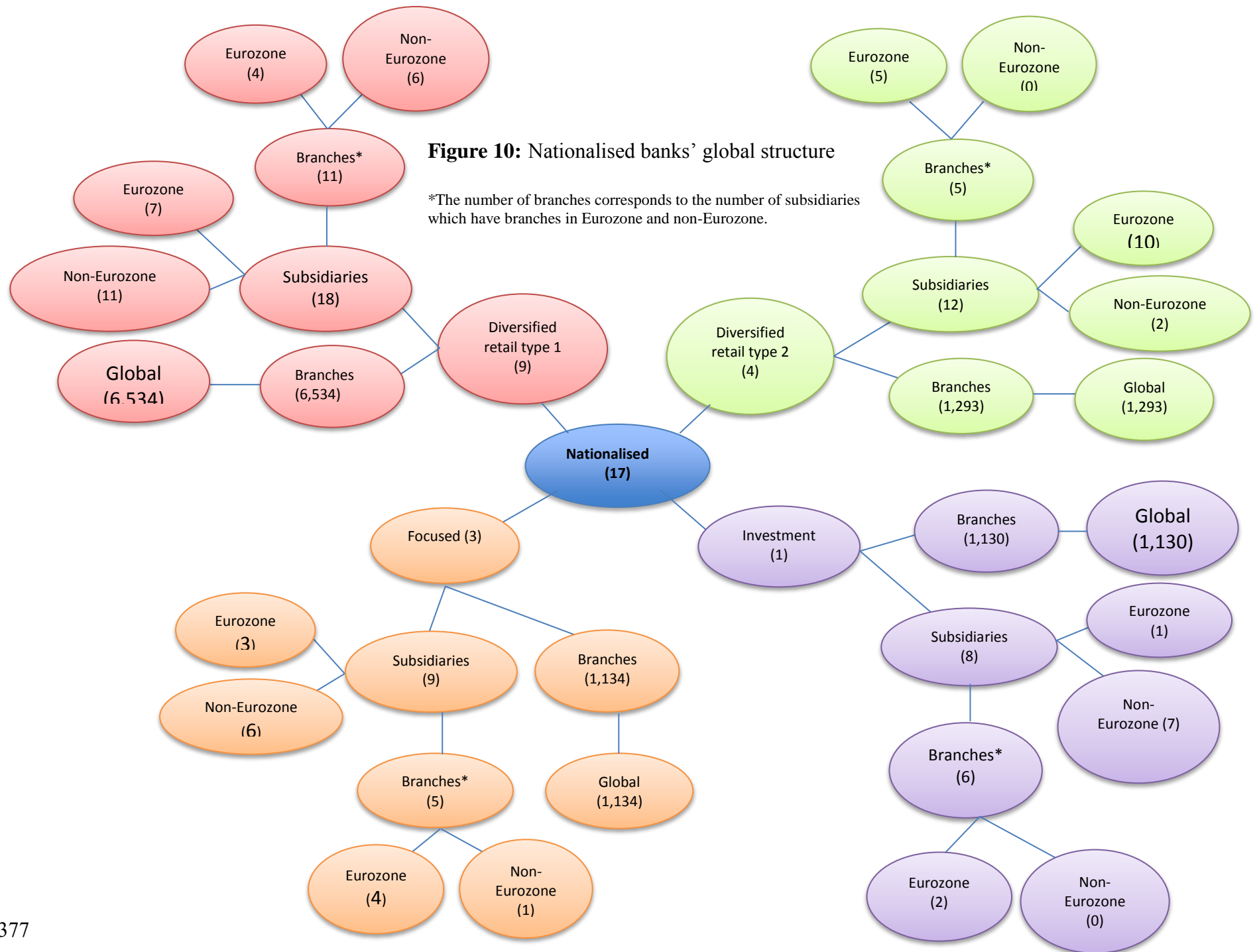


Figure 11: Public banks' global structure

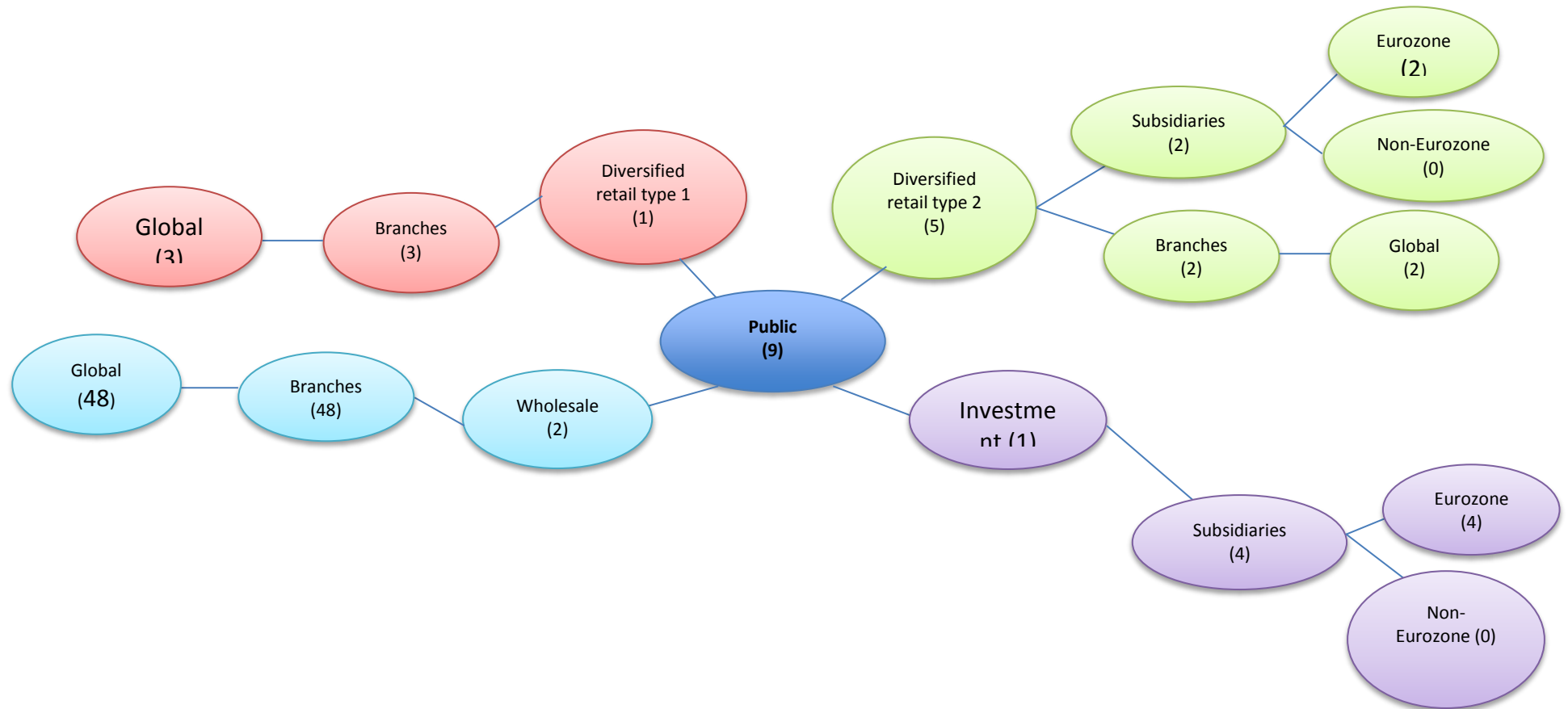
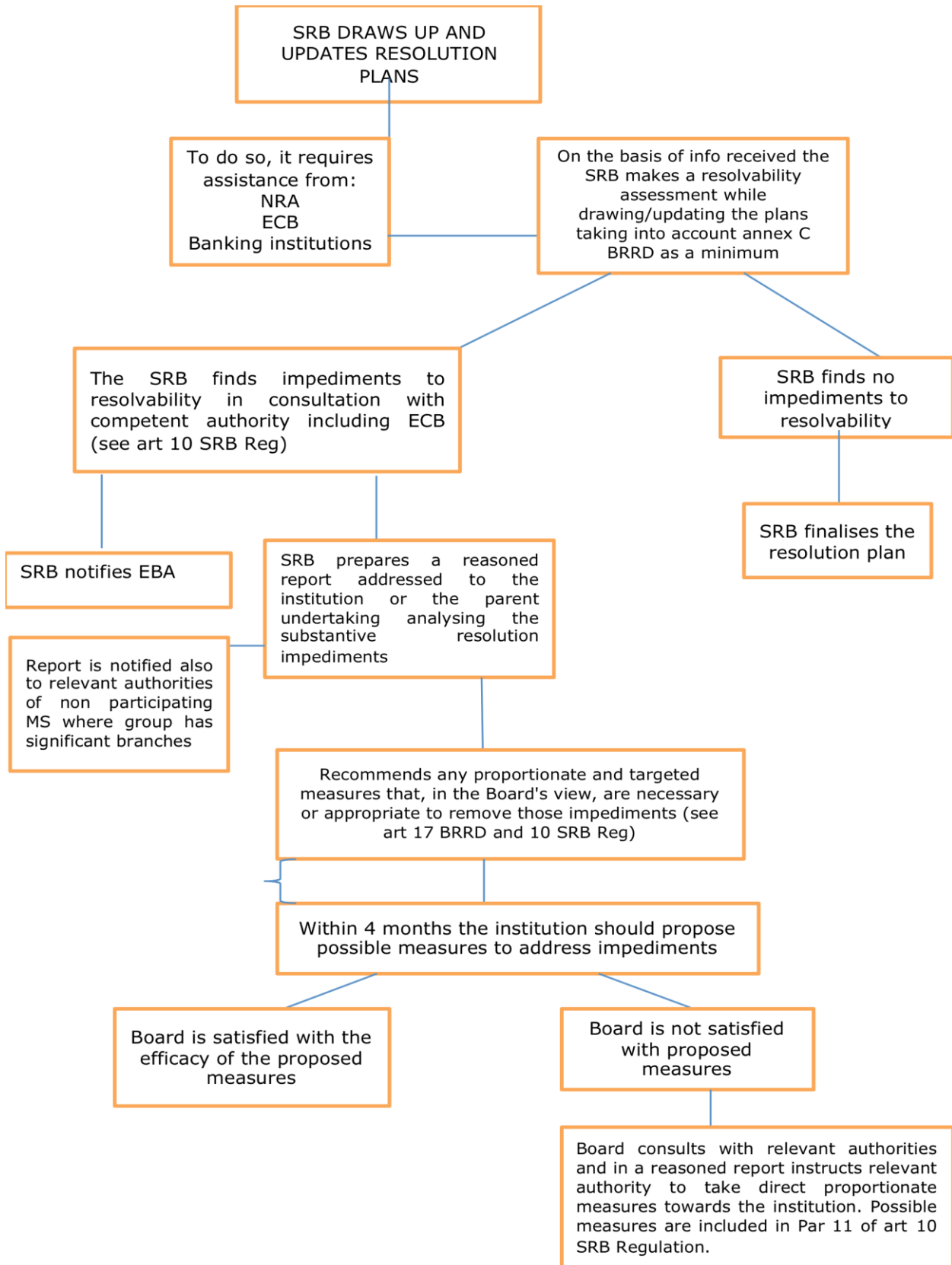


Figure 12: Resolution Trail



ANNEX 4

| Type of impediment | Type of group | Intensity | Rationale | Preferred resolution strategy | SRB suggested action | Is the measure necessary and proportionate? |
|--|---|---------------|--|---|---|--|
| The bail-in tool may not be effectively applied | Highly integrated Domestic Groups with a subsidiary model which lack a pure holding company (HC) at the top | Medium | The HC may be able to absorb the capital liabilities in an SPE scenario and then further losses via the bail-in tool | SPE | Require group to set up a HC | Yes, depending on group legal and operational structure |
| Difficulty to access capital markets for the sale of business tool/to raise funds in case of emergency | Retail focused cooperative groups | Medium / high | The typical ownership structure may not incentivise market-led solutions | SPE | Require cooperatives to operate via a holding company | Yes, depending on group ownership and applicable law |
| Critical functions are difficult to separate | Highly integrated pan European/ international groups | High | Critical functions do not follow the legal entity but are provided across the board by, usually, third party | SPE/MPE | Require group to set up an in house service company | Yes, depending on group size and level of integration |
| Resolution is disruptive to financial markets | Domestic and International investment focused groups | High | Groups with an Investment focus are more likely to be have large exposures in their trading books. | SPE/MPE | Require group to have portfolio wind down simulation plans. Ideally these should also highlight financial interconnections among banking entities and the broker/dealers. Also a portfolio segmentation analysis should be requested as well. | Yes |
| Third parties contracts include terminations/acceleration/ cross default clauses in case of event of default | Investment and diversified international groups | Medium / high | This is due to the level of cross border penetration and/or the business model, adopted by the group. A large scale, disorderly closed out of financial contracts may be very disruptive | MPE/SPE or a combination (MPE with regional subgroup SPE) | Require companies to include ad hoc contractual provisions which wave early termination rights/acceleration/cross default clauses for certain contracts and in those situations in which art 71 BRRD does not apply. They should also provide for recognition of resolution actions by home authorities | Yes, depending on the size, funding models and cross border penetration of the group |
| Liabilities, including MREL, are difficult to disentangle | Domestic and international retail and diversified groups | High | This is due to both intragroup transfers and to cash and liquidity management techniques | MPE/SPE | Require groups to have a clear structure of liabilities at legal entity level | Yes, depending on group size and integration |
| Cooperation and coordination problems with foreign jurisdictions | All International groups | Medim / High | A series of legal obstacle may arise in groups with a strong extra-EU presence, which may hamper the feasibility/credibility of the resolution strategy | N/A | SRB to have in place bi-lateral cooperation agreements with foreign jurisdictions | N/A |



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