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Bank Resolution and Creditor Distribution: The Tension Shaping Global Banking – Part I: "External and Intra-Group Funding" and "Ex Ante planning v. Ex Post Execution" Dimensions*

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Bank Resolution and Creditor Distribution: The Tension Shaping Global Banking – Part I: "External and Intra-Group Funding" and "Ex Ante planning v. Ex Post Execution" Dimensions[*]

David Ramos[*]

Javier Solana[*]

Banking has drastically changed since the 2007-2009 financial crisis and its aftermath. Of all the reforms that impinge upon the ability of global banks to run their business, none is more consequential than the new frameworks on bank resolution, which try to end "too-big-to-fail." Yet bank resolution's "macro" goals, such as systemic stability, limitation of contagion, and avoidance of moral hazard, run in the face of insolvency law and the more "micro" principles underpinning it. Among the latter, none is more pervasive than the need for fairness between creditors, and between (and within) creditor classes, enshrined in the ranking and priorities' systems under insolvency law. At first glance, these demands could set bank resolution and insolvency laws on a collision course with each other. On closer examination, however, the picture is much more

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complex, for the tension between bank resolution and insolvency law is giving rise to a series of equilibria that are giving shape to the modern face of global banking. This and a succeeding article provide an analytical framework to aid in grasping the full picture, which is a difficult, and often overwhelming, enterprise. The proposed analytical framework breaks down the complexity of international banking into three different layers: the "individual bank v. group" dimension, the duality of crisis-management (ex post) and crisis-prevention (ex ante) tools, and the cross-border dimension. We explore each of these three layers incrementally, drawing from precedent analysis as we progress. Part II of this article provides a general analysis of the tensions between bank resolution and insolvency law and introduces the analytical framework. It then moves on to explore the first two layers within that framework: the group dimension, and the duality of crisis-prevention and crisis-management tools. A separate article will address the cross-border dimension.

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I. INTRODUCTION

The collapse of numerous financial institutions since the outbreak of the 2007 financial crisis evidenced the inadequacy of insolvency law to manage the resolution of complex financial institutions. In the years that followed many of these collapses, new bank resolution frameworks have been put in place that aim to address the shortcomings of insolvency law; most notably, the Orderly Liquidation Authority (OLA) in the United States (US),[1] and the Bank Recovery and Resolution Directive (BRRD) in the European Union (EU).[2]

But even if these new frameworks try to take bank resolution out of the scope of insolvency law, questions about how losses will be

[1] Title II of the Dodd-Frank Act, § 12 USC 5380.

[2] *See* Directive 2014/59/EU, of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (hereafter: BRRD).

distributed among creditors remain. These distributional questions are at the heart of insolvency law, and, to the extent that priority rules in insolvency represent a legislature's basic benchmark of fairness, they cannot be ignored. The potential for conflict between how each of these frameworks addresses those distributional questions is a serious concern if we are to rely on new resolution frameworks to help us weather the next financial crisis.

At first sight, this potential conflict seems to recall an old paradox: what happens when an unstoppable force (a new resolution framework that will prevent the next financial crisis) meets an immovable object (a standard of fairness that is reflected in insolvency law)?[3] Or perhaps the question is not so much a paradox but a mind trick: if the force prevails, the object was not immovable; if the object does not move, then the force was not unstoppable.

Our goal in this paper is to explore this seemingly intractable problem. First, we provide a general description of banks' funding and structure, and of the origins and justification of bank resolution. We also explore the frictions that bank resolution rules create with insolvency at the level of policy goals, interpretative principles and decision-making procedures, and we present an analytical framework to examine how those frictions will give rise to practical problems when resolution authorities apply the new bank resolution rules. This analytical framework is comprised of three layers that reflect the main sources of complexity in bank resolution: the bank-group dimension, the co-existence of ex-ante and ex-post resolution mechanisms, and the cross-border dimension of bank resolution. We examine each of these layers in turn and we do so in an incremental manner, the analysis of each layer building on the analysis of any preceding layers.

In Section III we examine the first layer. We discuss how frictions of policy and principle can increase uncertainty about the treatment of key categories of bank liabilities in the context of bank resolution, including those liabilities held by third parties and those held within the group. We examine the second layer in Section IV. Here, we discuss how the rules on *ex-ante* planning try to sidestep the uncertainty identified in the first layer by changing the nature of liabilities that are external to the banking group and that are subject to bail-in, and by changing the very structure of banking groups. We also explore how these changes might affect *ex-post* crisis-management.

The third layer, which encapsulates the cross-border dimension of bank resolution, adds yet another level of complexity to the problems

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[3] The formulation of the paradox is attributed to attributed to a Chinese proverb found in a philosophical book written in the 3rd century, entitled *Han Feizi*.

identified in the first two layers. We examine this third layer in the second part of this paper, where we also reflect on how the attempts of financial regulators to deal with these problems are effectively reshaping the face of global banks. In the second part of the paper, we also draw some conclusions about what bank resolution was supposed to achieve, the obstacles it encountered, and the direction it, and global banking, are taking as a result.

II. BANK RESOLUTION: A (LAYERED) ANALYTICAL FRAMEWORK

This section presents the analytical framework that we will use to conduct our analysis of bank resolution frameworks in this and the succeeding article. We first provide a brief description of the complex bank structures that introduces key concepts that will be relevant for the ensuing analysis. We also provide a brief description of bank resolution frameworks worldwide (A). Then we describe how differences between bank resolution and insolvency law at the level of policies (B) and principles (C) can give rise to interpretative problems in cases where some creditors will have to be protected at the expense of other creditors. We conclude this section with a description of the analytical framework that we will use to examine these problems (D).

A. Context

i. Banks' Funding and Structure

To gauge the impact of different resolution and insolvency rules, one needs, first, to know the type of claims arising from banks' funding structures to which those rules would be applicable. It is possible to distinguish three explanatory dimensions among these funding structures: i) the transnational dimension, ii) the external-internal dimension, and iii) the institutional dimension.

The transnational dimension distinguishes between domestic and cross-border banks, especially the different models within the latter class. In addition to the problems that domestic banks pose for resolution and insolvency rules, cross-border banks pose unique problems that stem from their transnational dimension. We focus our analysis on cross-border banks.

Banks' corporate and funding structures are not uniform, but they tend to move around stable choices, which, in the transnational context, tend to be influenced by macroeconomic, financial, and regulatory

conditions.[4] Using banks' "business models" as a criterion for classification, we can distinguish between "multinational banks", which maintain sizeable foreign branches and subsidiaries in multiple jurisdictions, and "international banks", which, despite their important international presence, generally conduct their cross-border activities from the jurisdiction of their headquarters.[5] A second criterion[6] uses "funding models", and distinguishes between "centralized" funding, where banks borrow in international interbank markets, raise funds from non-bank investors through international deposits, or issue debt in international capital markets, and then use intragroup funding to distribute those funds; and "decentralized" funding, where banks fund their operations locally and each subsidiary enjoys a high degree of autonomy raising funds in its own name.[7]

Business and funding models can vary across jurisdictions, with Spanish banks being an example of multinational banks with decentralised funding;[8] Japanese banks, an example of international banks with centralised funding;[9] and US or UK banks, a mixed case.[10] Models can also vary with time, in response to macroeconomic or financial conditions. The post-crisis environment has signalled a retreat of global banking and of banks' international activities and exposures[11] in response to the perception that cross-border links were a source of contagion,[12] leading banks to pivot from international to multi-national business models.[13] In terms of the banks themselves, the impact was less

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4 This allowed banking institutions not only to change their investment profile, but also to diversify their sources of funding, by resorting to international interbank markets, including wholesale funding markets. *See* Leonardo Gambacorta, Adrian van Rixtel & Stefano SCHIAFFI *Changing Business Models in International Bank Funding*5-6 (Bank for Int'l Settlements BIS Working Papers No. 614, 2017) https://www.bis.org/publ/work614.pdf.

5 *See* Robert McCauley et al, *After the Global Financial Crisis: From International to Multinational Banking?* 64 J. of Econ. and Bus. 7,11 (2010).

6 *See* Gambarcorta, *supra* note 7, at 4.

7 And according to its own credit rating. *See* Merck-Martel et al, *Business Models of International Banks in the Wake of the 2007-2009 Global Financial Crisis,* Bank of Spain, *Revisista de Estabilidad Financiera* No. 29, 101 (2012).

8 *See* Gambarcorta, *supra* note 7, at 5.

9 *See id*.

10 *Id.* For example, some US banks use UK subsidiaries for managing European operations and funding, and UK banks use US subsidiaries for the same purpose.

11 *See* Pablo Garcia Luna & Adrian Van Rixtel, *International Interbank Activity in Retreat*, Banking for Int'l Settlements Q. Rev., Mar. 2014, at 14,15.

12 *See* Nicola Cetorelli & Linda S. Goldberg, *Global Banks and International Shock Transmission,* IMF Economic Review 1, 1 (2011); Hyun Song Shin, *Global Banking Glut and Loan Risk Premium*, 12th Jacques Polak Annual Research Conference 1, 3 (2011).

13 *See* McCauley et al, *supra* note 8, at 8.

significant for US and Japanese banks, whereas European banks retreated more.[14] In terms of markets, interbank funding markets suffered the most,[15] while local funding of operations remained stable or increased after the crisis.[16]

The external-internal dimension hearkens to the importance of banks' intra-group structures. Intra-group financial flows are critical for transnational banks; they are used to allocate resources across borders and thus stabilize lending in some countries,[17] to limit dependency on the availability of domestic funds, and to subject subsidiaries' funding to the competition with other subsidiaries.[18] Intra-group funding may compensate funding gaps in "normal" years, but it can also create funding gaps in intra-group positions during a liquidity crisis, thereby becoming a source of cross-border contagion.[19]

Surveys have shown that bank groups tend to assiduously resort to committed facilities (senior loans), subordinated loans (which are preferred to equity injections due to tax and dilution reasons), and guarantees as the main mechanisms of intra-group support.[20] Yet mere

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[14] *See* Emilio Muñoz-De La Peña & Adrian van Rixtel, *International Banking After the Crisis: Increasingly Local and Safer?*, IMF Chap. 2 of the Apr. Global Fin. Stability Rep. 55, 56 (2015).

[15] *See id.* at 56.

[16] IMF, International Banking after the Crisis: Increasingly Local and Safer?, at 55-91, Global Financial Stability Report, (Apr. 2010); Muñoz De La Peña and Van Rixtel, 2015; ECB, Report on Financial Structures, at 33 (Oct. 2016) (explaining that within the euro area, banks have experienced a general 'rebalancing' in funding, away from wholesale funding, and towards deposit funding).

[17] Intragroup funding tends to increase in times of uncertainty as banks use internal capital markets to adjust for liquidity risk. Buch and Goldberg (2015). Indeed, studies of banks' cross-border liabilities show that after the crisis liabilities from related banks increased as a proportion of foreign liabilities, unlike cross-border liabilities from unrelated banks and non-banks. The proportion of liabilities from related banks increased by 2,7% (from 24,7% to 27,4% of foreign liabilities), whereas those from unrelated banks and non-banks decreased by 3,7% and 5,7%. This means that cross-border groups rely more on intragroup transfers, and less on private sector sources. *See* Gambacorta, van Rixtel, Schiaffi *supra* note 7 at 19.

[18] D. Dahl, R.E. Shrieves, *The Extension of International Credit by US Banks: A Disaggregated Analysis*, 1988-1994, J. INT. MONEY FINANCE 18 at 153-167 (1999) (explaining that for banking groups in particular US studies show a 'substitution effect' between subsidiaries, i.e. a negative correlation between a subsidiary's credit growth and the loan growth for other subsidiaries).

[19] N. Cetorelli, L. Goldberg, *Global Banks and International Shock Transmission: Evidence from the Crisis*, IMF ECONOMIC REVIEW 59 at 41-76 (2011).

[20] Bank for International Settlements*, The Joint Forum: Report on Intra-group Support Measures, at 10-13* (Feb. 2012) (explaining that Other mechanisms of intra-group support are letters of credit, equity injections, bond swaps, and bond lending, or repo agreements, although they were less frequent).

references to "funding" do not fully capture the relevance of intra-group financial flows for the group's structure and organization, which is better captured by concepts such as "internal capital markets".[21] Most large banking groups have centralized capital management (globally or regionally), either keeping excess capital at a centralized level, or even raising capital at the parent level, which is then allocated across subsidiaries, which compete between them for resources.[22]

Most banking groups also have centralized liquidity management. They rely on different mechanisms of liquidity monitoring and they keep liquidity pools at a global or regional level that can be used as needed.[23] In the US resolution plans filed in 2015, for example, with few exceptions,[24] bank groups used a specialist entity[25] or other type of structural arrangement[26] to coordinate liquidity management. There is

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[21] *See* J. C. Stein, *Internal Capital Markets and the Competition for Corporate Resources,* JOURNAL OF FINANCE 52 (1), at 111-133 (Mar. 1997); *See* R. Rajan, H. Servaes, L. Zingales,*The Cost of Diversity: The Diversification Discount and Inefficient Investment*, *JOURNAL OF FINANCE* 54 (1), at 35-80 (Feb. 2000) (focused on the negative aspects of internal capital markets); D.S. Scharfstein, J. C. Stein, *The Dark Side of Internal Capital markets: Divisional Rent-Seeking and Inefficient Investment*, JOURNAL OF FINANCE 55 at 2537-2564 (Oct. 2000).

[22] Bank for International Settlements, *supra* note 23, at 7.

[23] *Ibid* at 8.

[24] *See* FDIC, Banco Santander SA. Resolution Plan for US Operations. Public section at 16 (Dec. 16, 2015), https://www.fdic.gov/regulations/reform/resplans/plans/santander-165-1512.pdf (explaining that there are some exceptions, such as Santander, which indicates that subsidiaries are generally self-funded, although it also states that most wholesale borrowing (in the US) is conducted through SHUSA (the US holding company), and SBNA (the major operating Company)); *See also* FDIC, HSBC Holdings plc HSBC Bank USA, National Association US Resolution Plan Section I – Public Section, at 2 (July 1, 2014), https://www.fdic.gov/regulations/reform/resplans/plans/hsbc-idi-1807.pdf (stating that banking entities manage their own liquidity pursuant to parameters set centrally).

[25] *See* FDIC, Bank of America Resolution Corporation Plan Public Executive Summary, at 27, 35 (July 1, 2015) https://www.fdic.gov/regulations/reform/resplans/plans/boa-165-1707.pdf; Barclays Resolution Plan Public section at 32-33 (July 2015)(explaining BCI Funding and NYBR Funding); FDIC, BNP Paribas Resolution, Plan Public Section, at 15 (Dec. 31, 2015) https://www.fdic.gov/regulations/reform/resplans/plans/bnp-idi-1512.pdf.
; FDIC, Citigroup Resolution Plan, Public Section, at 26, 28, 32 (July 1 2015) https://www.fdic.gov/regulations/reform/resplans/plans/citi-165-1507.pdf (explaining the liquidity provision shared between the parent holding company and the main banking entity, CBNA).

[26] FDIC, Credit Suisse Global Recovery and Resolution Plan, Public section, at 22 (does not clarify how the liquidity is managed); Deutsche Bank Resolution Plan, Public Section, at 8, 11, 12, 21 (2015) (references to a Pool Funding and Global Liquidity

less clarity about the extent to which the emphasis is placed on the "management" component of liquidity management, which means that the system is "notional", meaning based on internal accounting with no intra-group transfer of funds, or placed in the accumulation of "assets", in which case the cash pooling is "real", with intra-group transfer of resources.[27] The description of Lehman Brothers' "Global Cash and Collateral Management" (GCCM) system in the Examiner's Report[28] illustrates the complexity of intra-group liquidity management systems.[29]

Lastly, the institutional dimension emphasizes how business or funding models respond to regulatory conditions, as well as to macroeconomic and financial conditions. US banking groups, for example, are organized around a Financial Holding Company (FHC)[30]

Management business units, but it is unclear how the responsibilities are distributed across the group); Goldman Sachs Group, Inc Global Resolution Plan, Public Filing, at 23 (June 30, 2015); Morgan Stanley 2015 Resolution Plan, at 8, 26 (July 1, 2015) (indicating that it has a 'Global Liquidity Reserve' held between parent and subsidiaries, but not specifying how it is allocated, or managed); JP Morgan Chase Resolution Plan Public Filing, at 16 (July 1, 2015).

27 *See*, e.g. Jochen Vetter; Christian Schwandtner, *Cash Pooling Under the revised German Private Limited Companies Act (GmbHG),* GERMAN LAW JOURNAL VOL. 9, at 1156 (2008)(explaining that the distinction is used in the law of countries that have theorized about these intra-group arrangements, although the literature is not bank-specific).

28 In re Lehman Brothers Holdings Inc, No. 08-13555 Report of Anton R Valukas, Examiner, March 11, 2010, Volume 5 of 9. Section III.B: Avoidance Actions; Section III.C Barclays Transaction, p. 1549 (hereafter: Examiner Report). The report largely relied on Lehman's Motion to continue using its Global Cash and Collateral Management (GCCM) system. Motion 669 In re Lehman Brothers Holdings Inc, No. 08-13555 10 October 2008.

29 The report provides an excellent description of (i) the parent holding company's role as "central banker" and the intra-group Treasury Group's role in managing the firm's liquidity pool, or its subdivision in groups, including the Cash and Collateral Management Group; (ii) the categories of intra-group transfers, including the daily transfers from affiliate accounts to a consolidation account, not automatically but upon demand, the cash transfers between group entities' accounts, and the recording with no cash transfer of other intra-group transactions between such entities as "payables" and "receivables", plus the cash management transactions that took place outside the GCCM; or (iii) the role of in-house and external bank accounts. See Examiner Report at 1549-1562.

30 The Glass – Steagal Act imposed the separation between 'banking' and 'investment' activities. This was followed by the Bank Holding Company Act, which tried to ensure that the Glass – Steagal prohibition was not circumvented by using a bank holding company to put seemingly incompatible activities under the same corporate roof. Still, by then the use of holding companies was popular, and the Federal Reserve gradually changed its view on the Glass – Steagall prohibition, with the support of the Supreme Court. Thus, large, diversified groups presided over by a holding company became even more widespread. The death – knell for the Glass – Steagall was the Financial Services Modernization Act (Gramm-Leach-Bliley Act 1999) Pub.L. 106–102, 113 Stat. 1338, but

sitting atop the operating subsidiaries because the rules traditionally required separating commercial and investment banking or insurance, a separation gradually eroded by banking groups.[31] Banking groups in Continental Europe have traditionally been characterized by "universal banking" models with diversified but strongly coordinated groups presided over by a *credit* institution, i.e. not a holding company.[32] This is due, in part, to an institutional environment not conducive to strong decentralized capital markets but to markets dependent on major banks, which enjoyed a closer relationship with the State.[33]

After the 2007/08 financial crisis, regulatory conditions have become an even more important factor in the determination of banking groups' funding structures and business models. For example, in functional terms, "structural" measures have mandated the separation between deposit-taking and loan origination activities, on the one hand, and riskier capital markets activities, on the other, although there has been no uniformity about the kind of "risky" activities encompassed by the

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this came just after the merger between Citibank and Travellers (an insurance) had been authorized. Pre – crisis times also saw significant strategizing by investment banks that wished to become diversified financial groups under a holding company, while at the same time avoiding consolidated supervision by the Board of Governors of the Federal Reserve, which some of them achieved through the Consolidated supervisory Entity (CSE) program of the SEC.

[31] Naturally, corporate structures would not have sufficed to erode the mandatory separation of banking and investment included in the Glass-Steagall Act. It was accompanied by a growing consensus that the prohibition was ineffective, and constrained competition without clear benefits in return. In light of legislative deadlock, the evolution of the prohibition was marked by a gradual reinterpretation of the provisions by the Federal Reserve Board and the Office of the Comptroller of the Currency (OCC) sanctioned by the Supreme Court and federal courts. See e.g. George G. Kaufman, Larry R. Mote, "Glass-Steagall: Repeal by Regulatory and Judicial Reinterpretation," BANKING LAW JOURNAL, at 388-421(1990) (explaining that post-crisis mergers have left few systemically important institutions predominantly engaged in investment banking). That is the case of Goldman Sachs, or Morgan Stanley. Bear Stearns was bought by JP Morgan Chase, Lehman Brothers entered bankruptcy, and some of its assets were acquired by Barclays, and Merrill Lynch was acquired by Bank of America.

[32] Opinions vary as to the causes. Some would argue that this was due to a competitive advantage in mobilizing vast financial resources in aid of industrialization *See* Alexander Gerschenkron, *Economic Backwardness in Historical Perspective,*Harvard Univ. Press (1962)(stating that others would emphasize the pro – commercial bank institutional framework, which made it easy for politically connected banks to tighten their grip on the still incipient capital markets); *See* Caroline Fohlin, *Universal Banking in Pre-World War I Germany: Model or Myth?*, Explorations in Economic History Vol. 36, at 305-343 (1999).

[33] *See e.g.* John C. Coffee, Jr., "The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control," YALE L.J. Vol. 111, at 1, 51-58 (2002).

prohibition, the strategy of separation, and its application at the group level. In addition, different countries have tended to favour their own banking models.[34]

In geographical terms, regulators have used the new liquidity rules under the Basel framework on bank capital adequacy, which includes the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), to push forward the idea of "self – sufficiency", i.e. that every subsidiary, or even every branch, of international banks must be capable of fulfilling its own liquidity requirements without group assistance, something that favours "multinational banks" with decentralised funding.[35] Other measures have restricted cross-border funding even further, such as the "Foreign Bank Organizations" (FBO) rule in the US, which requires separately capitalized US Intermediate Holding Companies (IHC) to structure the US operations of foreign banks,[36] the "subsidiarisation" approach of the UK Prudential Regulation Authority (PRA),[37] or the limitation of intra-bank group exposures by Swiss rules.[38]

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[34] The US "Volcker rule" prohibited banking *groups* from engaging in proprietary trading and the sponsoring of hedge funds. Section § 619 Dodd-Frank Act. German and French rules are broader in scope, prohibiting activities beyond those two, but are limited to banking *entities,* i.e. they can be undertaken by other entities within the same banking group, provided certain safeguards are respected. British rules have taken the opposite course, by 'ring – fencing' depository institutions, and leaving a free rein on large trading banks within the same banking group. See Independent Commission on Banking. Final Report (Vickers Report) September 2011. France and Germany favoured the subsidiarisation of capital markets activities. The EU's proposed rules followed the Liikanen report and adopt the Franco-German approach. Articles 6, 8, 9, 10 (prohibitions and requirements implementing the rules) of the Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, COM (2014) 43 final (Jan. 29, 2014) (hereafter "Proposal Structural Measures"). *See also* High-Level Expert Group on reforming the structure of the EU banking sector, chaired by Erkki Liikanen, Final Report (2012), available at http://ec.europa.eu/internal_market/bank/docs/high- level_expert_group/report_en.pdf. The proposal included a grandfathering provision for UK banks (article 21), although Britain will soon cease to be part of the EU.

[35] R. McCauley; P. McGuire; G. Von Peter, "The architecture of global banking: From international to multinational", BIS Quarterly Review, 25–37 (March 2010).

[36] *Infra* 5.3.2. The rules also place restrictions on the ability of foreign banks to use US – raised dollar funding to fund their global activities. See H. S. Shin "Global banking glut and loan risk premium" Mundell-Fleming Lecture at the 2011 IMF Annual Research Conference, *IMF Economic Review*, 60, at 155-92.

[37] Bank of England, International banks: the Prudential Regulation Authority's approach to branch authorisation and supervision. (28 March, 2018). https://www.bankofengland.co.uk/prudential-regulation/publication/2018/international-banks-pras-approach-to-branch-authorisation-and-supervision-ss.

[38] See L. Goldberg; A. Gupta, "Ring-fencing and "financial protectionism" in international banking," Federal Reserve Bank of New York, Liberty Street Economics,

The result has been an important change in emphasis on the factors considered relevant in intra-group arrangements. For example, in the more recent US resolution plans for major banking groups,[39] there is less emphasis on the regular management of liquidity needs (often by a specialized entity) and more on the arrangements to pre-position liquidity resources on material entities, and on the availability of liquidity *support,* typically provided by the parent or holding company.[40] These initiatives can protect against certain risks, but they can also trap capital and liquidity where they are not needed, and make it more difficult for bank groups to smooth liquidity needs across borders or to exploit business opportunities.

ii. Bank Resolution Frameworks

Before we explore in greater detail how the complexity of banks' funding and structure may give rise to tensions between the goals of insolvency law and bank resolution, we need to briefly describe how resolution frameworks and tools work in different jurisdictions. Like the preceding introduction to banks' funding and structure, this overview of bank resolution frameworks will introduce basic concepts of our analysis.

(January 9, 2013), http://libertystreeteconomics.newyorkfed.org/2013/01/ring-fencing-and-financial-protectionism-in-international-banking.html.

[39] These are being determined by regulatory agencies' guidance. See, e.g. Federal reserve System - FDIC Final Guidance for the 2019 and subsequent resolution plan submissions by the eight largest, complex U.S. banking organizations. FRB Docket No. OP-1644; and also Guidance for 2018 §165(d) Annual Resolution Plan Submissions By Foreign-based Covered Companies that Submitted Resolution Plans in July 2015, March 24, 2017.

[40] *See, e.g.* Bank of America Corporation 2019 Resolution Plan, 31 July 2019, pp. 15-17, 23, 43 (emphasis on liquidity support by NB Holdings); Citigroup Resolution Plan Public Section, 31 July 2019, pp. 3, 16. BNP Paribas Resolution Plan Public Section 2018, pp. 13-14 although stating that the holding company (BNPP USA Inc) and the broker-dealer (BNP Paribas Securities Corp.) provide funding and services to other group companies, also emphasizes that material entities are self-funded. In Barclays US Resolution Plan 31 July 2018, there is still a reference to the centralized "management" through its Treasury function of capital and liquidity needs (pp. 39, 44), but the emphasis is on the pre-positioning of resources at each material entity (pp. 19-21), and on the existence of a Secured Support Agreement (SSA) whereby liquidity would be provided by the holding companies (BUSLLC, the IHC, and BGUS, the holding company below it) (pp. 11, 15-17, 28). Credit Suisse 2018 US Resolution Plan Public Section emphasizes the structural changes undertaken to improve resolvability, including a Support Agreement, involving the holding company and the Material Legal Entities dependent on its funding (pp. 5, 10, 13).

The Key Attributes for Effective Resolution Regimes[41] prepared by the Financial Stability Board (FSB) have guided many of the regulatory initiatives to improve the resolution of banks. Yet as the FSB reports and peer reviews show,[42] complete resolution frameworks are only in place in areas that were hit harder by the financial crisis, notably the US and the EU, as well as other jurisdictions like Switzerland or Japan, but progress is patchy elsewhere. By way of summary:

	US	EU	China	Japan	Switzerland
Separate regime & authority	Yes. 2 regimes FDIC	Yes. Resolution authorities	Yes. PBC, CBRC, DIFMA	Yes. Receivership under DIA Orderly liquidation	Yes. FINMA
Scope	Banks (FDIC) SIFIs (OLA)	Banks & inv. Firms	SIFIs	Banks SIFIs (orderly liquidation)	Banks Dealers Extension if in public interest
Tools	Purchase and assumption (P&A) SIFIs bridge bank	Sale of business Bridge bank Asset segregation Bail-in	P&A	P&A Nationalisation Transfer to bridge bank	Implementation of resolution plan. Transfer of business Bridge bank
Bail-in powers	Yes (implied)	Yes (explicit)	Not explicit	Yes (implied) restricted to equity or contractual bail-in	Yes (reorganization plan)
Priorities	Separate rules (OLA)	Insolvency (with carve-outs)	No separate rules	No separate rules	Insolvency (with specific rules)
Unequal treatment (I). Privileges	Yes (OLA: discretion)	Yes (exceptional)	No	No	No
Unequal treatment (II). Prejudice	Compensation. Insolvency as baseline	Compensation. Insolvency as baseline No Creditor Worse-Off (NCWO)	No	No	Compensation. Insolvency as baseline (NCWO)

The first difference is the existence and scope of a separate regime to deal with bank crises. Regulators in some jurisdictions, like the US or Japan, had already vested their deposit insurers with receivership powers and, after the 2007/08 financial crisis, decided to supplement those powers with a specific regime for systemically important financial institutions (SIFIs).[43] In the EU, regulators have introduced a whole new

41 FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, 15 October 2014.

42 *See e.g.* FSB, TEN YEARS ON – TAKING STOCK OF POST-CRISIS RESOLUTION REFORMS, Sixth Report on the Implementation of Resolution Reforms (July 6, 2017).; *see also* Second Thematic Review on Resolution Regimes Peer Review Report (March 18, 2016). See also http://www.fsb.org/what-we-do/implementation-monitoring/monitoring-of-priority-areas/effective-resolution-regimes-and-policies/.

43 *See* 12 USC sections §§ 1818, and 1819 (a) Ninth (FDIC authority), supplemented by §§ 5384 *et seq* (Orderly Liquidation Authority). For Japan, see the Deposit Insurance

framework for all banks (and investment firms), regardless of the systemic importance.[44] In Switzerland, there is a regime for banks and investment firms, and regulators permit an extension to other firms subject to a public interest test.[45] Lastly, while China seems to have supplemented the existing framework of powers of the People's Bank of China (PBC) with new powers for the Banking Regulatory Commission (CBRC) and the deposit insurer (DIFMA), China still lacks a complete framework.[46]

The second set of differences relates to resolution tools. All systems contemplate purchase and assumption (P&A) or sale of business.[47] Nevertheless, China does not seem to have fully developed these tools, while the US and Japan rely on the bridge bank as the preferred tool for orderly liquidation, generally restricted to SIFIs.[48] The EU lists the sale of business, bridge bank, asset segregation (or "bad bank") and bail-in as key tools,[49] while Switzerland regulates bankruptcy and reorganisation separately, and tools such as the bridge bank and bail-in are contemplated under the latter.[50]

These choices determine which forms of interference with the rights of creditors, and, generally, investors, are more likely. In the US or Japan, it would be in a transfer to a bridge bank to preserve critical functions, while shareholders and creditors are left behind, while in the EU it would be through the use of bail-in powers.[51] This results in a great divergence of approaches towards bail-in powers. While they are the

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Act of 1971, chapters IV-VII, articles 70-126, which deal with the purchase of deposits and other claims, management of business by an administrator, the transfer of business of failed institutions, the purchase of claims that are difficult to collect, or the responses to financial crises, and articles 126-2 et seq. (Chapter VII-2) on orderly resolution.

44 Article 1 BRRD (see the previous section).

45 FINMA Banking Insolvency Ordinance, Art. 2 (August 30, 2012) (hereafter: BIO-FINMA), provides that the rules apply to Banks, securities dealers, and central mortgage bond institutions. Section (2) states that the *reorganisation* provisions do not apply to firms or persons without the requisite license, but that FINMA may declare them applicable when there is sufficient public interest.

46 FSB Second Thematic Review on Resolution Regimes Peer Review Report, 18 March 2016, pp. 5, 11, 12.

47 *See id.* at 12-13.

48 In the US, *see* 12 USC §§ 5384 (a) (3) and § 5390 (h). In Japan the bridge bank is already a central tool to deal with the succession of business of failed financial institutions under Chapter VI of the DIA, articles 91 *et seq*, and it is again introduced as an orderly liquidation tool in Chapter VII-2, in article 126-34 of the DIA.

49 Article 37 BRRD.

50 BIO-FINMA chapter 2 (bankruptcy) and 3 (reorganization), the latter of which includes bail-in (articles 47-50) and the bridge bank (articles 51-52).

51 Article 43 BRRD.

central tool of the EU framework, they are absent from the Chinese framework,[52] implicit in the US and Japan, [53] and, in the case of Switzerland, they are restricted to cases where a reorganization plan is implemented.[54]

Finally, there are important differences in the degree of detail with which the different frameworks regulate the interference with creditors' rights, and the system of insolvency ranking and priorities. In some cases, like Japan, there are either no express provisions, or the rules only apply to equity or contractual bail-in instruments, so there should not be any interference with pre-existing rights.[55] In contrast, the US, the EU and Switzerland have attempted to enhance the credibility of burden-sharing by introducing express provisions to deal with ranking and priorities. These attempts open the door to potential conflicts between the policy goals of insolvency law and bank resolution. The remainder of this article will focus on these three jurisdictions: the US, the EU, and Switzerland.

B. Bank Resolution and Insolvency Law: Tensions at the Policy Level

i. General Considerations

To analyse the tensions at the level of policy, consider, first, insolvency law. Its policies and principles aim at dealing with failed debtors and protecting creditors.[56] This focus can be seen in international best practice from the World Bank[57] and the United Nations[58] in the form

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52 FSB, Ten Years On – Taking Stock of Post-Crisis Resolution Reforms, Sixth Report on the Implementation of Resolution Reforms, at 26 (July 6, 2017).

53 In Japan Arts. 102 and 126-2 cover, respectively, the situations of financial crisis and resolution, and although the rules make no express mention of write-down and conversion, they state that the Prime Minister will "decide on the treatment" of the equity, capital treatment and subordinated debt (Art. 102(3) and 126-2(4)). See Ignacio Tirado, "Banking Crisis and the Japanese Legal Framework," Institute for Monetary and Economic Studies – Bank of Japan. Discussion Paper No. 2017-E-2, at 55.

54 Articles 47-50 FINMA Banking Insolvency Ordinance.

55 Ignacio Tirado, "Banking Crisis and the Japanese Legal Framework," at 55.

56 Thomas Jackson, *The Logic and Limits of Bankruptcy Law,* Cambridge Mass: Harvard University Press, at 7 (1986).

57 International initiatives have sought to identify and promote best insolvency law practices to foster access to credit and economic development, under the aegis of both the United Nations and the World Bank. The World Bank's efforts have focused on the principles for effective Insolvency and Creditor/Debtor Regimes. These were originally developed in 2001 as part of international efforts to provide sound solutions to the problems arisen with the (Latin American, Asian, and Russian) crises of the 90s, and revised in 2005, 2011 and 2015. World Bank, *The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes*, Washington (2016), available at

of the Insolvency and Creditor Rights Standard (ICR),[59] which has received the endorsement of the Financial Stability Board (FSB) as one of the key standards for sound financial systems.[60] Insolvency ranking and priorities are critical elements of such best practices.[61]

In relatively recent times, different legal systems have combined those two goals (dealing with failed debtors and protecting creditors) in different ways, sometimes resulting in proceedings of a different nature: "insolvency" and "pre-insolvency" proceedings. In essence, legislators may prioritize minimizing destruction of value by rescuing the debtor's business or securing a prompt repayment to creditors through quick liquidation. Thus, if insolvency rules are designated as a point of reference to solve difficult cases in the context of bank resolution, it is unclear whether "insolvency" or "pre-insolvency" proceedings will serve as an actual reference.[62]

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http://documents.worldbank.org/curated/en/518861467086038847/Principles-for-effective-insolvency-and-creditor-and-debtor-regimes (hereafter: World Bank Principles).

[58] The United Nations, through its Commission on International Trade Law (UNCITRAL), began to contribute to the field in 1997, with the Model Law on Cross-Border Insolvency, with a Guide to Enactment and Interpretation being added in 2013. See UNCITRAL Model Law on Cross-Border Insolvency (1997) with Guide to Enactment and Interpretation (2013) United Nations New York 2014, available at http://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf (hereafter: UNCITRAL Model Law). In 2004, the Legislative Guide on Insolvency Law was added. See UNCITRAL Legislative Guide on Insolvency Law (Parts I and II). Available at: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html (hereafter: UNCITRAL Legislative Guide). This was later expanded in 2010 with its now-called Part Three for groups, and in 2013 with Part IV on Directors' obligations on the period approaching insolvency. See UNCITRAL Legislative Guide on Insolvency Law. Part Three: Treatment of Enterprise groups in insolvency. Available at http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf and http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf.

[59] The mutual influence between UN and World Bank efforts led to a 2011 amendment, where the Bank's principles were modified to incorporate the UNCITRAL Guide's updates. This was the case with new principles C16 and C17, regarding enterprise groups. Since then, the relationship between the two sets deepened, resulting in the ICR, which was formed by the Bank's Principles and the UNCITRAL Guide, available at http://siteresources.worldbank.org/INTGILD/Resources/ICRStandard_Jan2011_withC16 17.pdf

[60] See http://www.fsb.org/2011/01/cos_051201/.

[61] They figure prominently both in the World Bank Principles and the UNCITRAL Legislative Guide. World Bank Principles Principle C12; UNCITRAL Legislative Guide, Part II, Chapter V, paras. 51-81.

[62] EU resolution rules, when relying on sources outside resolution rules themselves, refer to 'normal insolvency proceedings', which are defined as *"'collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment*

In practice, the similarities between the two proceedings mitigate this problem. In particular, the rules that determine the hierarchy of claims are normally placed within the rules on "liquidation" but are common to both proceedings.[63] Existing principles and goals applicable to insolvency priorities include the following: (i) insolvency law needs to uphold the priorities of claims established prior to insolvency under commercial or other laws to protect legitimate expectations and encourage predictability;[64] (ii) the priority of secured creditors over their collateral needs to be upheld;[65] (iii) the payment of claims related to the costs and expenses of administration has to be prioritized;[66] (iv) once secured creditors and insolvency expenses have been satisfied, the law has to promote *pari passu* distribution of proceeds, which also means the need to restrict priority debt to a minimum;[67] and (v) public interests, e.g. tax liabilities, should not be prioritized, whereas the importance of workers to the enterprise should be acknowledged by giving them priority status.[68]

This could still leave some interpretive difficulties in the limited cases where priority rules can differ between reorganisation proceedings and liquidation proceedings.[69] More importantly for our purposes,

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of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person;". Article 2 (1) (47) BRRD.

63 This is the case in England, Germany, or Spain. *See* Hamish Anderson; Charlotte Cooke; Louise Gullifer "National Report for England"; Christoph G Paulus; Matthias Berberich "National Report for Germany" Ignacio Tirado "National Report for Spain" and Annina H person; Marie Karlsson-Tuula "National Report for Sweden" in Dennis Faber; Niels Vermunt; Jason Kilborn; Tomas Richter; Ignacio Tirado *Ranking and Priority of Creditors* Oxford University Press, 2016 pp. 225, 289, 529, 556. The case is the same in most EU jurisdictions.

64 World Bank Principles Principle C12.1; UNCITRAL Legislative Guide, Part II, Chapter V, paras. 51-81.

65 World Bank Principles Principle C12.2; UNCITRAL Recommendations no. 188, Recommendations no. 191.

66 World Bank Principles Principle C12.3; UNCITRAL recommendations no. 189.

67 World Bank Principles Principle C12.3; UNCITRAL Recommendations no. 187.

68 World Bank Principles Principle C12.3-12.4; UNCITRAL Recommendations.

69 This is the case in France. *See* articles L. 622-17 (reorganisation), and L. 641-13 (liquidation) of the French Commercial Code. The differences are 'slight', however. See Gilles Cuniberti; Isabelle Rueda "National Report for France" in Dennis Faber; Niels Vermunt; Jason Kilborn; Tomas Richter; Ignacio Tirado *Ranking and Priority of Creditors cit* p. 259. The same authors point that ranking in reorganisation proceedings is rarely applied, as it is only relevant in cases where the business is sold as a going concern. However, in a hypothetical case this should not be considered exceptional for a bank, since the bail – in tool may often be used in conjunction with the sale of business, bridge institution or asset separation tools, which involve such sale as a going concern (see Article 37 (3) BRRD). Fortunately, French resolution rules make an *express* reference to "liquidation" proceedings for these purposes. See article L. 613-55-5 no. I 4th

however, is whether the goals of a specific proceeding can affect priority rules. Resolution frameworks, for example, have a different inspiration from insolvency law. They were meant to address insolvency's shortcomings. In the wake of the 2007/08 financial crisis, insolvency tools turned out to lack expedience, and insolvency courts lacked the expertise to handle complex banks' crises more swiftly and to avoid contagion.[70] New rules were needed to preserve banks' key role of liquidity creation while at the same time protecting the public interest by avoiding the use of taxpayers' money to support distressed banks deemed too-big-to-fail.[71] In addition, existing insolvency rules were not capable of dealing with the operational complexity of some banks. For example, the "centralized" management of functions[72] required a greater emphasis on the "group" as the relevant resolution unit[73] and greater cross-border coordination.

Before the crisis, the US already had in place specific procedures for failing banks. The Federal Deposit Insurance Corporation ("FDIC"), which had been created through the Banking Act of 1933,[74] had preventive capabilities, such as the power to level cease-and-desist orders,[75] and the power to act as a receiver for a failing bank.[76] In addition, its extensive practice helped develop new resolution tools such as the sale of business or the "bad bank".[77] What it lacked, however, were specific tools to deal with systemic risk. Title II of the Dodd-Frank Act aimed at bridging that gap.[78] It introduced a new proceeding for financial companies whose failure would have an adverse impact on financial stability,[79] and it vested the FDIC with new (and vast) powers.[80]

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and 5th of the French Financial and Monetary Code, which refers to "liquidation proceedings" under Book VI of the Commercial Code.

[70] Eva Hüpkes, "Allocating costs of failure resolution" at 114 in R. LASTRA (ed.), Cross-border bank insolvency, Oxford, Oxford University Press (2011).

[71] FSB Key Attributes of Effective Resolution Systems for Financial Institutions at 1 (October 15, 2014).

[72] Report of Anton Valukas Examiner In re Lehman Brothers Holdings Inc. Chapter 11 Case No. 08-13555 Vol. 5 Section III.B. Avoidance Actions, p. 1549, report available at: http://web.stanford.edu/~jbulow/Lehmandocs/menu.html

[73] Articles 7-8, 12-13, 16, 18, 19-26, 30,

[74] FDIC *The First Fifty Years. A History of the FDIC* 1933-1983, Washington: Federal Deposit Insurance Corporation, 1984, pp. 84 et seq, available at https://www.fdic.gov/bank/analytical/firstfifty/index.html

[75] Banking Act 1933, 12 USC chapter 16, Section § 1811 *et seq.* See FDIC Resolutions Handbook, Revised Dec. 23 2014, p. 1.

[76] 12 USC sections §§ 1818, and 1819 (a) Ninth.

[77] *See* FDIC Resolutions Handbook, chapter 4, available at https://www.fdic.gov/bank/historical/reshandbook/

[78] Title II, Sections §§ 201-217 Dodd-Frank Act, 12 USC §§ 5381 *et seq.*

[79] Section 203 (b) Dodd-Frank Act, 12 USC §§ 5383 (b).

Unlike in the US, in the EU the legislator introduced both specific procedures for failing banks and specific tools to deal with systemic risk *simultaneously*, and it only did so in response to the 2007/08 financial crisis.[81] In so doing, EU legislators drew inspiration from the FDIC to vest its own resolution authorities with extensive crisis-management powers[82] and specific resolution tools.[83] In order to solve cross-border coordination problems, the EU legislator introduced "colleges" of resolution authorities.[84] Yet, unlike under US law, under EU law the goal of tackling systemic risk pervades the whole framework and applies to all banks regardless of their significance for systemic stability.[85] Moreover, in the EU, a bank resolution framework was seen as a key to pursue an EU-specific goal: the enhancement of coordination in the Eurozone through a Banking Union to sever the link between banks and sovereigns,[86] which included (i) supervision through a centralized Single Supervisory Mechanism (SSM),[87] (ii) regulation through the Single Rulebook,[88] (iii) resolution through the Single Resolution Mechanism (SRM),[89] with centralized decision-making in the Single Resolution Board (SRB)[90] and (iv) funding through the Single Resolution Fund (SRF),[91] and (v) a single system of deposit insurance.[92]

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80 Section 210 Dodd-Frank Act, 12 USC §§ 5390.

81 In the BRRD Directive 2014/59/EU, recital (1) describes the "significant lack of adequate tools to deal effectively with unsound or failing credit institutions", while recital (2) discusses systemic risk.

82 Articles 3, 61, 63-72, 81-84 BRRD.

83 Articles 37-42 BRRD.

85 Article 1 (1) BRRD.

86 Niamh Moloney 'European Banking Union: Assessing its Risks and Resilience' *Common Market Law Review* Vol. 51 (2014) p. 1622. The process leading to the Banking Union was set in motion when the 2007-2009 financial crisis mutated into to a sovereign debt crisis in the euro zone in 2010.

87 See Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (hereafter SSM Regulation, or SSMR). See also: https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html

88 http://www.eba.europa.eu/regulation-and-policy/single-rulebook.

89 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (hereafter: SRM Regulation, or SRMR). See also http://ec.europa.eu/finance/general-policy/banking-union/single-resolution-mechanism/index_en.htm

90 Articles 42-56 SRMR.

91 Articles 67-79 SRMR.

92 Article 1 SRMR; Intergovernmental Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund 8457/14 Brussels (May 14, 2014). *See*

In addition to protecting financial stability, the new rules on bank resolution needed to protect taxpayers and address the problem of moral hazard.[93] This resulted in rules for the write down and conversion of equity and debt instruments, i.e. the bail-in, as opposed to bail-out, tool.[94] In the US, bail-in rules were accompanied by the prohibition for the central bank to supply liquidity to individual institutions unless it was in the framework of a broader liquidity program.[95] In the EU, the specific aim of severing the link between banks and their sovereigns under the Banking Union had led the Commission to insist on burden-sharing by investors as a precondition to approve rescue packages under state-aid rules,[96] a complementarity that was reinforced in the resolution framework.[97]

This background resulted in a framework of *policies* quite different from that of insolvency law. First, the bank resolution framework is characterized by a more 'macro' perspective focused on the avoidance of contagion, the mitigation of moral hazard, and the protection of public funds, as well as the continuity of critical functions,[98] rather than the

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also Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 (stating the importance of deposit guarantee schemes).

[93] R. de Weijs, *Too Big to Fail as a game of chicken with the state: What insolvency law theory has to say about TBTF and vice versa*, 14 EUR. BUS. ORG. L. REV. 201, 207-215 (2013).

[94] Joseph H. Sommer, *Why Bail-In? And How?,* 20 ECON. POL'Y REV. 207, 207-228 (2014).

[95] 12 U.S.C.A. § 226 Section 13 (d) of the Federal Reserve Act.

[96] Article 107 TFEU declares state aids illegal unless they are included within the exceptions under section (3), whose letter (b) authorizes such state aid to "remedy a serious disturbance in the economy of a Member State". The Commission issued Guidelines stating that holders of equity and junior debt in a failed institution had to share in the losses in order for the rescue package not to be considered an illegal state aid. See Communication from the Commission of 30 July 2013 on the application from 1 August 2013 of Sate aid rules to support measures in favour of Banks in the context of the financial crisis O.J. 2013, C 216/1.

[97] Thus, bail-in would act as the primary mechanism for loss absorption and recovery, and resolution funding to cover the gaps left. *See e.g.* Recitals (73) and (74) and articles 37 (10), 44 (4) – (12) BRRD.

[98] *Key Attributes of Effective Resolution Regimes for Financial Institutions,* FINANCIAL STABILITY BOARD ("FSB"), 3-4 (15 Oct. 2014). *See* Article 31 BRRD (stating the objectives of resolution, which include ensuring the continuity of critical functions, avoiding contagion, imposing market discipline, protecting public funds, protecting depositors and client assets. In the US, one of the goals of the Dodd-Frank Act itself is "to end too big to fail", and protect the American taxpayer by ending bailouts". This is completed by Section § 204 Dodd Frank Act, 12 USC §5384, which refers to systemic risk, and moral hazard. Preserving key operations was already a goal of in 12 U.S.C. 1821(d) and 1823(c). New Orderly Liquidation Authority provisions reinforce this by the use of the bridge bank as a tool.). *See* 76 Fed. Reg. 41639 (July 15, 2011).

'micro' perspective of creditor protection, which ceases to be an end in itself, and becomes a means to achieve other goals.

Second, in contrast to insolvency law, where *pari passu* treatment was the background policy and priorities and privileges were only exceptions, in bank resolution, background policies try to protect certain liabilities such as deposits or clients' funds and assets.[99] The interests of other creditors are secondary and can only be justified in terms of resolution goals as the means to minimize resolution costs and the avoidance of "unnecessary" destruction of value.[100]

ii. Specific Examples

These differences at the policy level between insolvency law and bank resolution can give rise to frictions. Resolution frameworks in the US, the EU and Switzerland approach these frictions in different ways.

The US framework for the Orderly Liquidation Authority (OLA) is a high-stakes system, which tries to eliminate interpretative friction by relying on (i) FDIC discretion, (ii) separate rules, and (iii) legally-sanctioned discrimination (with limits). It provides that the FDIC, as receiver, shall terminate all rights arising from status as stockholder or creditor, except for the rights permitted under the specific OLA rules, and ensure that stockholders and creditors bear losses in accordance with the priority of claims under those rules.[101] The transfer of assets and liabilities to bridge companies is subject to what the FDIC, in its discretion, deems to be appropriate,[102] with the exception of equity claims, which are not transferred as a matter of law.[103] There are separate rules that rank *unsecured* claims in the following order: post-receivership financing, administrative expenses of the receiver, amounts owed to the United States, wages, salaries and commissions to employees, contributions to employee benefit plans, other senior liabilities, subordinated liabilities, wages salaries and commissions of senior

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[99] *See, e.g., Key Attributes of Effective Resolution Regimes for Financial Institutions,* FINANCIAL STABILITY BOARD ("FSB"), 3-4, 6-10,, 85-94 (15 Oct. 2014) (specifically preamble, no. 2.3, 3.2, 3.3, 3.4, 4.1, and App'x. II Annex 3). *See* 12 U.S.C. § 1811 (the U.S. FDIC's "primary mission is to preserve and promote public confidence in the U.S. financial system by insuring deposits."). *See Resolution Handbook*, FED. DEPOSIT INSURANCE CORP. ("FDIC"), 16 (updated Dec. 23, 2014). *See, e.g.,* Article 34 (2) (d) and BRRD (describing the EU's version).

[100] *Key Attributes of Effective Resolution Regimes for Financial Institutions,* FINANCIAL STABILITY BOARD ("FSB") 3, 6 (15 Oct. 2014) (specifically preamble (iv) and no. 2.3(iii)). *See also* BRRD Article 34(2) [para. 2].

[101] 12 U.S.C. § 5390(a)(1)(M) (2010).

[102] 12 USC § 5390 (h) (1) (B).

[103] 12 USC § 5390 (h) (3) (A)-(B).

executives and directors, and obligations to shareholders.[104] Other provisions deal with secured creditors[105] and prior contracts, including the transfer of qualified financial contracts.[106] Thus, the approach is not dissimilar from the one that could result from insolvency law, but regulated independently, and much more subject to discretion. Add the fact that there is very limited court intervention,[107] and the risks are clear: (i) arbitrary conduct, (ii) an all-or-nothing constitutional challenge,[108] and (iii) drastic legislative upheaval.[109]

Even if the system stands, it is unclear how its self-contained rules should be interpreted. If, say, there is disagreement as to whether liabilities under a complex contract that is not repudiated after appointment by the FDIC relate to a "services" agreement and should be treated as an "administrative expense of the receiver", or are post-receivership financing and should be preferential to it, or are considered to be left behind after transfer to the bridge bank,[110] it is unclear which principles should be used for interpretation.

The EU, for its part, exemplifies a deceivingly accommodating system. For EU rules, bail-in is the central resolution tool, encompassing the power to write down or convert equity or debt instruments (i) as a resolution tool used in isolation ("open bank" bail-in), (ii) as a resolution tool used in conjunction with the sale of business, bridge bank, etc ("closed bank" bail-in),[111] and (iii) independently, i.e. before resolution takes place.[112] Bail-in is anchored in an expert valuation, which determines the sufficiency/insufficiency of resources, and serves to determine the extent of the bail-in,[113] but this will normally offer a range

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[104] 12 USC § 5390 (b) (1), and (2).

[105] 12 USC § 5390 (b) (5).

[106] 12 USC § 5390 (c). Sub-sections (8) and (9) deal with qualified financial contracts.

[107] 12 USC § 5390 (a) (9) (D) and (e).

[108] *See, e.g.*, Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?*, 163 U. PA. L. REV. 165, 247 (2014). (examining the framework on procedural grounds (e.g. the strict time-limits, or the secrecy of proceedings), but also the discrimination against creditors).

[109] Department of Treasury, *Orderly Liquidation Authority and Bankruptcy Reform* (February 21, 2018).

[110] 12 USC 5390 (b) (7) (B) (post-receivership services), (b)(2) (post-receivership financing).

[111] Respectively, article 43 (2) (a) and (b) BRRD. *See* Emilios Avgouleas, Charles Goodhart, "Critical Reflections on Bank Bail-ins," 1 J. FIN. REG. 3, 8 (2015).

[112] Articles 37 (3) and 43-55 BRRD (resolution tool), and 37 (2) and 59-62 (tool independent of resolution) BRRD. In any event, the use of the pre-resolution bail-in tool is conditional to a state of financial distress, which makes bail-in the alternative to a formal resolution process. See, e.g. Article 59 (3) (b)-(d) and (4) BRRD. Karl-Philipp Wojcik, *Bail-in in the Banking Union*, 53 COMMON MKT. L. R. 91, 106 (2016).

[113] Articles 36, 46, 73-74 BRRD.

of values, and will not state the amount of instruments that need to be bailed-in to restore confidence.

In contrast, at first glance, EU resolution provisions accommodate insolvency law quite well by requiring bail-in to be exercised "in accordance with the hierarchy of claims in normal insolvency proceedings."[114] Yet this seamless transition between *rules* is only apparent. BRRD provisions regulate the ranking between equity, hybrid, and debt instruments,[115] introduce an express priority for eligible (retail) bank deposits,[116] and, more importantly, provide a (long) list of liabilities *excluded* from bail-in.[117] The exclusions comprise secured liabilities, liabilities arising from holding client money or instruments, or by virtue of a fiduciary relationship,[118] which are also protected by insolvency law. However, they also exclude short-term debt, or liabilities to providers of services critical to the daily functioning of operations,[119] an exclusion inspired by resolution goals. In short, while pretending to accommodate insolvency law, EU resolution rules force insolvency law's ranking, where liabilities are "up" or "down" the ladder, to coexist with a parallel system, where liabilities are "in" or "out" of bail-in, thereby creating an incentive for arbitrage: creditors will tend to plead that their right is "out" rather than "up".

Thus, classification problems are bound to arise. It is not difficult to imagine cases where it may be difficult to determine whether a liability is "secured" or arises from "holding client assets or money", or from a "fiduciary relationship".[120] In such cases, it is unclear whether one should rely on insolvency law principles or resolution principles as a tie-breaker. In principle, bail-in exclusions must be determined before the bail-in sequence,[121] and thus one must determine that a liability is "in" before determining whether it is "up". However, some liabilities, such as client money or securities, or wages, are excluded "provided that" they are

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[114] Article 48 (1) (d) and (e) BRRD.

[115] Article 48 (1) (a) – (c) BRRD.

[116] Article 108 BRRD. In addition to this, the rules also indicate the first instruments that will be subject to bail-in, including CET1, Tier 1 or Tier 2 instruments, regardless of what would be the result under insolvency rules. See article 48 (1) (a) – (c).

[117] Article 44 (2) and (3) BRRD.

[118] Article 44 (2) (b)-(d) BRRD.

[119] Article 44 (e), (f), (g) (ii) BRRD.

[120] *Infra* 3.1.2.

[121] Article 2 (1) (71) BRRD states that "'eligible liabilities' means the liabilities and capital instruments that do not qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments of an institution or entity referred to in point (b), (c) or (d) of Article 1(1) that are not excluded from the scope of the bail-in tool by virtue of Article 44(2)."

protected under insolvency law,[122] which reverses the order, i.e. insolvency rules must be considered first, resolution rules second. Other liabilities, such as those arising from fiduciary relationships, are excluded from bail-in *if* they are protected "under the applicable insolvency law *or* civil law".[123] This requires analyzing insolvency law, then private law, then resolution, but with an interpretative gap, because resolution provisions require the liabilities to be "protected", but do not specify the level of protection.

In other cases, liabilities are excluded without any reference to other laws, as in the case of "secured liabilities", but one may need to refer to private law or insolvency law to circumscribe the concept.[124] Then, some cases may be susceptible to classification under more than one category, e.g. short-term liabilities "secured" by collateral arrangements under a trust (i.e. fiduciary) agreement. In other cases, courts may have protected certain creditors "under insolvency law," yet by using as interpretative tools policies such as investor protection to determine the scope of rights, [125] which scope may be more limited in a resolution context, where considerations of stability and moral hazard are more important. Finally, in some cases, resolution authorities may be unable to state whether a liability is, or is not, protected under insolvency law, since there are no precedents on the issue. The case is similar for exclusions that do not rely on insolvency law:[126] a self-referenced interpretation of concepts like the short-term "commercial or trade creditor" may be difficult if, say, the case concerns services by a group entity (not excluded from bail-in)[127]

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[122] *Id.* art. 43(2)(c), (g)(iii) (resulting, in the case of liabilities, from the holding of client assets or money, or tax and social security liabilities).

[123] Article 44 (2) (d) BRRD.

[124] Article 44 (2) (b) BRRD includes among the excluded liabilities *"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 which according to national law are secured in a way similar to covered bonds;"*. Thus, a reference is made to 'national law' for the specific case of financial instruments similar to covered bonds, but not for the general category of 'secured liabilities'; yet a secured liability cannot exist unless it is given that category under some national law. Which law, and how this may be enforced in other jurisdiction, is another matter.

[125] The need to provide clients holding money or instruments with a "high level of protection" weighed heavily in the UK courts decision in the *Lehman Brothers (Client Money)* cases to provide insolvency protection. See *infra* III.A.2.

[126] This is the case of "covered deposits," deposit guarantee schemes, short-term liabilities, liabilities for employee fixed remuneration, and to trade creditors supplying goods or services critical to the daily functioning. Article 43 (2) (a), (e), (f), (g)-(i), (ii), (iv) BRRD.

[127] Article 44 (3) (e) BRRD.

that is nonetheless critical to the daily functioning of the entity's operations.[128]

The Swiss system is two-tracked, with rules on bank bankruptcy, which regulate assets, liabilities realization, and distribution, including priorities;[129] and rules on reorganization that involve the proposal and adoption of a restructuring plan, which can apply only if (i) creditors are likely to fare better, and (ii) the plan is feasible in terms of time and scope.[130] Swiss reorganization rules resemble EU resolution rules since (i) they rely on the insolvency hierarchy and private law,[131] but, (ii) like EU rules, they expressly regulate the bail-in ranking between equity instruments and debt instruments,[132] and provide a list of exclusions from bail-in.[133] However, Swiss resolution rules simply cross-reference the list of preferential creditors under that insolvency law, and preferred deposits, as regulated under the Banking Act.[134] Resolution rules only add the exclusion of "secured claims" and claims subject to set-off,[135] where, again, insolvency law may be used for interpretation. It is arguably the approach most in line with pre-existing creditor rights,[136] although this is easier when there is only one insolvency law to accommodate, rather than twenty-eight, as in the case of the EU.

C. *Bank Resolution and Insolvency Law: the Role of Principles*

The picture that arises from these policy tensions is clear yet unsettling. From a system (insolvency law) where creditor protection is a, if not *the*, primary goal, we move to a two-track system (bank resolution) with winners, i.e. the creditors whose individual interests are

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[128] Article 44 (2) (g) (ii) BRRD.

[129] BIO-FINMA, articles 11 *et seq*, including 16-23 (assets), 24-29 (liabiities), 31-34 (realisation), and 35-39 (distribution). Priorities are regulated in article 35, in favor of bank deposits and administration expenses, and expenses incurred after the opening of the proceedings.

[130] CC Aug. 30,2012, CC 952.05 art. 40 (BIO-FINMA).

[131] CC Aug. 30, 2012, CC 952.05 art. 47 ("If the restructuring plan allows corporate actions in accordance with this Section, it is necessary to ensure that: a) the creditors' interests take precedence over the interests of the owners and the hierarchy of creditors is respected; b) the provisions of the Swiss Code of Obligations[1]apply mutatis mutandis.").

[132] CC Aug. 30, 2012, CC 952.05 art. 48(1)(b)-(d).

[133] CC Aug. 30, 2012, CC 952.05 art. 49.

[134] CC Aug. 30, 2012, CC 952.05 art. 47(1)(a), with reference to article 219 of the Loi fédérale sur la poursuite pour dettes et la faillite (LP), and article 37[a] of the Bank Act. *See also* CC Aug. 20, 2012, CC 952.05 art. 25.

[135] CC Aug. 30, 2012, CC 952.05 art. 49(1)(b).

[136] To the mandatory limits to the exercise of bail-in we must add the procedural safeguard of allowing creditors' objection to the reorganization plan. *See* CC Aug. 30, 2012, CC 952.05 art. 46.

connected with the "macro" goals of bank resolution (e.g. stability, contagion), and losers, i.e. the creditors (and shareholders) whose interests must be sacrificed to further other goals (e.g. avoidance of moral hazard). In this context of clearly diverging policies, a key element is the configuration of *principles.* We consider principles as legal propositions, which, like policies, have a dimension of weight and importance, i.e. they do not apply in an all-or-nothing fashion, like rules do;[137] but, unlike policies, they establish rights and obligations rather than formulate goals.[138]

This distinction is useful since, while policies set the goals to be achieved, principles determine the means that are admissible to achieve them, in terms of the parties' rights, duties and responsibilities. Resolution goals can widely diverge from insolvency goals, but resolution principles need to take into account pre-existing rights established by private law and insolvency law if the system is not to become arbitrary. Exactly how resolution principles will take those pre-existing rights into account will depend on our conception of rights. For a conception that characterizes rights as "trumps", those rights, by the fact of being "rights to" something, would trump policy considerations and constitute absolute limits.[139] For views that see rights as "optimization mandates", [140] rights can project themselves *ad infinitum* until they encounter another right, or the public interest, in which case they are "balanced" against the colliding policy or right. Thus, those rights could be interfered with by policy considerations as long as a proper exercise of balancing and proportionality is present. In our view, the conflict between these two views is partly a product of viewing rights as either "abstract" rights, with a content that is not predetermined *ex ante*, or "concrete" rights, which are rights in a specific institutional context and normally entail a right "to" something in that particular context.[141] The former encompass rights such as "freedom of contract", "property", or "equal treatment"; the latter encompass the right to receive compensation in a specific case of contract breach.

In this light, it is not difficult to see why the task of resolution *principles* is hard: they need to further resolution's distinct goals while connecting it to the legal system as a whole, where resolution cannot

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[137] Ronald Dworkin, *Taking Rights Seriously*, 20-22, Duckworth, 1977.

[138] For a general discussion of "goals" or "policies," compared to "principles," and the contrast of the two with "rules," see Dworkin, *supra* note 140.

[139] Ronald Dworkin "Rights as Trumps" in J. Waldron *Theories of Rights*, Oxford University Press,153-167, 1st edition (1984).

[140] Robert Alexy *Teoría de los derechos fundamentales* (transl.) CEPC, 2007.

[141] Ronald Dworkin, *Hard Cases*, HARV. L. REV.1057-1109 (1975).

blatantly ignore rights that form part of that system's notions of fairness, such as "property" or "equal treatment".[142]

The principle of equal treatment is particularly relevant for our purposes. In general, in the context of insolvency law, there is a commitment to treat ordinary creditors *pari passu*.[143] When there is a need to deviate from a *pari passu* treatment, many legal regimes provide for a compensation to those creditors who have been treated differently. This principle is often referred to as the "no-creditor-worse-off" ("NCWO") principle, which, in essence, requires that no creditor be left worse than under insolvency liquidation.[144]

Different jurisdictions have adopted the NCWO principle at varying degrees. For example, in the US, the FDIC shall, in principle, treat "similarly situated" creditors in a "similar manner".[145] However, it may depart from this principle, if (i) such departure will achieve certain goals, e.g. the maximization of asset value or present value return from sale, the minimization of losses, or the continuity of key operations,[146] and (ii) all creditors receive no less than the value that they would have received in case of bankruptcy liquidation.[147] The latter is also the FDIC's maximum liability against the failing bank creditors.[148] However, additional payments or credits are permitted if 'such payments or credits are necessary or appropriate to minimize losses', i.e. typically if they affect key functions. Payments cannot exceed the face value of the claims, and this privilege does not entail an obligation to pay other creditors.[149]

FDIC rules tried to limit uncertainty by excluding the use of discretion to favour holders of equity, subordinated debt, and long-term senior debt.[150] Yet Treasury proposals have emphasized that discretion is still too large and a source of uncertainty and unfairness, and they

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[142] For an in-depth analysis of the potential conflicts between the application of the bail-in tool and the right to property and the principle against discrimination, among other fundamental rights, *see* Ramos and Solana, "Fundamental rights: a limit to bail-in?" (forthcoming 2019).

[143] FSB Key Attributes no. 5.1 (commitment to *pari passu* and respect for insolvency hierarchy).

[144] FSB Key Attributes no. 5.2 (compensation under the NCWO principle).

[145] 12 USC § 5390 (b) (4).

[146] 12 USC § 5390 (b) (4) (A).

[147] 12 USC § 5390 (b) (4) (B).

[148] 12 USC § 5390 (d) (2)

[149] 12 USC § 5390 (d) (4).

[150] 12 C.F.R. § 380.27.

recommend the elimination of discretionary disparate creditor treatment.[151]

The EU rules have created a comparable system, where no creditor can incur greater losses than under insolvency.[152] Procedurally speaking, the NCWO principle generally requires *ex post* valuation that compares the situation of creditors in resolution with a *hypothetical* valuation of their situation under insolvency.[153] That valuation gives rise to a right to compensation from the resolution fund,[154] but creditors do not have a *right* to a certain loss allocation during the resolution process itself.

In the EU, creditors of the same class must be treated *equitably*, but not equally.[155] Such equitable treatment, as well as the priority ranking under insolvency law, are taken as reference points, and apply *unless* resolution provisions state otherwise.[156] Thus, there is a weak commitment to equality as a matter of principle. Resolution authorities have the power to exclude "certain liabilities" (*ad hoc* exclusion),[157] but unlike the US case, the power is restricted to "exceptional circumstances", and subject to strict requirements.[158] One possibility is to exclude a liability where the exclusion is "strictly necessary" and "proportionate" to achieve the continuity of critical functions and core business lines, or avoid widespread contagion;[159] or when "it is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority".[160] Many of these concepts, however, are open-textured. Clear principles would help solve the interpretation issues that could arise, but the weak commitment to equal treatment makes the solution more uncertain.

Swiss rules are less controversial. The NCWO is a test to simply set reorganization proceedings in motion.[161] Then, bail-in relies on insolvency ranking, and resolution authorities lack the power to exclude liabilities other than those stipulated under the law.[162] FINMA's has certain discretion on whether to order a write-down or conversion of

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151 Department of Treasury *Orderly Liquidation Authority and Bankruptcy Reform,* 32-33 (2018).
152 See article 73 BRRD, and also article 34 (1) (b), (f), (g) BRRD.
153 Article 74 BRRD.
154 Recital (73), article 75 BRRD.

157 This may increase the burden for liabilities that remain subject to bail-in. *Id.* art. 43(3) ⁋ 2 BRRD.
158 Article 44 (3) BRRD.
159 Article 44 (3) (b) and (c) BRRD.
160 Article 44 (3) (a) BRRD.
161 Article 40 81) (a) BIO-FINMA.
162 Articles 48-49 BIO-FINMA.

claims, but it is always subject to the same rules.[163] It does not seem to be able to privilege certain classes of liabilities.

The NCWO principle tends to be associated with fundamental rights: if NCWO is not respected, there is a clear risk of a fundamental rights violation.[164] We have explored this risk in greater detail in another paper.[165] Suffice it to say here that, in cases where the correct balance between principles and policies may result in *prima facie* violations of the principle of equal treatment, procedural safeguards become particularly relevant and, when reviewing administrative decisions, courts will put a great emphasis on the justification of those decisions.[166]

The above shows that the problem of classification and application of rules has less to do with the complexity of facts, and more with the tension between different policies and principles. Classifying a liability as a deposit, secured liability, or essential to preserve critical functions is not a mere semantic problem. It is a hard case of legal interpretation, a *pivotal* problem that confronts competing policies and principles, and it needs to be solved by adequately identifying those principles and goals, finding the best "fit", and determining its consequences for the parties' rights and obligations.[167]

D. A Layered Analytical Framework

Banks' funding structures are complex, and they fall in the midst of an unresolved tension between the policies and principles enshrined in insolvency law and bank resolution. That tension will have to be partly addressed on a case-by-case basis, and will, in our view, depend on the process' legitimacy. To address the different angles of this problem in a constructive way, we need a proper explanatory plan. We propose a "layered" approach that takes the "core" tension between insolvency and resolution policies and principles in the context of key types of bank funding, and lets it unfold across the different dimensions of the

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[163] Article 50 BIO-FINMA.

[164] EBA Regulatory Technical Standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution under Directive 2014/59/EU on recovery and resolution of credit institutions and investment firms. EBA/RTS/2017/05 - Final draft RTS on valuation before resolution EBA/RTS/2017/06 - Final draft RTS on valuation after resolution 23 May 2017 pp. 7-8; EBA *Handbook on Valuation for Purposes of Resolution* 22 February 2019, pp. 10, 12. See also World Bank *Understanding Recovery and Resolution in the EU: A Guidebook to the BRRD* April 2017, pp. 139-142.

[165] *See* Ramos and Solana, "Fundamental rights: a limit to bail-in?" (Forthcoming 2019).

[166] *See* Ramos and Solana, "Fundamental rights: a limit to bail-in?" (Forthcoming 2019).

[167] Ronald Dworkin, *Law's Empire* at 42-43, Oxford, Hart, (1986).

problem. Choosing the layers is as important as choosing the order in which they will be addressed.

In our view, Layer 1 needs to address (i) the dimension of the basic principle/policy conflict, i.e. between ensuring a fair and equal treatment of creditors, and avoiding systemic risk and moral hazard, *in relation with* key categories of bank funding to see where problems may arise. We have identified four such key categories: deposits, liabilities resulting from the management of money and instruments as collateral, derivatives, and contractually subordinated debt. (ii) Layer 1 also needs to consider these key categories not only in the context of individual banks, but also of bank groups. This external versus intra-group dimension will also inform our analysis in subsequent layers.

The uncertainty resulting from the principle/policy conflict in Layer 1 leads to regulatory attempts to *plan in advance* in order to sidestep potential problems were the crisis to erupt, thereby eliminating the principle/policy conflict before it arises. Yet such rules can also create tensions between "prudential" and "crisis management" rules, in both external and intragroup funding. Thus, Layer 2 will explore the tension between insolvency and bank resolution in the context of prevention regulation (or *ex-ante* resolution mechanisms) and crisis management regulation (or *ex-post* resolution mechanisms).

Finally, Layer 3 will explore the cross-border dimension of the problem. The frictions between resolution and insolvency rules at the level of bank and intra-group funding are difficult to comprehend. Adding the tensions between crisis-management and preventive rules on top of that further increases the complexity of the challenge. When we add yet another level of analysis by exploring cross-border recognition *and* coordination, the problem becomes truly daunting. Yet we attempt to identify the sources of conflict and suggest avenues to mitigate existing problems, both from a perspective of external and intragroup funding. We explore Layer 3 in a succeeding article.

III. LAYER 1: THE EXTERNAL FUNDING V. THE INTRA-GROUP FUNDING DIMENSION

A. Operational Liabilities

i. Deposits and Claims Against Deposit Guarantee Schemes

Enhancing the protection of retail deposits has become a matter of public policy. Indeed, the FSB has identified this matter as one of the

goals of bank resolution in its recommendations.[168] There are two clear objectives behind this policy: i) to foster confidence in the system, and ii) to guarantee that depositors will continue to have access to their deposits despite any resolution action.[169]

Nevertheless, bank resolution frameworks treat different types of deposits differently. For example, deposits covered under a Deposit Guarantee Scheme ("DGS"), i.e. "covered deposits",[170] are given priority "up" the insolvency ladder and are left "out" of bail-in.[171] "Eligible deposits", however, i.e. deposits that fall under the scope of DGS but may not necessarily be "covered", or at least not in full, are also "up" in the insolvency ladder (yet below "covered deposits")[172] but are not excluded from bail-in,[173] In other words, "eligible (yet uncovered)" deposits are "up" (although not as high as "covered deposits") and "in. Claims that the DGS may have against the insolvent institution when subrogating to the rights and obligations of covered depositors will rank just as high as "covered deposits" in the insolvency ladder,[174] but they are not excluded from bail-in:[175] they are also "up-and-in". Deposits that do not fall under the scope of DGS, i.e. "ineligible deposits", rank *pari passu* with ordinary liabilities: they are "down" and "in".

The different treatment of all these claims can create frictions between bank resolution frameworks and insolvency law. For example, covered deposits and DGS claims resulting from subrogation are both "up" in the insolvency ladder but only the former are "out" (i.e. excluded from bail-in).

More complicated scenarios can be envisaged in cases where, in order to avoid a panic, a DGS decides to extend their coverage level beyond the amount specified in article 6 of the DGS Directive, i.e.

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168 See, e.g. FSB Key Attributes of Effective Resolution Regimes for Financial Institutions 15 October 2014. See also art. 31(2)(d) BRRD.

169 See e.g. BRRD, art 69(4)(a). This second objective contributes to the first objective.

170 This is the term used in EU legislation. See e.g. Directive 2014/49/EU of the European Parliament and of the Council of 16 of April 2014 on deposit guarantee schemes ("DGS Directive), article 2(1)(5). Art 6(1) of the DGS Directive stipulates that, if deposits are unavailable, 'the coverage level for the aggregate deposits of each depositor is EUR 100 000'. The second paragraph of this article requires Member States to provide a higher coverage for specific deposits that can last between three and twelve months.

171 See e.g. article 108 (b)(i) (insolvency priority) and article 44(2)(a) (bail-in) BRRD.

172 See article 108(a)(i) BRRD. Letter (ii) of that provision extends the same protection to deposits made through third-country branches of EU institutions.

173 See article 44(2), fourth paragraph, BRRD.

174 See article 108(b)(ii) BRRD.

175 See article 44(2) BRRD. On the other hand, liabilities to "deposit guarantee schemes arising from contributions due in accordance with Directive 2014/49/EU" are excluded from bail-in. See article 44 (2) (g) (iv) BRRD.

€100,000. Bank resolution provisions use the definition of "covered deposits" under the DGS Directive to define the scope of the privileged treatments in insolvency. If the DGS of any Member State raised the coverage level to €250,000, for example, it is unclear whether the privileged treatment that article 108(B)(i) BRRD recognises to "covered deposits" would only cover the first €100,000, i.e. the coverage level defined in article 6 DGS Directive, or whether it would cover the €150,000 extension as well. The same doubts would arise in relation to DGS claims in insolvency that arose from subrogation of "covered depositors".[176] In our opinion, the underlying policy rationale would dictate that the privilege be extended to the full amount, but this would also raise questions about how DGS in different Member States might respond to a looming crisis. Different coverage levels in different Member States could introduce additional frictions in the application of the bank resolution framework if, for example, one bank goes into resolution and its depositors are treated differently depending on the bank's subsidiary with which they entered into the deposit.

Another problem might arise where a "host" DGS covers the deposits of a branch within its jurisdiction because the "home" DGS is insufficiently funded. The host DGS can make the payment "on behalf of" and "under instructions from" the home DGS, and it is stipulated that the home DGS "shall provide the necessary funding *prior to* payout."[177] Yet nothing is said about those cases where a host DGS decides to cover the liabilities of the home DGS before receiving the funding. Problems may arise because the right of subrogation and the right of priority are provided to "the DGS that makes payments under guarantee within a national framework," but it is unclear whether a host DGS filing in for the home DGS without having received prior funding would be making payments "within a national framework."[178]

In addition, it is important to note that short-term debt is excluded from bail-in.[179] This could give creditors whose deposits could be bailed-

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[176] See article 108(b)(ii) BRRD.

[177] Article 14 (2) DGS Directive (emphasis added.)

[178] The host DGS can make the payment 'on behalf of' and 'under instructions from' the home DGS, and it is stipulated that the home DGS 'shall provide the necessary funding *prior to* payout'. Article 14 (2) DGS Directive. (Emphasis added.). Yet nothing is said about those cases where a host DGS decides to cover the liabilities of the home DGS before receiving the funding. Problems may arise because the right of subrogation and the right of priority are provided to 'the DGS that makes payments under guarantee within a national framework', but it is unclear whether a host DGS filing in for the home DGS without having received prior funding would be making payments 'within a national framework'.

[179] Liabilities with less than 7-days maturity are excluded from bail-in Article 44 (2) (e) BRRD.

in, i.e. "eligible (yet uncovered)" and "ineligible" deposits, an incentive to replace their deposits with short-term debt. But if the entity is not put into resolution but enters insolvency, DGS claims will rank higher than short-term debt despite the former not being excluded from bail-in.

In our opinion, these problems arise because resolution rules have blurred the rationale for the protection of DGS claims. In principle, the protection of DGS claims is grounded in a "right of subrogation," yet resolution rules deal with the issue as a matter of insolvency "privileges," which means that they *de facto* take the "right" of subrogation away. This also contradicts the constant references to their "equal treatment," which is referred to in insolvency law, while resolution rules introduce an additional privilege for covered deposits by excluding them from bail-in. It is as if a bullseye were moved after the shot had been fired.

ii. Liabilities Resulting from the Management of Client Money and Client Assets

In principle, liabilities arising from managing client money and client assets are expressly excluded from bail-in as long as "[the] client is protected under the applicable insolvency law."[180] Liabilities that may arise from holding assets for the benefit of another person, e.g. as a result of a fiduciary relationship, are also excluded from bail-in provided that "[the] beneficiary is protected under the applicable insolvency or civil law."[181] These cases raise several concerns.

First, the protection of the client or the beneficiary under the applicable law may itself be unclear. For example, in the *Lehman Brothers (Client Money)* cases, it took three lengthy decisions by the High Court, the Court of Appeal and the Supreme Court in the UK to clarify that investors' rights over "client money" were protected despite Lehman's breach of its duty to place that money in segregated accounts.[182] A constructive trust[183] was held to exist:[184] clients were

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[180] Article 44(2)(c) BRRD.

[181] Article 44(2)(d) BRRD.

[182] Instead, Lehman commingled its clients' money with its own funds in its house accounts. In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2009] EWHC (Ch) 3228; In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2010] EWCA (Civ) 917; In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2012] UKSC 6, (appeal taken from Eng.).

[183] For the purposes of this paper, we regard trusts as an example of "fiduciary agreements" as the term is used in Article 44(2)(d) BRRD, *supra* note 5. Unfortunately, however, the BRRD does not provide a specific definition of the term "fiduciary agreement". In reality, trusts are a creature of the English common law and they may present some differences with fiduciary agreements as understood, for example, in civil

given protection because their money *should have been* placed in segregated accounts. Still, different facts could alter the policy/principle considerations at stake.[185]

In another Lehman case, *Lomas v RAB Market Cycles*,[186] the difficulty was whether the Prime Broker Agreement (Charge version) (the "PB Agreement") that was concluded by LBIE, Lehman's parent

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law jurisdictions. For a detailed analysis of the reception of trust-like mechanisms in civil law jurisdictions, see M Lupoi, *Trusts: A Comparative Study* (Cambridge University Press 2000); LD Smith (ed), *Re-imagining the Trust: Trusts in Civil Law* (Cambridge University Press 2012).

[184] The High Court concluded that there was a constructive trust, a conclusion accepted by the Court of Appeal and the Supreme Court. Yet, the High Court considered that clients' money were excluded from the specific reimbursement procedure envisaged by regulatory rules on "client money", while the Court of Appeal and the Supreme Court concluded that they were protected by it. In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2009] EWHC (Ch) 3228; In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2010] EWCA (Civ) 917; In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2012] UKSC 6, (appeal taken from Eng.).

[185] The conclusion that the specific protection procedure should apply to all clients, regardless of whether their moneys were commingled or not, was based strictly on insolvency law, but on a finalistic reading of MiFID rules, specifically article 16 of Directive 2006/73/EC (MiFID Implementation Directive), which required States to dispense a 'high level of protection'. The High Court held that, since property law was not harmonized, each State should achieve the level of protection 'taking its property law as given'. According to the Court of Appeal and the Supreme Court, however, the 'high level of protection' required that the specific restitution procedure arising from the CMP should be available to all clients. *See* In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2009] EWHC (Ch) 3228; In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2010] EWCA (Civ) 917; In the matter of Lehman Brothers International (Europe) (In Administration) and In the matter of the Insolvency Act 1986 [2012] UKSC 6, (appeal taken from Eng.). Furthermore, the courts' holding was partly based on the fact that the custody mechanisms available at that time left a protection gap. The "alternative approach" sanctioned by UK regulatory rules permitted the firm to not segregate the moneys immediately, but to deposit the money in house accounts and effect a daily reconciliation procedure. This, together with the lack of internal controls, resulted in a failure 'on a truly spectacular scale'. *See* In the matter of Lehman Brothers International Europe, [2009] EWHC 3228 (Ch) at 4. In contrast, article 38 of Regulation 909/2014 on Central Securities Depositaries (CSDs) provides for segregation by giving clients an express choice between more protective and expensive mechanisms (individual segregated accounts) and cheaper but riskier ones (omnibus accounts), while CSD participants must inform their clients of the level of protection of each system. Clients' acceptance of the harmful consequences associated with the chosen protection mechanism could influence a court's calibration of the level of insolvency protection, which would determine exclusion from bail-in.

[186] Lomas v. RAB Market Cycles (Master) Fund Limited [2009] EWHC (Ch) 2545.

entity for the EU, was a trust that would make LBIE a trustee and thus give its clients proprietary protection in the event of LBIE's insolvency. Unsecured creditors objected on grounds that, although the PB Agreement described LBIE as trustee of the assets for the benefit of its clients, it gave LBIE rights to substitute and use its clients' assets, which, unsecured creditors alleged, was incompatible with a trust and should have deprived clients of any proprietary rights in the assets in insolvency.[187] Despite recognising certain anomalies,[188] the court concluded that, taken as a whole, the PB Agreement did disclose a sufficient intention to make LBIE the trustee over the client's assets or their substitute.[189]

A second concern is *how* clients are actually protected. Going back to the *Lehman (Client Money)* saga, it was clear that clients' rights were protected under a fiduciary arrangement, i.e. a trust. Yet the trust itself would have merely given them the remedy of "tracing", which is extremely difficult to enforce over money commingled in house accounts.[190] The real question was whether clients, in addition to "tracing", were *also* protected under a specific restitution procedure envisaged by regulatory rules, with the High Court saying they were not, and the Court of Appeal and the Supreme Court saying they were.[191] In the context of bail-in, the question thus becomes whether the protection offered by a trust would suffice to exclude the resulting liabilities from bail-in despite the practical difficulties associated with the enforcement of the trust.

The problem is worse in civil law countries due to the limited admissibility of fiduciary arrangements.[192] Otherwise, this figure could help fill any gaps in the attempts to determine the specific rights over

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[187] *Id* at 20.

[188] *Ibid* at 49-52.

[189] *Ibid* at 53-63. The court found the existence of a trust *"*notwithstanding the conferral of rights on LBIE in relation to it which would have made a 19th century trust lawyer turn in his grave.*" See* Justice Briggs, "Has English law coped with the Lehman collapse?" at 132, Butterworths Journal of International Banking and Financial Law (March 2013).

[190] Tracing requires the beneficiary to identify "his" property, which is extremely difficult to do in case of money assets commingled in different accounts. *See In the matter of Lehman Brothers International Europe*, [2009] EWHC 3228 (Ch) at 172 et seq.

[191] In other words, if clients simply had had a constructive trust, whereas the specific procedure envisaged in regulatory rules, which consisted in the forming of a Client Money Pool (CMP) to be promptly restituted, was reserved only for clients whose moneys were effectively segregated, there would be a clear difference in treatment. Thus, the Court of Appeal and the Supreme Court considered that the CMP should encompass all clients, regardless of whether their moneys had been effectively segregated. See In the matter of Lehman Brothers International Europe, [2010] EWCA Civ 917; and [2012] UKSC 6.

[192] Saverio Bartoli *Il Trust*m 916 Milano: Giuffrè (2001).

client assets.[193] As a result, jurisdictions that admit fiduciary arrangements would effectively grant clients a better protection. The difference may be particularly acute when the insolvency law and the law of the fiduciary arrangement differ, since, to be excluded from bail-in, liabilities from client money or instruments must be protected under insolvency law, whereas liabilities arising from fiduciary arrangements can be protected under insolvency law *or* civil law.[194]

In short, the same liabilities arising in relation to client money and client assets may be treated differently under the EU bank resolution framework depending on the classification of those liabilities, on the level of protection granted by the applicable insolvency law, and on elements, such as the recognition of fiduciary arrangements, that are deeply embedded in legal culture. Whether such differences are arbitrary (and thus potentially illegal) will depend on whether they are backed by the principles and policies underpinning resolution rules.

iii. Liabilities Arising from Derivative Contracts

Derivatives are financial instruments the value of which is derived from the value of an underlying asset.[195] Derivatives can be traded in a regulated market ("exchange–traded") or over-the-counter ("OTC"),[196] and they can be cleared on the books of each counterparty i.e. "bilaterally cleared," or on the books of a central counterparty ("CCP"), i.e. "centrally cleared." Exchange-traded derivatives are always centrally cleared.

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[193] In the case of Spain, for example, recent clearing and settlement rules provide for the possibility of settlement using special accounts opened by CSD participants on behalf of financial intermediaries, who, in turn, use the accounts for their clients. This gives rise to complex issues if the financial intermediary goes insolvent, and there are securities deposited in those accounts. There are strong arguments, partly based on the law of mandate, partly based on insolvency law, to support that those securities do not belong to the intermediary's estate, but admit that this remains an open issue. *See* David Ramos, Ignacio Tirado, "El Procedimiento Alternativo de Liquidación a Través de Intermediario Financiero" 693-749 (2017).

[194] Articles 44 (2) (c) or (d) BRRD.

[195] Commodities, securities, currencies, and interest rates or yields are the most common underlying assets, but the scope is much broader. See e.g. Directive 2014/65 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (hereinafter, "MiFID II"), Annex I, Section C (4) to (10).

[196] That is, directly between the two parties, without the involvement of a regulated market. See Regulation (EU) no. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (hereinafter, "MiFIR"), art 2(1)(32); and Regulation (EU) no. 648/2012 of the European Parliament and of the Council of 4 of July 2012 on OTC derivatives, central counterparties and trade repositories (hereinafter, "EMIR"), art 2(7).

Liabilities arising from derivative contracts are, in principle, eligible for bail-in,[197] but only for the amount that results from the application of any close-out netting agreement between the parties, and only if that amount is not covered by a "financial collateral arrangement" that the parties might have entered into to support the derivative transactions.[198] Thus, in practice, only the part of the derivatives liability that is unsecured, for example because it is "under-collateralised," will be eligible for bail-in.[199]

It is important to note, however, that crisis prevention or crisis management measures will not necessarily trigger the application of a close-out netting agreement nor the enforceability of a financial collateral arrangement, provided that the substantive obligations under the derivative contract continue to be performed.[200] In addition, bank resolution frameworks vest resolution authorities with the necessary powers to suspend payment and delivery obligations,[201] to restrict the enforcement of security interests,[202] and to suspend termination rights,[203] all for a very short period of time: one day after the publication by the resolution authority of a notice summarising the effects of the resolution action. The scope of these powers, however, is restricted to bilaterally cleared derivatives.[204]

Despite the clear intention of financial regulators to design a uniform framework that would make liabilities arising from derivative contracts potentially eligible for bail-in, the divergences in the treatment of these liabilities under insolvency law could give rise to potential frictions in the application of bank resolution frameworks. For example, in the EU, the Financial Collateral Directive does not require any privileged treatment of these liabilities in insolvency beyond the enforceability of financial collateral arrangements and close-out netting agreements. Indeed, most Member States appear to rank claims arising from derivatives as general unsecured claims.[205] Spain, however, is an exception. To incentivize parties to maintain derivatives contracts despite

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197 These liabilities are not in the list of liabilities expressly excluded from bail-in. See arts 44(1) and (2), BRRD.

198 *See* Council Directive 2002/47 of June 6, 2002, on financial collateral arrangements, 2002 O.J. (L 168) 4, 5, 6, 7.

199 *See* BRRD, art 44(2), third sub-paragraph. An "under-collateralised" amount defines the part of a liability that is not covered by the value of the collateral assets that secure the liability.

200 *See* art 68(1) and (3), BRRD.

201 *See* e.g. art 69 BRRD.

202 *See* e.g. art 70(1) BRRD.

203 *See* e.g. art 71 BRRD.

204 *See* arts. 69(4)(b), 70(2) and 71(3) BRRD, respectively.

205 *See e.g.* the Financial Collateral Arrangements, No.2 (U.K. 2003).

the opening of insolvency proceedings, Spanish law makes the claim resulting from the early termination of derivatives transactions payable against the insolvent estate (i.e. privileged) ahead of all unsecured creditors if the early termination event occurs after the filing for insolvency, whereas the claim will be ordinary and non-privileged if such an event is concurrent with, or prior to, the filing for insolvency.[206]

In principle, the privileged treatment that claims arising from derivatives receive under Spanish law need not be problematic in the context of bank resolution. For example, resolution authorities could exercise their right to suspend early termination rights under the derivatives in accordance with article 71(1) BRRD. This would allow resolution authorities to block any attempt from derivatives counterparties to behave opportunistically. Nevertheless, the privileged treatment may be upheld if resolution authorities decide not to transfer those liabilities to another entity or if they decide not to write down or convert those liabilities on the application of the bail-in tool for recapitalisation purposes.[207] They may also be upheld if resolution authorities decide to exclude those liabilities from bail-in due to extraordinary circumstances, including the possibility of spreading contagion.[208] In these cases, the place of incorporation of the derivatives counterparty would matter: if the counterparty is a bank incorporated in Spain, a derivatives creditor would have a better treatment in insolvency than a derivatives creditor whose counterparty is incorporated in another Member State.

In these cases, the privileged treatment of derivatives creditors could pose challenges to the resolution of Spanish banks. In addition, it could also give participants in derivatives markets an incentive to structure their transactions in a way that would allow them to benefit from the privileged insolvency treatment under Spanish law, thereby potentially challenging the effective resolution of banks incorporated in other Member States. We consider that privilege to be unjustified and have

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[206] Art. 16 (2) second sub – paragraph, of Royal Decree – Law 5/2005, which transposes FCD in Spain. At the end of 2015, the Spanish Supreme Court excluded this preferential treatment in cases where a bank had entered into one derivative transaction with one of its retail customers. The Court did not examine the applicability of such privileged insolvency treatment where the counterparty was another sophisticated participant nor where the parties had entered into several derivative transactions under the same master agreement. For a critical commentary of the decision, *see* Javier Solana, 'Swaps y Concurso: Reflexiones a Propósito de La Sentencia Del Tribunal Supremo Núm. 629/2015, de 17 de Noviembre' [2016] *La Ley mercantil* 2.

[207] *See* article 71(4) BRRD.

[208] *See* article 44(3) BRRD.

advocated for legislative reform elsewhere.[209] Until that happens, the diverse treatment of liabilities arising from derivatives contracts across the different insolvency laws of the EU Member States could introduce frictions in the effective application of the EU bank resolution framework. These frictions further support our call for legislative reform.

iv. Contractual Subordination

If bank resolution, and bail-in in particular, is about ensuring that losses are absorbed by the bank, holders of "subordinated" instruments, broadly conceived to encompass subordinated debt and equity, play a determinant role.[210] It is therefore necessary to discuss the role of subordination provisions under insolvency law.

Debts may be subordinated as a result of contractual agreement ("contractual subordination"), the application of statutory provisions ("statutory subordination") or court order to avoid unfair results ("equitable subordination"). In the specific context of banking groups, we may also see structural subordination as a reflection of the group's corporate structure. Here we refer to *contractual* subordination issues, dealing with statutory, equitable, and structural subordination in the next sub-section.

The terms "contractual subordination" and "subordination agreements" can refer both to agreements that subordinate the payment of a certain (typically unsecured) debt to the payment of another debt, and to agreements amongst secured creditors that establish the order of priority of their security rights. In the US, each of these two types of subordination agreements are referred to as "payment subordination" and "lien subordination", respectively.[211] In civil law countries, the second type tends to be seen as an agreement that is circumscribed to the specific security or collateral, not as a subordination agreement. Our concern here is thus with the first type, i.e. payment subordination.

Contractual subordination is admissible in jurisdictions like England,[212] Germany,[213] Spain,[214] and France,[215] as well as in the United

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[209] *See* Javier Solana, "Swaps y Concurso: Reflexiones a Propósito de La Sentencia Del Tribunal Supremo Núm. 629/2015, de 17 de Noviembre" [2016] *La Ley mercantil* 2.

[210] In fact, in the bail-in sequence envisaged in article 43 (2) BRRD, letters (a), (b) and (c) are dedicated to Tier 1, Tier 2 capital, and subordinated debt.

[211] *See* Koback v. National City Bank (In re Koback), 280 B.R. 164 (Bankr. S.D. Ohio 2002). In England, *see* Cheah v. Equitycorp Finance Group Ltd, [1992] 1 AC 472 (PC).

[212] *In Re Maxwell Communications Corp PLC* (No 2) ChD [1993] 1 WLR 1402.

[213] § 39 para. 2 Insolvency Statute.

[214] Insolvency Act art. 92.

[215] French Comm. Code, art. L 228-97, L 228-36.

States.[216] Despite the widespread admissibility of subordination agreements, their enforceability can be problematic, particularly if it would alter the priority ranking laid down in insolvency law and the *pari passu* principle. Generally, agreements that affect priorities and ranking (i) cannot impose additional burdens on the insolvent estate;[217] and (ii) need to be consented by the parties whose rights are at stake.

Yet subordination agreements offer variations. We can distinguish at least between (i) agreements for "full" and "partial" subordination, depending on whether a creditor agrees to be subordinated to all ordinary creditors or only to specific creditors; and (ii) "agreements between creditors" and "agreements with the debtor". It makes sense for "full" subordination agreements to be concluded with the debtor, but this may be also desirable in partial subordination agreements.

With these basic categories in mind, jurisdictions vary in their approach to the validity and enforceability of subordination agreements. Countries like France have no general doctrine of contract subordination,[218] and subordinated securities or loans are often based on specific statutory provisions.[219] Others, like Germany or Spain, have explicit provisions that render enforceable full subordination agreements, but say nothing of partial subordination ones.[220]

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[216] Section § 510 (a) of the Bankruptcy Code, 11 U.S.C. § 510(a), stipulates that *"*A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law,*"* which means that a two-step test will be needed to establish enforceability.

[217] Christoph G Paulus & Matthias Berberich, *National Report for Germany*, *in* RANKING AND PRIORITY OF CREDITORS, 300 (Dennis Faber, Niels Vermunt, Jason Kilborn, Tomas Richter & Ignacio Tirado, OXFORD UNIVERISTY PRESS (2016).

[218] French Comm. Code, art. L 228-97, L 228-36.

[219] Although subordination agreements are allowed, for example between creditors secured by a same asset, there is no general doctrine of contractual subordination. Gilles Cuniberti & Isabelle Rueda, *National Report for France in* RANKING AND PRIORITY OF CREDITORS, 260-61 (Dennis Faber, Niels Vermunt, Jason Kilborn, Tomas Richter & Ignacio Tirado, OXFORD UNIVERISTY PRESS (2016).

[220] Insolvenzordnung [InsO] [Insolvency Statute], Oct. 5, 1994, BGB1 §39(1) (Ger.). In Germany, the debt subject to such agreements does not count for purposes of determining a balance sheet insolvency.

Let us illustrate the specific problems that might arise from contractual subordination in the context of bank resolution with an example.

Example. Categories of debt and interpretative problems

A1 and A2 are two banks that partly fund themselves with deposits: A1's deposits are mostly retail, while A2 has a base of large corporate deposits. The two also have interbank deposits between them, and with other entities, A3 and A4. Besides this, both banks provide custody services to clients, and A2 to counterparties such as hedge funds (together with prime brokerage services). A2 uses the same clearing and settlement accounts to clear and settle proprietary trades, and trades on behalf of clients, and for its own transactions it uses counterparties' money and instruments as collateral, many of which are pooled in omnibus accounts held by A3. To fund their expansion in, respectively, the retail and corporate markets, A2 has obtained a loan facility from a syndicate of several banks (B1-B3) which includes a loan agreement and an inter-creditor agreement that organizes the rights from more senior (B1) to more junior (B3). A1 for its part has issued subordinated and non-subordinated bonds, the majority of which (but not all) are held by A3. To hedge against FX and interest rate risk, the entities have concluded hedging agreements with A3, although A2 has also hedged the FX risk of the syndicated loan facility through a derivative with B1.

In this example, the status of subordinated bonds would be less problematic, but the laws of France, Germany or Spain could pose problems for the loan facility with B1-B3, or in reconciling it with the other subordination clauses if A1 and A2 entered insolvency.

In England, although subordination agreements are valid,[221] they are typically enforced between creditors, not vis-à-vis the insolvency administration, and they are often structured through a trust, where insolvency proceeds are received by the junior creditor on trust for the senior creditor.[222] This could spell trouble if, for example, A1 and A2 entered insolvency, D were an English creditor and senior over B, but the latter was located outside England (say, France) and entered insolvency as well. In this case, the trust would have to be enforced against A1-A2 and/or B.

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221 *In Re Maxwell Communications Corp* PLC (No 2) ChD [1993] 1 WLR 1402.

222 *See Re SSSL Realisations* (2002) Ltd [2005] 1 BCLC (where the court also had to decide whether the trust agreed upon by the parties had to be re-characterized as a charge subject to registration (the court decided in the negative)).

In the United States, the trust device operates as a matter of law if the debtor were a party to the agreement,[223] but the situation is more complicated if it were not.[224] Furthermore, the agreement will only be enforceable if it is enforceable under the applicable non-bankruptcy law.[225] This can be a source of uncertainty if A1-A2 are located in the United States but one of the loan facilities is subject to French law, for example, which has no general doctrine of subordination.

B. Intra-group Funding

The previous section has illustrated the tension at the level of policy and principle that may crystalize in bank resolution if the bail-in tool is deployed over a bank's complex funding structure. To have a complete picture of that funding structure, we need to add the dimension that compares "external" with "intra-group" funding. The last category of debt analysed above provides a smooth transition, since intra-group funding is, to a large extent, characterized by subordination issues (III.B.1). We then discuss the relevance of the intra-group dimension beyond subordination (III.B.2).

i. Subordinated Debt in Bank Groups

If the discussion of contractual subordination above showed an important level of uncertainty over the enforceability of the agreements, the picture is even more uncertain for *statutory* subordination due to the significant differences between jurisdictions and categories of debt,[226] although intra-group debt remains the more relevant category for our purposes. In Germany, the country that first provided for a doctrine of subordination of shareholder loans, that doctrine stems from corporate

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223 The Sumitomo Trust and Banking Co., Ltd. v. Holly's, Inc., 160 B.R. 643, 667-668 (Bankr. W.D. Mich. 1992).

224 *Ibid*. In that case, the junior creditor must transfer the money to the senior creditor, who nonetheless has not been satisfied by the debtor himself, which means that he can fully recover the amounts owed by the debtor. The junior creditor, however, has a right of "subrogation", which is an equitable remedy to prevent unjust enrichment. See also Michael S. Quinn, "Subrogation, Restitution and Indemnity," 74 TEX. L. REV. 1361, 1388-90 (1996).

225 11 U.S.C. § 510(a) (1984).

226 Categories of subordinated debt include debt for interests and penalties in Germany and Spain, claims filed late in Spain, claims for deferred unsecured provable debts and non-provable liabilities in England, costs incurred by creditors due to participation in the proceedings, and claims for which no consideration is due by the debtor in Germany, claims by bad faith counterparts in transactions subject to avoidance, or under executory contracts when the court is satisfied that the counterpart is obstructing the execution of the contract in the interest of the insolvency proceedings in Spain. *See* Insolvenzordnung [InsO] [Insolvency Statute], Oct. 5, 1994, BGB1 §39(1) (Ger.).

law principles of capital raising (*Kapitalaufbringung*) and capital maintenance (*Kapitalerhaltung*). The doctrine of "equity-replacing loans" tried to dissuade shareholders from supplying funds via loans instead of equity by subordinating the loans granted in circumstances where a shareholder with the diligence of a prudent businessperson would have granted equity, typically in times of crisis; a rule whose scope was broadened once it was incorporated into insolvency law.[227] The foundation of the rule lies in the "equity-replacing" character of the loans, and in the shareholders' responsibility for funding a company in times of crisis.[228]

The logic of preventing opportunistic behaviour by shareholders also inspired Spanish rule-making in the same domain, but the risk of using of open-textured concepts like "equity-replacing" or "prudent", and case-by-case variations, led to a stricter rule that automatically subordinates loans by "especially related" parties.[229] Despite criticism,[230] this approach has inspired more recent German rules that omit the "equity-replacing" requirement for the loan[231] and subordinate *all* shareholder loans,[232] thus sacrificing flexibility for certainty. Italian law also subordinates shareholder loans; although it uses the German original approach and makes subordination conditional on the existence of a situation of a debt "imbalance" or a financial situation where an equity contribution would have been "reasonable".[233]

The United States makes these adjustments through the use of equitable subordination,[234] which normally requires that a creditor's "inequitable conduct" results in an "unfair advantage".[235] Alternatively, a

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227 *Id.* at §39(1), (4), (5), (135). Spanish Insolvency Act art. 92(5) and 93 (R.D.L. 2014, 1664) (Spain).

228 BGH, NJW (1995) pp. 326, 329. The principles of capital raising and maintenance require shareholders to raise the registered capital in full, and subsequently maintain and protect it, and encourage them to provide additional equity capital in times of crisis.

229 Spanish Insolvency Act art. 92(5) (R.D.L. 2014, 1664) (Spain).

230 *See e.g.*, Carmen Alonso Ledesma, *El automatismo en la subordinación de créditos y la posición de las entidades de crédito in* IMPLICACIONES FINANCIERAS DE LA LEY CONCURSAL, 175-83 (Alberto Alonso Ureba & Juana Pulgar Ezquerra, LA LEY, 2009).

231 Martin Gelter, Jürg Roth, "Subordination of Shareholder Loans from a Legal and Economic Perspective," 2 CESifo DICE Report at 43, 2007.

232 Insolvenzordnung [InsO] [Insolvency Statute], Oct. 5, 1994, BGB1 §39(1)(5), (4-5) (Ger.). The rules exempt only non-managing shareholders holding less than 10% of shares, and creditors who acquire shares in the company as a rescue attempt in case of illiquidity or balance sheet insolvency.

233 Article 2467 Italian Civil Code.

234 *See* Section § 510 (c) of the Bankruptcy Code, 11 U.S.C. § 510 (c).

235 As a final condition, equitable subordination must not be inconsistent with the provisions of the Bankruptcy Code. *See* In re Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977).

bankruptcy court may use its equitable powers[236] to re-characterise a debt claim as an equity claim[237] although some courts have not clarified whether they consider re-characterization admissible under equitable powers.[238] Being procedural powers, however, they are deployed on a case-by-case basis, which is a source of uncertainty. In addition, their use is not limited to debt claims by "insiders",[239] which means that they provide no firm basis to determine the status of intra-group funding, i.e. there is no "law of shareholder/intra-group loans" nor can precedents be easily extrapolated to the resolution context, where the procedure and powers are different.

A final point of US Law that connects with the issues that will be revisited below is the "source-of-strength" doctrine, which is not part of

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[236] *See* 11 U.S.C. § 105 (2010). Re-characterization operates to determine whether a debt claim exists, and does not require an unfair conduct on the side of the lender, while subordination subordinate an existing debt claim, and requires unfairness. *See* James H.M. Sprayregen, Jonathan P. Friedland, Jo Ann J. Brighton; Salvatore F. Bianca, *Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine,* William L. Norton, Jr. Annual Survey of Bankruptcy Law (2004). *But see* Matthew Nozemack, *Making Sense Out of Bankruptcy Court's Recharacterization of Claims Why Not Use Section 510(c) Equitable Subordination?*, 56 Wash. & Lee L. Rev. 689, 716 (1999).

[237] *See* In re AutoStyle Plastics, Inc., 269 F.3d 726, 749 (6th Cir. 2001) (holding an authoritative 11-point test, which emphasizes the insufficiency of funds of the subsidiary through undercapitalization or otherwise). The possibility to recharacterize a debt claim as an equity claim under the court's general powers is also admitted by courts in the Third Circuit, In re SubMicron Sys., 432 F.3d 448, 454 (3d Cir. 2006), the Fourth Circuit, Dornier Aviation (North America), Inc. v. Official Comm. of Unsecured Creditors (In re Dornier Aviation), 453 F.3d 225, 231 (4th Cir. 2006), and the Tenth Circuit, Sender v. Bronze Group, Ltd. (*In re* Hedged Investments Assocs., Inc.), 380 F.3d 1292, 1297 (10th Cir. 2004).

[238] This is the case of the Seventh Circuit. *See* FCC v. Airadigm Commc'ns, Inc. (*In re* Airadigm Commc'ns, Inc.), 616 F.3d 642, 657 n. 11 (7th Cir. 2010). Furthermore, other courts, notably those of the Fifth Circuit, have not used the more general powers of Section § 105, but Section § 502 (b) (1) of the Code, which provides for the power to object to, or disallow, claims based on the applicable laws and rules. *See* In re Lothian Oil, Inc., 650 F.3d 539, 542–43 (5th Cir. 2011), or In re Fitness Holdings International, Inc., 2013 WL 1800000, *1 (9th Cir. April 30, 2013).

[239] The definition of "insider" is found in Section § 101 (31) of the Bankruptcy Code, and it includes directors and controlling parties. The standard of review is more exacting in case of "insiders", but subordination is also possible in case of non-insiders, although "gross and egregious conduct will be required before a court [can] equitably subordinate a claim". See *Waslow v. MNC Commercial Corp. (In re Paolella & Sons, Inc.)*, 161 B.R.107, 119 (Bankr. E.D. Pa. 1993). Then, subordination in case of insiders may be denied in case there has been no harm to creditors as a result of the funding by insiders, because subordination is remedial, not punitive. See *Wooley v Faulkner, In re SI restructuring, Inc.*, 532 F. 3d 355 (5th Cir. 2008). In a recharacterization case, such as *In re Lothian Oil*, Inc., 650 F.3d 539, 542–43 (5th Cir. 2011) the court held that the powers could be exercised beyond loans by insiders.

insolvency law, but of the law of bank group supervision.[240] Grounded in the broad language of the Bank Holding Company Act section granting powers to the Federal Reserve Board (the "Fed") as a supervisor,[241] the latter used the said doctrine to demand parent holding companies to be a "source of strength" for their subsidiaries.[242] This doctrine was considered valid by the courts,[243] but the actual scope of the Board's powers to force a parent holding company to contribute funds to its subsidiary remained unclear.[244] Yet the Fed or the FDIC could use the

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240 *See,* Paul L. Lee, *The Source-of-Strength Doctrine: Reversed and Revisited (Part I),* The Banking Law Journal Vol. 129 No. 9 (October 2012) at 771; *see,* Paul L. Lee, *The Source-of-Strength Doctrine: Reversed and Revisited (Part II),* The Banking Law Journal, Vol. 129 No. 10 (November/December 2012) at 867; *see,* Leonard Bierman & Donald R. Fraser, *The 'Source of Strength' Doctrine: Formulating the Future of American Financial Markets*, ANN. REV. BANKING. L. 269 (1993); *see,* James F. Groth, *Can Regulators Force Bank Holding Companies to Bail Out their Failing Subsidiaries? – An Analysis of the Federal Reserve Board's Source-of-Strength Doctrine*, 86 Nw. U. L. REV. 112 (1991); *see,* Kieran J. Fallon, *Source of Strength or Source of Weakness?: A Critique of the Source-of-Strength" Doctrine in Banking Reform*, 66 *N.Y.U. L. REV.1344, 1382 (1991).*

241 Section 3 (c) (2) required the Board to take into consideration "the financial and managerial resources and future prospects of the Company or companies" before deciding on a transaction subject to its approval, including the authorization for a company to become a holding company.

242 The more specific formulation by the Board was made in Regulation Y, of 1984, where it expressly stated that "bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner" (Section 225.4(a)(1) of Regulation Y, 49 Fed. Reg. 794 (1984)), and, in 1987, where the Board published a policy statement stating that a bank holding company "should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress", and it would be considered "unsafe and unsound" in the absence of this. However, the Board's refused to authorize bank holding companies on that basis, a policy that was challenged, and reviewed judicially, during the 70s.

243 First Lincolnwood bank challenged the Board's power to refuse authorization of a holding company on the sole grounds of an absence of "source of strength". The 7th Circuit Court considered that the Board had exceeded its powers, because its powers allowed it to restrict unsafe practice, such as the increase of debt, but not to impose new requirements if the transaction itself (the creation of a parent holding company) would represent no change in the group's financial profile. See First Lincolnwood Corp. v. Board of Governors, 560 F.2d 258, 262 (7th Cir. 1977). However, the Supreme Court reversed the 7th Circuit decision, holding that this was a legitimate use of the Board's powers. See First Lincolnwood Corp. v. Board of Governors 439 U.S. 234 (1978).

244 In 1988 the Board issued a cease-and-desist order against MCorp, a multibank holding company, as engaging in "unsafe and unsound practices", and required it to use all available assets to recapitalize the subsidiary banks suffering capital deficiencies. This was followed by a declaration of insolvency and receivership by the FDIC, and a bankruptcy petition. MCorp sought, and obtained, a court order enjoining the Board from supervisory action based on the source-of-strength doctrine. In re MCorp, 101 B. R. 483 (S.D. Tex. 1989). The order was appealed by the Board. The Fifth Circuit ruled that the

doctrine to force the parent holding companies' commitment to recapitalize subsidiaries. As a result of a modification of the Bankruptcy Code, parent's "commitments" made to a regulatory agency to cure any deficit or to maintain the capital of the subsidiary now have priority, which means that the agency can obtain the payment as a precondition for restructuring. This shows that subordinating a parent's loans can be equivalent to forcing it to make fresh contributions.

The relevance of parent-subsidiary, especially the holding-subsidiary relationship in the banking context, justifies distinguishing *structural subordination* as a fourth category. Here, subordination does not result from agreement, law, or court powers, but from the very structure of the banking group. Once the assets are held by operating subsidiaries (the parent holding's assets being mostly the subsidiaries' shares), third-party funding to the parent will necessarily be subordinated to subsidiaries' funding *vis-à-vis* the subsidiaries' assets. This operation is an example of resolution planning and will be analysed in section IV.B.

ii. Intra-group Operational Debt

As seen above, the law generally tries to dissuade groups from adopting strategies that replace equity or subordinated funding with ordinary liabilities. The ultimate tool to accomplish this is subordination; but, as we will see now, subordination is combined with the exclusion of intra-group debt from categories of debt that receive preferential treatment from the law. Although this principle is generally sound, in light of the absence of arm's length conditions, it can disrupt banks' intra-group funding structures, which involve "sensitive" types of operational debt. Following the order of section III.A, we will discuss intra-group deposits and short-term funding, management of client money and client assets, and derivatives.

Starting with deposits, these are generally excluded from bail-in and protected by insolvency rules, but this does not encompass interbank

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Board could decide to refuse authorization of a parent holding company on the basis of the source-of-strength doctrine, but, once the authorization was granted, it could not use its power to issue cease-and-desist orders against "unsafe and unsound" practices to force parent holding companies to transfer funds to troubled subsidiaries, in a way that would force the holding to disregard its separate corporate status, and interest, and thus cause a wats of corporate assets, and violate its duty to shareholders. See MCorp. Financial Inc v. Board of Governors Federal Reserve System, 900 F.2d 852 (5th Cir. 1990). The decision was appealed to the Supreme Court, which held that the Bankruptcy Court lacked jurisdiction to review the Board's regulatory action. See Board of Governors of Federal Reserve System v. MCorp Fin. Inc., 502 U.S. 32, 40 (1991). However, the Supreme Court never settled whether it was legal for the Board to force a holding company to fund its subsidiary.

deposits or deposits with other financial institutions, which include intra-group bank deposits.[245] Considering short-term debt more broadly, claims from short-term loans are "out" of bail-in. Therefore, there is an incentive to use these loans to replace corporate or interbank deposits, which are "in." Yet this strategy is not available in intra-group situations since intra-group short-term liabilities are not left "out" of bail-in.[246]

The problem of intra-group deposits is not only that they are "in" bail-in; they may also be subordinated to ordinary creditors in countries with specific statutory subordination rules (e.g. Spain or Germany) or countries that use equitable subordination (e.g. the United States) if a court sees them as part of a strategy to defraud ordinary creditors. This can raise interpretative issues.

If rules subordinate "hidden equity contributions" posing as shareholder loans, like traditional German rules did, this creates important classification problems. If rules are simpler and subordinate all intra-group loans, they may still not subordinate liabilities 'different from loans or acts with analogous finality', like the Spanish rules do,[247] which raises the question of whether an inter-bank deposit has an "analogous finality" to a loan.[248] This would largely depend on whether the relevant authority or court accepts a finalistic construction of the rule that sees it as a provision dissuading from opportunistic behaviour but not from managing intra-group liquidity. If bail-in were deployed over some liabilities but not others it would be contrary to resolution policies, which try to preserve "critical functions".[249] In countries where "equitable

[245] They are excluded from the definition of "covered deposits", under Directive 2014/49/EU Article 5(1)(a), (d) and (e), and do not fall within any of the categories under Directive 2014/59/EU Article 108(a)(i) or (ii).

[246] Directive 2014/59/EU Article 44(2)(e) excludes from bail-in "liabilities to institutions, excluding entities that are part of the same group, with an original maturity of less than seven days."

[247] Article 92. 5º Spanish Insolvency Act.

[248] Here we are weighing different interpretations, which always consider the intention of the agreement, relying on the reference to 'finality', and leaving out a strict and formal reading of the agreement's typified, or objective, *causa.* For a discussion of 'objective' and 'subjective' or finalistic *causa,* see L. Diez Picazo *Fundamentos del Derecho Civil Patrimonial* Vol. I. 2007. Even considering the 'objective legal nature' of the agreement, the bank deposit, as an 'irregular deposit', lacks a specific regulation in the Civil code, which means that its regime is assimilated to that of the loan. The significant difference would be that, under this assumption, each deposit should invariably be the subject of separate treatment, and the treatment of the intra-group liquidity management arrangement as a whole should cease to be an option.

[249] Against this, one could still argue that resolution rules try to incentivize groups to clarify their internal arrangements, corporate and otherwise, and that carving-out an exception to the subordination rules for intra-group deposits on grounds that the arrangement has a different "finality" to a loan weakens that incentive.

subordination" is used, like the United States, it seems less likely that an authority or court would consider intra-group deposits as an instance of fraud or harm to creditors.

In light of these difficulties, bank groups will continue to place intra-group deposits in the context of broader schemes for the management of liquidity and instruments, backed by collateral arrangements and set-off or netting clauses, which benefit from protections for financial collateral.[250] Yet this can give rise to other interpretative problems. For example, resolution rules exclude from bail-in those liabilities arising from holding client money or client assets.[251] In the *Lehman Brothers (Client Money)* case discussed earlier, courts determined that "clients" enjoyed proprietary protection despite the commingling of their funds;[252] but the commingling was due to the *intra-group* funding structure, where clients' balances were used to cover the liquidity needs of group entities, with a "reconciliation" being operated later.[253] This would raise the question whether, in such a case, liabilities incurred with clients could be effectively separated from liabilities incurred with group entities.[254]

Even if intra-group arrangements are not protected as liabilities arising from 'client money or instruments', the liabilities resulting from those intra-group arrangements may be protected as liabilities arising from a 'fiduciary arrangement' or as "secured liabilities".[255] Yet the complexity of intra-group arrangement can give rise to important classification problems, which raises the question of how much certainty is needed from the private law of credit and security, and insolvency law before a certain class of liabilities is excluded.

Consider the category of liabilities arising from "fiduciary arrangements". In another Lehman case, *Pearson v Lehman Brothers Finance*,[256] generally known by the acronym *RASCALS*, the group had a system for the acquisition of securities: every time a group company would acquire securities, the "hub" company (i.e. LBIE, the parent company for Europe) would hold all the securities *for the account of* the

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[250] For example, Directive 2002/47/EC Articles 4, 6 and 7 protect the enforcement of financial collateral arrangements, the recognition of title transfer financial collateral arrangements, and that of close-out netting provisions, respectively.
[251] Directive 2014/59/EU Article 44(2)(c).
[252] *Supra* section III.A.2.
[253] In the Matter of Lehman Brothers International Europe, [2009] EWHC 3228 (Ch) "Statement of Assumed Facts", 2.21-2.50.
[254] We must also remember that courts also granted protection to counterparties, such as hedge funds, as 'clients' under Primer Brokerage arrangements. See *Lomas v RAB Market Cycles (Master Fund) Limited* [2009] EWHC 2545 (Ch).
[255] Article 44 (2) (b) and (d) BRRD.
[256] Pearson v Lehman Brothers Finance *S*A [2010] EWHC 2914 (Ch), [2011] EWCA Civ 1544.

group affiliate and would use the securities for its own purposes, e.g. lending them for liquidity management, selling them to meet short positions within the group, etc., while crediting the affiliate for whom it held the securities with the securities' value and any income accruing from it, e.g. interest or dividend. The securities would be repo-ed on a daily basis to LBIE, using an automated system for the period during which securities would be held inside the group. After Lehman entered insolvency and the automated transfer system was stopped, the question before the court eventually was the identity of the beneficial owner of the securities. Against the objections of LBIE's administrators, the court held that the automated system only made sense if the parties assumed that the beneficial ownership had been transferred to the affiliates,[257] which could only happen if LBIE was a trustee for the securities, which revealed a sufficient intention to create a trust.[258]

Consider now the category of "secured liabilities" in the context of yet another case in the Lehman Brother's saga, the so-called *Lehman Brothers 'Extended Liens'* case.[259] In that case, the European parent company (LBIE) held securities for group entities, including Lehman Brothers Finance (LBF), as part of a Master Custody Agreement ("MCA"), signed between LBIE and LBF, which was instrumental for the intra-group management of financial instruments. Pursuant to that agreement, LBIE, as custodian, held a "lien" over those assets, which secured not only the debts of affiliates to LBIE, the parent company, but also the debts of affiliates to any other affiliate within the Lehman group (hence the term "extended liens"[260]). LBIE's "lien" was subject to a *sui generis* clause, copied from client custody agreements, and pasted on an intra-group agreement for cash and instruments management.[261]

This posed important characterization problems. Under English law, a "lien" is a possessory security interest, which cannot be perfected over non-movables, which meant that the security interest had to be re-characterized as a charge,[262] and, more specifically, as a floating charge.[263] The ruling also discussed whether EU financial collateral rules

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[257] *Ibid*.

[258] Mr Justice Briggs, "Has English law coped with the Lehman collapse?" Butterworths Journal of International Banking and Financial Law (March 2013) p. 132.

[259] In the matter of Lehman Brothers International Europe, [2012] EWHC 2997 (Ch).

[260] *See* Daniel Saoul, "Lehman and the la won liens," Butterworths Journal of International Banking and Financial Law (November 2011) p. 598.

[261] The clause was initially developed for client custody agreements. It is reproduced in *In the matter of Lehman Brothers International Europe*, [2012] EWHC 2997 (Ch) at 32.

[262] *Ibid* at 34-48.

[263] *Ibid* at 70. Ever since *Re Spectrum Plus Ltd* [2005] UKHL 41, English courts look at the substance of the security interest to characterize a charge as fixed or floating.

could apply to the arrangement. Justice Briggs held that, although a floating charge compliant with the FCD was possible in theory,[264] the FCD introduced a requirement of "possession or control,"[265] which was not satisfied, given that, in the accounts LBIE held for LBF as custodian, LBF retained uncontrolled rights of recall and disposal.[266] Finally, Justice Briggs held that any security right held by LBIE was not held under an implied fiduciary arrangement for the benefit of the other group companies, which meant that, in deciding whether and how to exercise the security right, LBIE would take into account its own business judgment, and would not be constrained by a fiduciary duty towards its affiliates.[267] Although the conclusion was quite well reasoned,[268] some might find it surprising that the potential opportunism of the parent within a group would not be contained by fiduciary duties or a similar kind of constraint.[269]

Therefore, if a group uses some kind of "floating" right for its intra-group cash and collateral management arrangements to be operational,

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[264] *In the matter of Lehman Brothers International Europe*, [2012] EWHC 2997 (Ch) at 135.

[265] *Ibid* at 116 *et seq.* On this point Briggs J relied on the previous opinion of Vos in *Re F2G Realisations Ltd: Gray v GTP Group Limited* [2011] 1 BCLC 313.

[266] *Ibid* at 147. Another point was whether the FCD imposed a requirement for collateral arrangements to be 'bilateral' in order for FCD rules to apply, which Briggs J concluded, it did not. The court did so in spite of references to 'bilateral collateral arrangements' in recital (3) of the Directive, which it took more as a reference to mark the contrast with Directive 98/26/EC, on Settlement and Finality Systems.

[267] *In the matter of Lehman Brothers International Europe*, [2012] EWHC 2997 (Ch) at 205-211.

[268] As an example: *"[T]he Lehman group's business was not generally managed on a company by company basis, but on a product by product basis, so that the interests of the group would be in the forefront of the minds of relevant business managers when deciding whether, and if so to what extent, to exercise rights over the property of street clients,"* In that context, *"the very existence of ill-defined fiduciary obligations would be an impediment to the sensible and practical making of business decisions in relation to the exercise of the rights in clause 13* [the general lien]*"*. Thus, subjecting LBIE to a fiduciary duty *"would require LBIE to maintain a constant watch upon the day to day account balances between each of its clients (the subject of an MCA in this standard form) and each of its many affiliates. It would enable an affiliate with a modest debt to demand enforcement in circumstances where to do so would gravely prejudice a continuing business relationship between LBIE and the client in question, or between some other affiliate and the same client". In the matter of Lehman Brothers International Europe*, [2012] EWHC 2997 (Ch) at 208-210.

[269] *See* n. 268, *supra*. Indeed, in Justice Briggs' reasoning, it was the particular dynamics of the Lehman group that justified LBIE's decisions based on its business judgment.

such arrangements may be mired in uncertainty. Floating securities are valid in several countries; but UK rules, for example, rank creditors under floating securities behind creditors with fixed security *and* other preferred creditors (e.g. for winding-up or administration expenses, pension contributions, or wages),[270] and carve-out a percentage of the assets subject to the floating charge ("net assets") for the satisfaction of ordinary, unsecured, creditors.[271] Other countries, like Sweden, have rules that characterize the charge as a mere privilege over 55% of the debtor's assets, ranking after all special priorities.[272] Other countries, like Italy, consider "floating securities" valid, but have no specific insolvency rules.[273] Some, like Germany, do not contemplate floating securities, while others, like Spain, may allow things similar to a floating security but with a restricted scope.[274]

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[270] See s. 176ZA (winding-up expenses); Schedule B1 para. 99 (3) (administration expenses); and s. 175(2) (b) in relation to s. 386 and Schedule 6 paras. 8-9 Insolvency Act 1986. The resulting ranking upon insolvency was thus stated by Lord Neuberger in *Re Nortel GmbH* [2014] AC 209 (SC) at [39]. The order set out in that decision is (1) creditors with a fixed security; (2) expenses of insolvency proceedings; (3) preferential creditors; (4) floating charge creditors; (5) unsecured probable debts; (6) statutory interests in probable debts; (7) deferred, unsecured, probable debts; (8) non-provable liabilities; (9) shareholders' return on capital and (10) shareholders' distribution of surplus.

[271] The prescribed part is a 50% of the first £10,000 of assets subject to the floating charge, and 20% of the remaining part, with a limit of £600,000. See article 3 Insolvency Act 1986 (Prescribed Part) Order 2003 SI 2003/2097. Since the amount of assets carved out for unsecured creditors is capped at £600,000, the impact should presumably be lesser in case of banks.

[272] Priority Rights Act, s. 4 and 5.

[273] In Italy, the Decree Law n. 59 of 3 May 2016, later transformed into Act 119/2016, introduced the pledge without dispossession, which also admitted the possibility for the debtor to dispose of the assets, in which case the pledge would fall over the proceeds/assets that replaced the original collateral. See article 1 (2) Decree Law 59 of 2016. According to article 1 (8), however, in order for the creditor to enforce its security over the collateral it would have to be recognized, first, as creditor with privilege. Article 1 (6) states that the creditor protected by a non-possessory pledge could not be used against a creditor who funds the acquisition of a specific asset with a reservation of title or pledge over that asset. The provisions do not expressly address the relationship with other secured creditors, or with creditors with general privilege, e.g. workers.

[274] Articles 21-22 of the Act of 16 December 1964, on Mortgages over Movables and Non-Possessory Pledge provides for the extension of the mortgage right over commercial establishments over the goods that are part of the trade, which, by definition, are constantly purchased and sold, and article 54 of the same act permits a non-possessory pledge over receivables. In combination, they could provide some basis to something close to a floating security, but the basis is too narrow to give rise to a full-fledge version of it. *See* David Ramos Munoz, '*Transacciones Trascendentes. Operaciones Fuera de Balance, Disociación de la Propiedad y Problemas Regulatorios, Patrimoniales y de Gobierno'*, 125 REVISTA DE DERECHO BANCARIO Y BURSÁTIL 216, 231 (2012).

Financial collateral rules that pre-empted traditional law of credit and security, like the FCD does, were the way to sidestep this uncertainty:[275] they created specific security rights with relatively few formal requirements which could be recognizable and enforced across borders.[276] The *Extended Liens* case, however, cast a long shadow of doubt over the ability to "fit" a floating security as a financial collateral arrangement subject to a "possession or control" requirement.[277]

To top it all, resolution rules completely exclude from bail-in "secured liabilities" and "liabilities arising from fiduciary arrangements" without making any distinction.[278] Thus, resolution authorities would have to first decide whether the security qualifies as a protected financial collateral arrangement; and, if so, they would most likely exclude the liability from bail-in. Yet, if they could not classify it as a protected financial collateral arrangement, they would have to classify it under the applicable private law, and determine whether, under that law, it is a secured liability or not. This could create friction between (i) the private law of security interests and secured transactions; (ii) the insolvency law hypothetically applicable; and (iii) resolution rules, if they are susceptible of a self-referenced interpretation.

Presumably, resolution authorities would decide, first, whether the security qualifies as a "financial collateral arrangement" under the FCD, because that would automatically exclude it. The difficulty would arise if the arrangement were considered to fall outside the FCD. In that case, the second step would be for resolution authorities to decide which is the law (or laws) applicable to the arrangement, a task for which there are no uniform conflict rules.[279] Simultaneously, resolution authorities would need to determine *which assets* are subject to which law. If the authority manages to find a suitable conflicts-of-laws rule, the third step would be

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[275] In the case *MJA and others c. Bank of London and The Middle East PLC* decided with Arrêt nº 627 of 7 December 2015 (14-18.435) ECLI:FR:CCASS:2015:AP00627, the French Civil chamber of the *Cour de cassation* in plenary session applied the FCD to a non-possessory pledge over stocks, and in so doing it overruled the finding of the court of appeal, which had decided that, despite the existence of FCD rules, the parties had chosen to regulate the relationship through the rules of the Civil code (the issue concerned the validity of the *pacte commissoire*, by which the secured creditor can seize the asset and obtain its ownership in case of default).

[276] See e.g. article 3 of the FCD.

[277] In relation to the suitability of floating security interests over cash collateral kept in bank accounts to qualify as "financial collateral arrangements" under the FCD, see Case C 156/15 Private Equity Insurance Group SIA v. Swedbank AS.

[278] Article 44 (2) (b) BRRD.

[279] Article 21 of Directive 2001/24/EC on the Reorganisation and Winding Up of Credit Institutions (the Bank Winding Up Directive) does not provide a conflicts-of-laws rule but a mutual recognition rule, which requires, first, to determine which is the law applicable to the rights in re.

to determine whether the type of security arrangement is admissible and enforceable for a specific asset pool under the applicable national law.

Even if the law confirms the validity and enforceability of the arrangement, it leaves one final doubt as to whether the conditions and exceptions imposed by that law may raise doubts regarding whether the liability qualifies as a "secured liability" under resolution rules, and thus must be excluded. In principle, the definition of "secured liability" is very broad and relies on the classification under domestic laws.[280] However, resolution authorities may be reluctant to grant full exclusion to something that looks like a mere "general preferential right" rather than a secured liability.

This leaves the final issue of intra-group derivatives exposures, where classification problems look no less daunting. In the same way that groups adopt liquidity management strategies, they may adopt group-level hedging strategies to reduce the overall cost by using internal hedges between group entities to minimize the (more expensive) external hedges, and then using investment-grade parties for external hedging purposes.

Let us illustrate complexity with an example.

Example. Categories of debt and interpretative problems

A1 and A2 are two banks that partly fund themselves with deposits: A1's deposits are mostly retail, while A2 has a base of large corporate deposits. The two also have interbank deposits between them, and with other entities, A3 and A4. Besides this, both banks provide custody services to clients, and A2 to counterparties such as hedge funds (together with prime brokerage services). A2 uses the same clearing and settlement accounts to clear and settle proprietary trades, and trades on behalf of clients, and for its own transactions it uses counterparties' money and instruments as collateral, many of which are pooled in omnibus accounts held by A3. To fund their expansion in, respectively, the retail and corporate markets, A2 has obtained a loan facility from a syndicate of several banks (B1-B3) which includes a loan agreement and an inter-creditor agreement that organizes the rights from more senior (B1) to more junior (B3). A1 for its part has issued subordinated and non-subordinated bonds, the majority of which (but not all) are held by A3. To hedge against FX and interest rate risk, the entities have concluded hedging agreements with A3, although A2 has also hedged the FX risk of the syndicated loan facility through a derivative with B1.

[280] Article 2 (1) (67) BRRD states that: *"'secured liability' means a liability where the right of the creditor to payment or other form of performance is secured by a charge, pledge or lien, or collateral arrangements including liabilities arising from repurchase trans- actions and other title transfer collateral arrangements;"*

Here, save for isolated cases, such as A2's specific derivative agreement with B1, A3 acts as group treasurer, with two types of strategies: A3 either concludes specific hedging agreements with counterparties, e.g. for specific credit risks, and then concludes back-to-back hedging agreements with the corresponding group entity; or, for broader risks, such as FX, it concludes "macro/portfolio" hedging agreements with counterparties, and then concludes multiple intra-group hedges subject to netting agreements.[281] To lower the cost, A3 receives a guarantee from A4, its own parent.

Intra-group derivatives can be a source of uncertainty if their treatment varies across jurisdictions, especially in the case of non-collateralized derivatives, where the counterparty merely holds a personal right. The first problem is the risk of subordination in jurisdictions that provide so for intra-group loans. This depends on whether a derivative can be characterized as a "loan" or a "funding" agreement (see above). The fact that derivatives are used for "hedging" purposes should exclude subordination. Likewise, the enforcement of the netting agreements that typically accompany the conclusion of multiple derivatives (including between group entities) should not encounter any exception in intra-group agreements,[282] nor should the preferential treatment enjoyed by the netted debt in some jurisdictions like Spain[283] be excepted in intra-group cases.

Having said that, the picture of intra-group hedging strategies is bound to be complex and varied, and one cannot exclude that a specific structure of derivatives is used, or at least is seen by resolution authorities or courts as being used, for purposes of funding subsidiaries, or, conversely, for drawing resources from them. In such extreme cases, characterization and subordination, and the resulting risk of avoidance, would remain a possibility.

IV. LAYER 2: THE *EX-ANTE* (CRISIS PREVENTION) V. *EX-POST* (CRISIS MANAGEMENT) DIMENSION

The previous section has shown the tensions at the level of policy and principle between bank resolution, specifically the bail-in of debt instruments, and insolvency priorities at the intra-group dimension. This

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[281] Anuschka Bakker; Krzysztof Łukosz "Treading Carefully through the Murky Labyrinth of Intra-Group Financial Derivatives" *Derivatives & Financial Instruments*, Vol. 18 No. 4 (2016).

[282] Neither article 7 of the FCD, nor articles 76 (2) (d), or 77 make an express exception for cases where the 'counterparty' to the netting agreement is a group entity.

[283] *Supra* 3.1.3.

section adds one more layer to the problem. This considers the relationship between the *ex post* crisis management rules, such as bail-in, which present the problems outlined before, and the regulatory rules that try to plan ahead and *ex ante* avoid those problems. The first sub-section discusses how the planning and prevention perspective has acquired an increasing importance under resolution rules, and how this has influenced additional changes in insolvency ranking (A). The second section discusses the interplay of the *ex-ante* prevention with the 'external v. intra-group' dimension (B).

A. *Ex-Ante Resolution Planning, TLAC/MREL Standards, and Tensions in Policy and Principle*

Rules on *ex ante* resolution planning anticipate the problems arising from insolvency law and try to sidestep them by creating a new type of instrument that can guarantee loss absorbency (1). At a regional (that is, within the EU) level, this gives rise to implementation frictions due to the presence of diverging criteria in different countries (2). In general, however, this creates tensions at the level of policy, between financial stability and investor protection, and at the level of principle, due to considerations of proportionality (3).

i. TLAC and MREL Standards: Sidestepping the Problem of Insolvency Ranking?

Resolution rules include *ex post* tools, such as bail-in, which are deployed once the entity enters a critical stage, but also include rules to plan *ex ante* for the entity's "recovery"[284] and potential "resolution".[285] In these "living wills", resolution authorities must anticipate any major obstacles to resolution (arising, *inter alia*, from complex corporate structures and financial arrangements), remove them, and devise a clear resolution strategy, including the use of one or more resolution tools. If bail-in is the chosen strategy, as it is in many large groups, the entity must have an adequate layer of capital and debt instruments to absorb losses and be recapitalized quickly.

This idea of "ear-marking" a layer of capital and debt has been the subject of harmonization efforts at a global and regional, i.e. EU level. At a global level, the key concept is Total Loss-Absorbency Capital (TLAC), espoused by the Financial Stability Board (FSB) for Global

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[284] Articles 5-9 BRRD.
[285] Articles 10-18 BRRD.

Systemically Important Banks/Institutions ("G-SIIBs/G-SIIs").[286] At an EU-level, the key concept is Minimum Requirements for Own Funds (MREL), which applies to all banks.[287] In both cases, the idea is to use TLAC/MREL-eligible debt and equity to absorb losses and recapitalize the bank through conversion into equity, to ensure continuity of critical functions without taxpayer support (TLAC), or to leave a Core Equity Tier 1 (CET1) level compliant with prudential rules (MREL).[288] TLAC and MREL standards, however, present some differences. These include their scope of application (G-SIIs v. all banks); level of uniformity (single common requirement v. case-by-case assessment[289]); calculation;[290] relationship with prudential requirements (TLAC is integrated with them, whilst MREL was initially conceived separately under the resolution framework[291]); and the size of debt-to-equity,

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[286] *See*, e.g. FSB Total Loss-Absorbency Capacity Standard, 6 November 2014; and also its Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution Total Loss-absorbing Capacity (TLAC) Term Sheet 9 November 2015 (hereafter: TLAC Term Sheet). See also Basel Committee on Banking Supervision (BCBS) Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement July 2013.

[287] Article 45 and recital (80) BRRD.

[288] Article 45 (6) BRRD. That is, the entity needs to keep a capital level to keep the authorization under CRD (Directive 2013/36/EU) and CRR (Regulation 575/2013). This means *"the need to ensure that, if the resolution plan anticipates that certain classes of eligible liabilities might be excluded from bail-in under Article 44(3) or that certain classes of eligible liabilities might be transferred to a recipient in full under a partial transfer, that the institution has sufficient other eligible liabilities to ensure that losses could be absorbed".*

[289] TLAC requirements are the greater between a 16% of risk-weighted assets (from 1 January 2019, 18% from 1 January 2022) and the 6% of the assets used to calculate the leverage ratio under Basel rules (from 1 January 2019, 6,75% from 1 January 2022). See FSB *TLAC Term Sheet* no. 4, p. 10. Since MREL levels need to ensure a compliant CET1, and this is a risk – weighted ratio, MREL levels will vary depending on the specific circumstances of the entity. In addition to the achievement of resolution objectives, and the need to be compliant with CRD/CRR requirements after resolution, the elements to be considered include the size, business model, funding model and risk profile of the institution, the potential contribution of the Deposit Guarantee Scheme, and the adverse impact of the institution's failure on financial stability. See article 45 (6) BRRD.

[290] There are some differences regarding eligibility of debt, which affect the numerator, while, in the denominator, TLAC uses risk-weighted assets (RWA) and the assets used to calculate the leverage ratio, whereas MREL uses total liabilities and own funds (article 45 (1) BRRD) which may cause a problem of double counting

[291] *See* FINANCIAL STABILITY BOARD, PRINCIPLES ON LOSS-ABSORBING AND RECAPITALISATION CAPACITY OF G-SIBS IN RESOLUTION. TOTAL LOSS-ABSORBING CAPACITY (TLAC) TERM SHEET 5-6 (2015). Integration makes it easier, in the case of TLAC, to ensure that the calculation of firm-specific requirements is aligned for capital and MREL requirements.

"expected" to be at least 33% of TLAC,[292] whereas there is no minimum expectation in the case of MREL. Yet, the potential frictions created by these differences led EU authorities to consider reforming MREL rules to ensure a better alignment with TLAC.[293] This led to new rules in the resolution framework,[294] but also in the prudential regulation framework (see below).[295]

It is important to note that not all liabilities that are subject to bail-in will be TLAC/MREL-eligible. Insolvency laws vary across jurisdictions. Moreover, bail-in can also be disruptive if applied to "operational" liabilities. Thus, TLAC/MREL rules try to use planning to impose the duty to have enough "clean" liabilities to sidestep ranking and priority issues.[296]

TLAC and MREL standards try to ensure the "cleanliness" or susceptibility to bail-in through a series of requirements, consisting of:

(i) a list of eligibility criteria; i.e. debt fully paid-in, unsecured and *not* subject to set-off/netting, 1-year remaining maturity, not redeemable, and not directly or indirectly funded by the resolution entity or related party;
(ii) a list of excluded liabilities, comprised of deposits, derivatives, non-contractual liabilities, including taxes, preferred liabilities, including secured liabilities, and other bail-in-excluded liabilities; and
(iii) (this one only for TLAC:) a requirement of "subordination" of TLAC-eligible instruments to TLAC-excluded liabilities,

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292 TLAC Term Sheet no. 6 para. 4, p. 12.

293 Council of the European Union Press Release, Council Conclusions on a roadmap to complete the Banking Union (June 17, 2016). Highlight the amendments to implement TLAC standard and reviewing the minimum requirement for own funds and eligible liabilities (MREL). *See* Council Directive 2016/0632, 2016 O.J. (L 852) 377, 378.

294 Directive 2019/879 of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC (hereafter we will refer to the reformed BRRD provisions as BRRD II).

295 Regulation 2019/876 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (hereafter we will refer to the reformed provisions as CRR 5).

296 Entities subject to the FSB TLAC framework may use non-subordinated instruments to satisfy TLAC requirements only up to a limit of 2,5% of Risk-Weighted Assets. FSB TLAC Term Sheet no. 11, p. 16. See also article 72b (3) CRR 5, which allows non-subordinated instruments to qualify as TLAC up to a 3,5% of total risk exposures.

> with some allowance for cases where there is no subordination or where the subordination is not full.[297] Since MREL is calculated case-by-case, it depends on each entity and resolution strategy.[298] Thus, the new TLAC rules modified this aspect to comply with the TLAC standard.[299]

Another important difference is that the TLAC standard demanded TLAC instruments to be subordinated to non-TLAC liabilities, while expressly allowing entities to comply with that requirement using "contractual subordination," "statutory subordination" (i.e. ear-marking debt that is junior in the insolvency ranking), or "structural subordination" (i.e. using debt issued by a "clean" holding company).[300] The latter explicitly deals with the case of banking groups, an essential aspect that will be discussed in section III.B.1, and which, originally, MREL rules did not address. MREL rules, initially conceived as an extension of resolution rules rather than as a "semi-prudential" requirement, were less detailed. They did not require subordination beyond allowing statutory subordination, contractual subordination and "contractual bail-in", which is similar, but not equivalent, to contractual subordination.[301]

Reformed EU rules try to align MREL rules with TLAC approach, but not fully. They differentiate between G-SIIs, and other banks subject to resolution, with a gradation of TLAC/MREL cushions (higher for the former, lower for the latter[302]) subject to a phase-in.[303] Furthermore, the

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[297] Subordination is not required if (i) the amount of excluded liabilities that rank *pari passu* or junior to TLAC-eligible liabilities does not exceed 5% of the entity's eligible external TLAC, (ii) the resolution authority has the authority to differentiate among *pari passu* creditors in resolution, (iii) such differentiation would not give rise to a material risk of successful legal challenge or compensation claims, and (iv) this does not have a material impact on resolvability. See TLAC Term Sheet no. 11. Article 45 (4) BRRD includes the requirements for MREL-eligible debt

[298] EUROPEAN BANKING AUTHORITY, FINAL REPORT ON MREL. REPORT ON THE IMPLEMENTATION AND DESIGN OF THE MREL FRAMEWORK 114 (2016) (hereinafter: EBA *Final Report on MREL*).

[299] *See* Article 45d BRRD II, with reference to new Article 92a CRR 5.

[300] TLAC Term Sheet nos. 9 (eligibility criteria), 10 (liabilities excluded from TLAC) and 11 (priority) pp. 14-15.

[301] This means that the contract clauses need to explicitly state that, in case of bail-in, the debt will be written down or converted, and that, in case of insolvency, the debt will be subordinated. Article 45 (13) and (14) BRRD. Resolution authorities can, in the same decision where they set MREL levels, determine which part of MREL shall be met through contractual bail-in instruments.

[302] *See* Articles 45d BRRD II and 92a CRR (G-SIIs), and article 45c (3) BRRD II (other banks).

[303] *See, e.g.* Article 494 CRR (G-SIIs) or 45m BRRD II (other banks).

calculation of MREL for GSIIs is based on TLAC rules. However, EU rules also apply TLAC-based requirements to a new category of "top-tier banks" (more than 100 billion euros, or those "fished-in" by the authorities[304]). Furthermore, MREL is still considered institution-specific, which means that it is calculated individually for other (i.e. non-G-SIIs, non-top-tier) banks, while G-SIIs and top-tier banks can be hit with additional requirements if justified by the situation of the bank.[305] More important for present purposes, however, is the nature of the instruments that can be used to comply with TLAC/MREL (including subordination), which we discuss in the next section.

ii. What kind of (TLAC) Instruments? Regional Challenges to employ MREL in the EU, and the Risk of Fragmentation

The basic idea underpinning TLAC is simple: make bail-in easier to deploy. Yet due to the cost it imposes on banks, countries may have different priorities on how to allocate that cost. Indeed, the move from TLAC to MREL in the EU has broadened the scope of the concept to smaller banks, which, in turn, has made some adjustments necessary, e.g. the possibility to use non-subordinated debt to comply with MREL. Then, as EU law left some leeway to comply with MREL to Member States, they initially pursued different legislative strategies. The UK, like the US, adopted a strategy of "structural subordination". Germany and Italy, on the other hand, followed a "statutory subordination" strategy, where they amended the insolvency ranking of *existing* debt instruments. Germany established that, in case of insolvency, subordinated senior unsecured bonds and similar debt instruments would be subordinated to other senior liabilities.[306] Italy chose the opposite way, and simply gave

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[304] Article 45c (5) and (6) BRRD II (top-tier banks). Article 45m BRRD II applies to transitional arrangements.

[305] Article 45d (1) (b) BRRD II. In addition to this, EU rules prevent resolution funds from making contributions unless an 8% of Total Liabilities including Own Funds (TLOF) has been bailed-in (see, e.g. article 44 (5) (a) BRRD). Thus, in practice this 8% TLOF provides an extra "floor" or minimum level of MREL.

[306] See Section § 46f (5) *et seq.* of the German Banking Act (*Kreditwesengesetz,* or KWG), and Section § 97 (1) para. 3rd. of the German Act on Recovery and Resolution, as introduced by the Resolution Mechanism Act (*Abwicklungsmechanismusgesetz,* AbwMechG) of November 2015. The subordinated instruments included were bearer bonds, order bonds, and similar rights tradable in capital markets, as well as promissory note loans and registered bonds, with the express exclusion of debt instruments where the payment of principal or interest is subject to the occurrence/non-occurrence of an uncertain event, e.g. derivatives in securitised form. Section § 46f (7) German Banking Act.

preferential status to *all* bank deposits, including large corporate deposits and interbank deposits.[307] Thus, this was more a statutory *privilege* than statutory subordination, strategy.

The advantage of this approach is that German and Italian banks could comply with MREL with their long-term non-operational debt without making any new issuance. The ECB concluded that German rules made senior debt TLAC/MREL compliant, but ineligible for ECB operations,[308] but was more cautious about TLAC-eligibility of Italian banks' senior debt: some operational liabilities, such as derivatives, still ranked *pari passu* with senior unsecured bank debt.[309]

Interestingly, both Italy and Germany chose to subordinate senior debt's position under insolvency law. This would result in its subordination under resolution rules, while avoiding any issues concerning the No Creditor Worse-Off principle,[310] or discriminatory treatment, since creditors would not be treated "worse" than under insolvency rules (they would be treated worse than they were under the preceding insolvency rules). Still, since both types of measures apply to existing rights, they could be challenged as a retroactive interference with property.[311] By interfering with an ongoing process, the rules are not a case of strict retroactivity (*echte Rückwirkung)*, but of "not real retroactivity" (*unechte Rückwirkung*) and are backed by German Supreme Court case law, validating, for example, the 2014 incorporation via statute of collective action clauses (CACs) in bonds outstanding at the time the measure was adopted.[312]

Spain and France (especially the latter) introduced a new type of "Tier 3 debt", which, in case of resolution, would be senior to Tier 2 debt

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[307] See the modifications to article 91 of the Legislative Decree No. 385 of 1 September 1993, Consolidated Law of Banking (TUB).

[308] In the ECB's view, they facilitated the implementation of the bail-in tool, and carried a lower contagion risk, by postponing financial liabilities to operational liabilities. Opinion of the ECB of 2 September 2015 on bank resolution (CON/2015/31), at 3.2.2-3.3 pp. 5-6 (and reference to articles 64 and 141 of the ECB Guideline (EU) 2015/510 (ECB/2014/60) on the Eurosystem operations on the issue of (in)eligibility.

[309] Opinion of the ECB of 16 October 2015 on recovery and resolution of credit institutions and investment firms (CON/2015/35), no. 3.7.1-3.7.2, pp. 13-14. TLAC-eligible debt must be subordinated to *all* TLAC-excluded liabilities, i.e. not only deposits.

[310] Opinion of the ECB of 2 September 2015 on bank resolution (CON/2015/31), at 3.2.2, p. 5.

[311] Admittedly less likely so in Italy, where the rules establish a new privilege, than in Germany, where they subordinate senior debt.

[312] Bundesgerichtshof [BGH] [Federal Court of Justice] July 1, 2014, II ZR 381/13 (Ger.).

but rank below other senior debt,[313] such as derivatives, non-covered deposits, and other operational liabilities. This approach can be seen either as "contractual subordination", since the debt must include specific contract clauses; or as "statutory subordination", since specific legislative provisions regulate the debt's insolvency or resolution ranking.[314] The advantage of a Tier-3 approach is its legal certainty and "fairness," as investors can know their status from the moment they subscribe the debt. Its disadvantage is the greater cost for banks to raise new TLAC/MREL-compliant debt.[315]

Even if each strategy may respond to each State's perceived priorities, there may be trouble in cross-border cases. Suppose that an entity issues bonds subject to a clause providing their subordination and/or debt indicating its non-preferred status in case of insolvency and/or bail-in (i.e. the French/Spanish approach), but the applicable insolvency law is that of a "statutory subordination" country, such as Germany: Should the order be (1) subordinated bonds, (2) non-preferred bonds, (3) other senior bonds, and (4) other senior debt? Should subordinated and non-preferred bonds rank *pari passu* since German law makes no express allowance for "non-preferred" debt? Should they rank *pari passu* with senior bonds issued under German law, since the latter subordinates *all* senior bonds? If the applicable insolvency law is France's, should the bonds with a subordination clause be deemed subordinated or "equivalent" to Tier-3 bonds? Would there be a difference if the clauses make reference to the bonds' status in "insolvency," "resolution," or both?

The risk of uncertainty led to new legislative efforts to further harmonize the rules on insolvency hierarchy.[316] To the already existing

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313 See, e.g. Article L 613-30-3 French Financial and Monetary Code, articles 48 (1) (d) and (3). In Spain, see Additional Provision 14th of the Spanish Act 11/2015 on the Recovery and Resolution of Credit Institutions and Investment Firms. The Spanish provision is drafted in 'subordination' terms, but the broad language could be used to issue something similar to Tier-3 debt. Spanish banks, however, are not making much use of debt to comply with MREL.

314 Article 151 II and III of LOI n° 2016-1691 du 9 décembre 2016 relative à la transparence, à la lutte contre la corruption et à la modernisation de la vie économique, JORF n°0287 10 December 2016, which modifies article L-613-30-3 in the French Monetary and Financial Code states that the provision applies to instruments issued, and to liquidation procedures opened, after the act's entry into force. They do not apply retroactively to existing types of debt.

315 *Opinion of the European Central Bank on "The Hierarchy or Creditors of Credit Institutions*," 2016 E.C.B. (CON/2016/7) 3, 3.

316 Council of the European Union, Council Conclusions on a roadmap to complete the Banking Union (June 17, 2016) (underlining the effort to "put forward a proposal on a common approach to the bank creditor hierarchy, to enhance legal certainty in case of

deposit preference, the new rules add a provision regulating a *new* kind of senior debt with 'non-preferred' status, i.e. an EU-wide Tier-3 debt with the following characteristics: (i) maturity of at least 1 year; (ii) no features typical of derivatives; and (iii) explicit reference in contractual documentation to the (lower) insolvency ranking.[317] In line with the French approach, the rules introduced a ranking for EU-Tier-3 debt below ordinary unsecured debt, and above the CET1, Tier 1 and Tier 2 instruments.[318] This was accompanied by transitional provisions, and "grandfathering" provisions that protected different States' previous choices. Thus, (i) insolvency law shall apply to debt issued before the new provisions entered into force;[319] (ii) debt issued under the domestic laws of Tier-3 countries, like France, shall have the same ranking as Tier-3 debt under the new (EU-harmonized) rules;[320] and (iii) for debt issued under the laws of "statutory subordination" countries like Germany or Italy, which split unsecured debt into two or more rankings, or changed the ranking of some instruments in relation to others, the rules say that those States *may* give the lowest ranking category of ordinary debt the same ranking as "EU Tier-3 debt."[321] Thus, doubts would arise only if a State in that situation decided otherwise, or simply did not clarify the matter, in which case there would be a lack of guidance about the hierarchy between "harmonized" debt (i.e. Tier-3 debt under harmonized rules) and ordinary debt subordinated by statute. Another problem is the relationship between non-preferred debt and subordinated debt issued for purposes of complying with TLAC, especially if there are ambiguities in the contract language.

Yet, the rules show the difficulty of combining *ex post* and *ex ante* approaches. While the *ex post* rules on insolvency hierarchy put Tier-3 debt below ordinary liabilities, *ex ante* prudential rules, with the aim of complying with the international TLAC standard, include a long list of

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resolution."); *see also* Directive 2017/2399, of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards The Ranking of Unsecured Debt Instruments in Insolvency Hierarchy (hereafter Directive on Insolvency Hierarchy of Unsecured Debt Instruments).

317 New article 108 (2) BRRD II, by Directive on Insolvency Hierarchy of Unsecured Debt Instruments.

318 New article 108 (2) and (3) BRRD II.

319 New article 108 (4) BRRD is the default provision, and states that insolvency laws should apply to standard debt.

320 New article 108 (5) BRRD. The treatment is conditional upon the debt having the features of 1-year maturity (or longer), no embedded derivatives, and an explicit reference in the prospectus to its non-preferred status.

321 New article 108 (7) BRRD.

requirements for 'eligible debt'[322] which comprise the MREL-instruments requirements, plus others that try to ensure that the instruments are not subject to early redemption, acceleration or modification,[323] plus, crucially, the requirement that MREL instruments must, in principle, be subordinated to non-MREL ones, at least for G-SIIs and top-tier banks.[324] This could give rise to interpretative difficulties if a bank issues both debt indicating its non-preferred status, and debt indicating its subordinated status. It would not be clear whether the former would qualify for MREL, and whether it would be preferred to the latter. Still, as important as establishing the nature of the instruments is to identify the market for those instruments, and the frictions that this can give rise to between financial stability and investor protection, and the resulting favourable setting for big banks, as we analyse in the next section.

iii. Who Should Hold the Instruments? Retail Investor Protection's Interplay with Bank Resolution, EU Rules, "Big Bank Bias," and proportionality issues.

On a global scale, issues of implementation of MREL in the EU can be considered anecdotal and should not obscure the fact that TLAC/MREL face more daunting challenges at the level of policy and principle, related, first, to the interplay between resolution and investor protection, and, second, to considerations of proportionality.

On the first point, resolution rules adopting TLAC and MREL have taken a decisive step towards financial stability with little regard for other policy concerns such as investor protection: for a bank to have loss absorbency, someone has to absorb that loss. This is particularly cumbersome if non-preferred debt is marketed to retail investors, the EU being the case in point. Because MREL rules apply to small banks, and these often lack access to international capital markets, their only possibility is to place MREL instruments among their clients with the subsequent risk of mis-selling. Current EU provisions emphasize that the debt's status must be advertised in "the relevant contractual documentation and, where applicable, the prospectus."[325] Yet this information is of little relevance for retail investors, who do not base their investment decisions on the prospectus but on the advice received from financial intermediaries. For them, it is MiFID and similar standards that matter. If the information is found to be defective, it can

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322 Article 72b (2) CRR 5.
323 Article 72b (2) (g) – (m) CRR 5.
324 Article 72b (2) (d) CRR 5.
325 New article 108 (2) (c) and (5) (a) (iii) BRRD.

give rise to a wave of mis-selling claims, where the breach of regulatory provisions can give rise to actions for annulment, avoidance, or damages for the value of the securities sold.[326]

The experience of some EU countries like Spain, and, to a lesser extent, Italy, shows that the large-scale marketing of instruments by sizeable-but-not-systemic institutions intended to boost their prudential cushions can result in a problem of mis-selling of those instruments.[327] For years there was little inquiry on marketing practices, until cases of the so-called *participaciones preferentes* reached the civil courts, with retail clients claiming that the breach of investor protection rules gave them an action for the annulment of the contract under the doctrine of "mistake."[328] A system of large-scale arbitration was put in place to deal with the majority of retail claims in a systematic,[329] rather than case-specific, manner, but some individual investors continued to press their claims in court.[330] The result was a reimbursement of a large volume of

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326 *See, e.g.* Bundesgerichshof (BGH) Ref. No. XI ZR 33/10 (March 22, 2011) in Germany (damages claim); *Rubenstein v HSBC Bank plc* [2012] EWCA Civ 1184 in the UK (action in damages); Supreme Court Decision Cass. Civ. 16 February 2007, No. 3683 in Italy (action of avoidance and/or damages); or Supreme Court Decision 20 January 2014 App. No. 879/2012, in Spain (action of annulment).

327 *See* S. Alvaro, M. Lamandini, D. Ramos Muñoz, E. Ghibellini, F. Pellegrini "The marketing of MREL securities after BRRD Interactions between prudential and transparency requirements and the challenges which lie ahead" *CONSOB Legal Research Papers* No. 15 (December 2017); Marco Lamandini; Giuseppe Lusignani; David Ramos Muñoz "Does Europe Have What It Takes to Finish the Banking Union? Non-Performing Loans (NPLs) and Their Hard Choices, Non-Choices and Evolving Choices" *Columbia Journal of European Law* (2018 forthcoming); D. Ramos Muñoz "Las participaciones preferentes y su contexto: resolviendo el sudoku" *Diario La Ley* Nº 7970, Tribuna 22 (November 2012). Italy experienced the same with cases on alleged and mis-selling of banks' shares and bonds on a massive scale. It even went through the first (successful) experiment of a public offer of settlement in 2017 to prevent thousands of claims by retail investors of Banca Popolare di Vicenza and Veneto Banca from becoming a fatal impediment to restructuring (the settlement was finally targeted by a vast majority of holders of these securities).

328 See, e.g. Spanish Supreme Court decision no. 504/2015, of 30 September 2015. The decisions from lower courts were much earlier.

329 Royal Decree-Law 6/2013, of 23 March. Similar schemes were crafted in Italy in 2016, first for the holders of subordinated debt issued by the four banks resolved in 2015 and then for MPS subordinated debt mis-sold to retail investors.

330 In its seventh report in early 2015 the commission indicated that a total of 328.059 holders of hybrid instruments resorted to arbitration, for an amount of 5.188 million euro. This is 79% of all holders, and 65% of the amounts held. Of these, 245.072, or a 75% of the requests received, and 53% of the amount, were admitted. That left a 28% of the requests presented, and 47% of the total, being rejected. This left 27.232 claims before the courts, which looks a low number compared with requests for arbitration but is still impressive in terms of the number of judicial proceedings. The figure is more important if one considers that the amount of the claims was 1.724 million euro, or 25% of the amounts in both arbitration and litigation. In other words, holders of small amounts of

instruments. Yet, the goal was not to ascertain the breaches of rules for the marketing of instruments, but to address the risk of contagion and mistrust resulting from the holding of such volume of instruments among the general public, not to mention the bad publicity. Thus, there was not an inquiry about the nature, reasons, and extent of the mis-selling.[331] Yet, the problem resulted in a change of heart in the courts' towards a more investor-friendly stance, one that took place through a modification on the doctrine of mistake, with unforeseeable consequences.[332]

Apart from causing friction in bank-investor relationships, the presence of such instruments and marketing practices can create problems for resolution at the level of procedure, policy and principle. At the level of procedure, if an entity is put into resolution, a claim of damages, avoidance or annulment should, in principle, be classified as an "ordinary" claim. This can create a difference in treatment between holders of TLAC/MREL instruments, who would be bailed-in right after Tier 2 instruments, and holders of "mis-sold instruments," who would be treated as ordinary unsecured creditors, thus ranking above holders of instruments with no mis-selling claim.[333] This creates an incentive for investors to overstate their case and sue for annulment, avoidance, or damages if the entity is in financial difficulties with the intention of ensuring a better treatment.

At the level of policy, since the advantage of resolution tools lies in their swift implementation, the risk of mis-selling claims could bog down the process, and create an impediment to resolution.[334] This would make it likelier for resolution authorities to exclude TLAC/MREL instruments held by retail investors from bail-in. However, this would defeat the purpose of distributing TLAC/MREL instruments in the first place. At the level of principle, if resolution authorities are aware of evidence

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claims went to arbitration, and succeeded, holders of large amounts went to court, often succeeding, or went to arbitration, and generally failed. See the Séptimo informe trimestral sobre la comercialización de instrumentos híbridos de capital y deuda subordinada (real decreto-ley 6/2013, de 22 de marzo). Enero 2015, available at: http://www.rdmf.es/wp-content/uploads/2015/04/informe.pdf. See Marco Lamandini; Giuseppe Lusignani; David Ramos Muñoz "Does Europe Have What It Takes to Finish the Banking Union? *Columbia Journal of European Law* vol. 24 (2018).

[331] *Id.*

[332] *Id.*

[333] In addition to this, the TLAC standard states that entities should be prohibited from redeeming debt prior to maturity without supervisory approval. FSB TLAC Termsheet no. 12, p. 17. See also EBA *Final Report on MREL* pp. 104-107, which suggest some measures to structure a redemption authorization procedure. Yet this prohibition cannot prevent avoidance/annulment/damages claims, which would have the same effect.

[334] FSB Review of the Technical Implementation of the Total Loss-Absorbing Capacity (TLAC) Standard 2 July 2019, p. 22.

pointing towards mis-selling on a large scale, an argument could be made that these authorities would be under a duty to clarify the issue before materializing the risk that investors were not duly informed about, or even excluding retail-held instruments from bail-in. This would be reinforced if one considers investor protection as a general principle of the Law of Finance, which helps define the requisite of proportionality, which is supposed to apply to resolution action.[335]

One alternative would be to adjust the marketing process so that the additional complexity of TLAC/MREL securities is not used as grounds to presume investors' lack of information:[336] the risk itself is lower than the risk of equities, which can be acquired by retail investors. Another alternative would be to phase MREL requirements, especially among non-G-SIIs.[337]

Recently reformed rules, however, simply restrict the marketing MREL securities to retail clients. This can only be done if the seller has performed a (documented) suitability test, it is satisfied that the securities are suitable for the retail client,[338]*and* crucially there is both a high minimum investment in the instruments; but this does not represent a high percentage of the investor's portfolio.[339] The rules try to deter banks from marketing MREL securities to retail clients (or do so only to the wealthier clients). Similar initiatives are in place in Hong Kong, Japan

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335 These tensions are explored in S. Alvaro, M. Lamandini, D. Ramos Muñoz, E. Ghibellini, F. Pellegrini "The marketing of MREL securities after BRRD Interactions between prudential and transparency requirements and the challenges which lie ahead" *CONSOB Legal Research Papers* No. 15 (December 2017).

336 It is suggested that a streamlined marketing process where risks are well-identified, but intermediaries (and investors) are given relatively simple indications, could also improve things. See S. Alvaro, M. Lamandini, D. Ramos Muñoz, E. Ghibellini, F. Pellegrini "The marketing of MREL securities after BRRD Interactions between prudential and transparency requirements and the challenges which lie ahead" *cit.* pp. 76-78.

337 *Id* at 74-76. Indeed, the TLAC standard was conceived only for G-SIIBs, and many of the problems of the MREL standard arise not in relation with the largest international Banks, but in relation with medium-sized Banks, which have no access to international capital markets to place their debentures.

338 Article 44a (1) (a) – (c) BRRD II. Article 44a (1) para. 2nd extends the requirement to every instrument classifiable as a potential target for bail-in.

339 Member States' options are: (i) a combined requirement that the minimum investment is EUR 10,000 and the instruments do not represent more than 10% of the investor's portfolio; (i) an EUR 50,000 minimum denomination for securities subject to bail-in; or (iii) (only for smaller banks) that EUR 10,000 is the minimum investment. See article 44a (2), (5) (6).

and Switzerland, but for *TLAC* securities,[340] i.e. rules applicable to G-SIIs. The US and Canada have not introduced any such restrictions.

The consequences of the rules are unclear. Are banks asked to monitor how their TLAC/MREL securities are distributed by their own personnel, or also all across the market (e.g. by other intermediaries[341])? Are banks expected to know the composition of their investor base? And how accurately? Are resolution authorities expected to perform market monitoring tasks, which fall outside their mandate, and within the mandate of market regulators (e.g. securities markets commissions, such as the SEC)? And what is the consequence of a breach of marketing rules (e.g. if TLAC/MREL securities are marketed to retail clients beyond the limits)? Is it simply a fine for the institution (in which case, who should levy it?) or does that render the instruments not subject to bail-in? Will markets perceive that instruments held by retail investors are not subject to bail-in? Will that translate into differences in pricing of the same instruments?

These questions illustrate the pattern that results from combining the *ex ante* and *ex post* perspectives: (i) difficulties are anticipated in the *ex post* implementation stage (e.g. problems of bail-in enforceability over instruments held by retail clients); (ii) *ex ante* rules adopt the more risk-averse solution (excluding or strictly limiting marketing of TLAC/MREL instruments among retail clients); (iii) but that, in turn, creates other *ex post* problems (e.g. bail-in enforceability over instruments sold in breach, coordination problems between resolution and markets authorities); (iv) as well as unintended consequences (incentives for wealthy retail investors to claim mis-selling, monitoring challenges and loss of credibility for resolution authorities).

Such (supposedly) unintended consequences also affect the structure of the banking system. Indeed, the most serious consequence that could arise if TLAC or MREL instruments cannot be marketed among retail investors is that it leaves non-large banks without any options. This is especially acute in the EU, where the applicability of MREL to all banks

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[340] In Hong Kong TLAC securities are marketed only to professional investors, with denominations of minimum HKD 2 million, USD 250,000 or EUR 200,000; in Japan the minimum denomination is JPY 10million; in Switzerland FINMA requires TLAC denominations large enough to deter retail investors. See FSB Review of the Technical Implementation of the Total Loss-Absorbing Capacity (TLAC) Standard 2 July 2019, p. 22.

[341] Even if we restrict the banks' monitoring efforts to their own clients, how accurately can they know the total size of their clients' portfolio (to apply the maximum of 10% discussed in the previous footnote) if they have diversified their investment management across several entities?

means that, in practice, many of them would be forced to integrate into larger groups or breach the rules.[342]

This introduces a second consideration about the importance of proportionality as a principle of bank regulation and resolution. Proportionality evolved as a criterion to adjudicate on the legality of an interference by the law or administrative action in fundamental rights.[343] Today, some regard it as an overarching principle in financial regulation.[344] But although the term "proportionality" is the same in form, in substance it is little more than a worthy aspiration,[345] one that is seldom followed by EU legislation, which tends to apply a one-size-fits-all.[346] This sits in contrast with other jurisdictions, such as the United States and Japan, which are characterized by two-tiered, or three-tiered, systems of bank regulation and supervision, as the rules of TLAC illustrate.[347] There is an increasingly perceived need to adjust prudential and quasi-prudential requirements, such as MREL, to banks' size and business models, to ensure that rules designed against systemic risk are primarily applicable to Systemically Important Financial Institutions (SIFIs).[348]

Rather than on lofty words, proportionality's usefulness would run in parallel to its "actionability", i.e. the extent to which it could turn into a basis for legal challenges. This could occur if proportionality were to be acknowledged as a specific policy goal. In that case, it would still be difficult to envisage a case where a set of bank rules could be annulled for being "disproportionate". However, it would introduce a "legitimacy"

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342 S. Alvaro, M. Lamandini, D. Ramos Muñoz, E. Ghibellini, F. Pellegrini "The marketing of MREL securities after BRRD Interactions between prudential and transparency requirements and the challenges which lie ahead" *CONSOB Legal research papers* No. 15 (December 2017).

343 Moshe Cohen-Eliya; Iddo Porat "American balancing and German proportionality: The historical origins" *International Journal of Constitutional Law*, Volume 8, Issue 2, (2010) pp. 263-286

344 Proportionality in Bank Regulation, A Report by the EBA Banking Stakeholder Group, London (December 2015), pp. 30.

345 Bart Joosen; Marco Lamandini; Matthias Lehmann; Kitty Lieverse; Ignacio Tirado Stability, Flexibility and Proportionality: Towards a two-tiered European Banking Law? EBI Working Paper Series 2018 no. 20 (21 February 2018).

346 Proportionality in Bank Regulation, A Report by the EBA Banking Stakeholder Group *cit.*

347 Bart Joosen; Marco Lamandini; Matthias Lehmann; Kitty Lieverse; Ignacio Tirado Stability, Flexibility and Proportionality: Towards a two-tiered European Banking Law? EBI Working Paper Series 2018 no. 20 (21 February 2018) pp. 12-14.

348 *Ibid*. See also S. Alvaro, M. Lamandini, D. Ramos Muñoz, E. Ghibellini, F. Pellegrini "The marketing of MREL securities after BRRD Interactions between prudential and transparency requirements and the challenges which lie ahead" *CONSOB Legal research papers* No. 15 (December 2017) p. 71.

dimension, where supervisory and resolution authorities would have to offer a justification if they were to impose burdensome rules without distinguishing between institutions. This system is present in the United States to some extent through rules that require regulators to make a previous assessment of the impact of the rules on small entities before adopting them,[349] in line with the increasing drive towards requiring a Cost-Benefit Analysis (CBA) of regulatory action across the board.[350] In some cases, the burden imposed, together with the lack of justification, could constitute grounds for an annulment action. A precedent is *Metlife v Financial Stability Oversight Council*,[351] where the Court of the District of Columbia found the action by the FSOC to classify Metlife, an insurance company, as systemically important, and, under the purview of the Fed, as "arbitrary and capricious" for lacking a CBA.[352] The court's decision was very controversial, and courts in the EU do not tend to follow such a strict review of regulatory action, but it remains a useful illustration of how courts may react if there is no appropriate process to ensure that the rules are proportionate.

B. The Group Dimension: "Internal TLAC," Single/Multiple-Point-of-Entry (SPE/MPE), Source-of-Strength, and Interference with Group Structure

The problems related to TLAC/MREL debt are much more complex when we introduce the "external vs. intra-group" dimension. This dimension leaves open a series of choices for resolution authorities and banks, yet by taking a specific position, resolution authorities constrain the choices of banks and largely shape their intra-group organization. First, there is a direct interference by resolution authorities on banking group structures, with important considerations of policy (1). Second, the need to ensure a smooth process to allocate losses and bail-in debt raises difficult questions of principles and interpretation, especially in light of the interference with banks' funding structure (2). Finally, the question of whether a parent company has an obligation to financially assist its subsidiaries poses both questions of principle and policy, as it gradually results in a push towards a centralization of functions (3).

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[349] Regulatory Flexibility Act 1980, see U.S.C. at 601-602.

[350] See, e.g. Cass R. Sunstein "Cost-Benefit Analysis and Arbitrariness Review" *Harvard Environmental Law Review* Vol. 41 (2017) p. 1.

[351] Metlife v Financial Stability Oversight Council (FSOC) US Dist. C. D. Col. Civil Action No. 15-0045 (2016).

[352] On this the court relied on the US Supreme Court decision in Michigan *v.* Environmental Protection Agency, 135 S. Ct. 2699 (2015).

i. Internal "TLAC," SPE/MPE, Interference with Group Structure, and Policy Considerations

The intra-group perspective of TLAC/MREL forms part of the group-level resolution planning and assessment of resolvability.[353] This assessment is no longer restricted to determining *levels* of TLAC/MREL. It now has to encompass (i) an identification of the "resolution entities," i.e. those that will be subject to resolution tools, including bail-in;[354] (ii) the determination of overall TLAC/MREL levels and the amounts that need to be issued and subscribed by third parties; (iii) the internal *allocation* of debt by "down-streaming" the proceeds from externally issued debt to subsidiaries,[355] which must in turn issue instruments which are subscribed by the parent-resolution entity to ensure that TLAC is "pre-positioned" in the material subgroups where losses may occur; (iv) the up-streaming of losses from operating subsidiaries to the resolution entities;[356] and (v) if losses are too large for the resolution entity, a bail-in of external instruments plus other resolution tools, if necessary. Graphically:[357]

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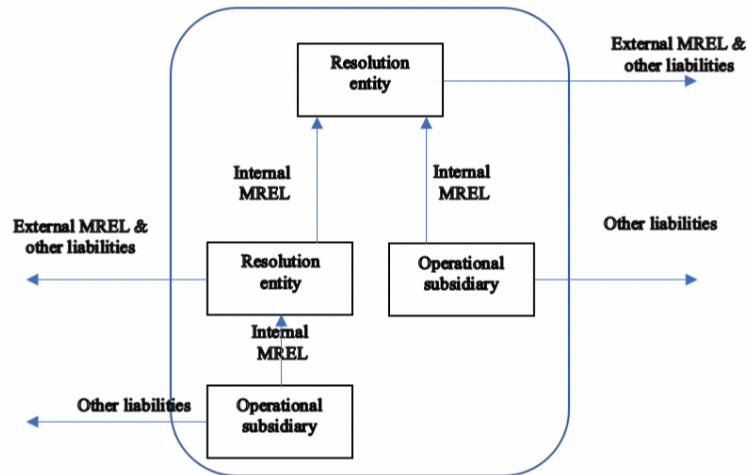
[353] *See* Articles 12-13 BRRD (group resolution plans). This includes an assessment of resolvability for the entity/group, to determine whether it could be wound up under insolvency or resolved using resolution tools to avoid significant effects in the financial system and ensure the continuity of critical functions. Article 16 (1) para. 2nd BRRD. The elements to be considered in making such an assessment are listed under the Annex, section C of BRRD. The resolution authorities at group-level, and for each subsidiary and significant branches have powers to address impediments to resolvability of a group, through joint or separate decisions. Article 18 BRRD. MREL are particularly relevant in the context of groups, where certain liabilities can be an obstacle for effective group resolution. EBA *Final Draft Regulatory Standards* p. 9-10.

[354] *See, e.g.* Bank of England *The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)* Consultation on a proposed Statement of Policy, December 2015, p. 26. See also FSB Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution; Total Loss-absorbing Capacity (TLAC) Term Sheet 9 November 2015, principle no. (vi), and no. 3 of the term-sheet.

[355] Recital (80) of BRRD states that: *'it is imperative that loss-absorbing capacity is located in, or accessible to, the legal person within the group in which losses occur'*.

[356] EBA Final Report on MREL p. 133.

[357] The graph adapts the one in Bank of England *The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)* 2015 p. 29 Figure 2.



Initial EU rules provided little guidance, leaving the determination of MREL below group level to a collaborative procedure between resolution authorities and the binding mediation of the European Banking Authority (EBA) in case of conflict.[358] Conversely, the TLAC standard introduced the conceptual distinction between "external" TLAC instruments, which are the equity/debt instruments issued by resolution entities and held by third parties, and "internal" TLAC instruments, which are issued by group entities that are not resolution entities, usually operating subsidiaries, and held by other group entities, usually resolution entities.[359] as the TLAC standard also introduced the requirement that the "pre-positioned internal TLAC" be in a 75-90%

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[358] The MREL is imposed at an entity level, if the entity is itself subject to resolution rules, regardless of whether that entity is a material subsidiary that will be subject to resolution action. Then, the determination of MREL at both an entity level and consolidated level will depend on the resolution strategy envisaged in the applicable resolution plan. This should be the group resolution plan, unless the host resolution authority exercises its power to draw up its own resolution plan pursuant to article 15 (6) BRRD. Even if there is a group resolution plan, the MREL at both consolidated and individual level is the result of a joint decision of the resolution college. Disagreements may be referred to the EBA for binding mediation, but if no agreement is reached the decision of resolution authorities for each subsidiary shall apply. See article 45 (10) BRRD.

[359] The TLAC Termsheet introduces the distinction between 'external' and 'internal' TLAC in its no. 3 and dedicates 4 points out of 21 to group issues, including 16 (internal TLAC), 17 (material subgroups), 18 (size of the internal TLAC requirement), and 19 (core features of eligible internal TLAC).

range of the external TLAC level.[360] Amended EU rules are more aligned with the TLAC conceptual framework.[361]

Once the intra-group situation is considered, the question is no longer solely about the instruments' features to ensure loss-absorbency. It is about the position of those instruments within group's structure to ensure that resolution tools can be implemented quickly and efficiently. This raises the question of whether (and, if so, how much) the law should interfere with strategic decisions such as those regarding a group's structure. The basic, stylized choices are two: under a strategy of "Single Point of Entry" (SPE) resolution, measures are adopted at the parent company level; under a "Multiple Points of Entry" (MPE) strategy, there are different "resolution entities" where resolution tools will be implemented.

The purported advantage of SPE is its simplicity: the parent holding company is the only resolution entity, a "clean HoldCo", i.e. a company with no operational liabilities. This makes "structural subordination" easy:[362] losses are up-streamed to the holding company using subordinated "internal TLAC/MREL" and then "external TLAC/MREL" is bailed-in, which is easy, since it is the only kind of liabilities issued by the parent.[363] It is also ideal for structures characterized by a financial holding company (FHC), typical in the US. The Dodd-Frank Act is purportedly neutral,[364] as has been the guidance on resolution planning, which uses the concept of "legal entity rationalization", but does not openly advocate one approach over the other.[365] Yet, American

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360 This allocation ensures (i) that only the resolution entity is put into resolution, and (ii) that there is adequate cooperation between home and host resolution authorities. FSB TLAC Term Sheet, no. 16.

361 New article 45g BRRD II. Still, some adjustments are needed. One relevant aspect is the adjustment needed to the concept of "material sub-groups", which is defined in the TLAC standard as one or more direct or indirect subsidiaries of a resolution entity 'incorporated in the same jurisdiction outside of their resolution entity's home jurisdiction', whilst the EU should, to this effect, be treated as a 'single jurisdiction'. See EBA *Final Report on MREL* p. 135.

362 We first discussed 'structural subordination' in section III.B.1. The main implications of the concept become clear now.

363 Bank of England *The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)* Consultation on a proposed Statement of Policy, December 2015, pp. 25-26, 31.

364 See, e.g. Section § 210 (a) (E) Dodd-Frank Act (power of the FDIC to appoint itself receiver of a subsidiary when it has appointed itself receiver of the parent company).

365 FDIC and Fed Guidance for 2017 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015 § VI.

authorities have decidedly moved towards SPE.[366] Advocates of SPE argue that EU rules should be bolder and force financial groups into American-style FHC structures.[367]

While EU rules are neutral,[368] UK authorities have opted for an SPE strategy with "structural subordination" for all entities subject to bail-in on policy grounds, i.e. because it is considered better in general terms.[369] In France, home to some large universal banks, authorities also opted for an SPE strategy,[370] yet clarifying that the choice is not definitive, irreversible or systematic,[371] but idiosyncratic, i.e. based on a list of factors to choose the best strategy for the larger banking groups that are *dominant in France*.[372] When banking groups have been allowed to

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[366] Wells Fargo was the only group with an MPE approach, and in the December 2016 assessment of resolvability it was the only one found to have failed in its efforts to correct obstacles to resolvability, primarily because of a lack of 'legal entity rationalisation'. See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation Agencies announce determinations on October resolution plan submissions of five systemically important domestic banking institutions Joint Press Release, December 13, 2016, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20161213a.htm. Wells Fargo's 2019 Resolution Plan (Public Section) states that: *"Since filing the 2017 165(d) Plan, we announced on October 13, 2017 that we were moving to a single point of entry (SPOE) approach as a part of our Preferred Resolution Strategy for this 2019 165(d) Plan submission. We believe this approach better aligns with our business model and corporate structure as we continue to evolve as a company."*

[367] This could be achieved by introducing the requirement under structural rules for Banks, or by using prudential (Basel) rules to "penalize" structures without financial holding companies. See Jeffrey Gordon; Wolf-George Ringe 'Bank resolution in Europe: The Unfinished Agenda of Structural Reform' *ECGI Working Paper Series* WP No. 507 (Jan. 2015), and also 'Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take' Vol. 115, No. 5 (June 2015), pp. 1297-1369.

[368] See Recital (80) of BRRD.

[369] Bank of England *The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) Responses to Consultation and Statement of Policy* (November 2016) p. 9.

[370] Autorité de Control Prudentielle et de Résolution (ACPR) Communication on the Resolution Strategy of ACPR Resolution Board 18 July 2014.

[371] "The choice of an SPE strategy may be combined with a pragmatic approach to resolution. It should not be viewed as definitive, irreversible or systematic, but rather as a position in favour of the strategy that seems best suited from an operational perspective, given the organisation and functioning of the main French entities. "

[372] These were (i) the centralisation of decision-making; (ii) integration of business model; (iii) location of the business in France; (iv) concentration of loss-absorbing capacity in the parent company (financial structure); (v) pooling of management of support functions (operational structure); (vi) number of significant foreign subsidiaries

choose, many have opted for SPE, including large German banking groups such as Deutsche Bank,[373] with Santander being the exception of major banking groups in using an MPE strategy.[374]

Yet, despite the relentless move towards SPE, there are clear objections to it. First, an approach that considers the structure of US FHC-based financial groups as the least risky is debatable.[375] Then, the SPE dismisses too quickly the usefulness of market forces in disciplining subsidiaries when they seek external funding and ignores the rigidities that a "clean HoldCo + bail-in" strategy may impose if, say, a sale of business is needed and no suitors are found for the whole group, which needs to be sold in parts.[376] Furthermore, the group-level seamless implementation required by an SPE approach may be jeopardized if, say, resolution authorities in the parent HoldCo country object to the up-streaming of losses of a foreign country subsidiary into "their" parent holding company and to the subsequent bail-in of "their" investors.[377]

Most importantly, stark distinctions between SPE and MPE can be equivocal. US bodies, for example, favour SPE for US banking groups, but also *for the US activities* of foreign banks. Large foreign banks have to create an Intermediate Holding Company (IHC) for their US

(legal structure); (vii) centralisation of funding; and (viii) level of intragroup transactions. ACPR *Communication on the Resolution Strategy of ACPR Resolution Board* 18 July 2014 p. 13. A 'high' level in each and every of these categories (save for the number of significant foreign subsidiaries) favoured SPE as the preferred approach, whereas a 'low' level favoured MPE.

[373] *See, e.g*. Deutsche Bank U.S. Resolution Plan Submission Section 1: Public Section July 1, 2015, p. 39. Despite the title of the document, the references to SPE in the plan are not restricted to US operations but refer to the overall strategy for the international group as a whole.

[374] Banco Santander, S.A. Resolution Plan for U.S. Operations Public Section at 6, 8 (December 31, 2018). This is due to its business model based on local units with separate governance structures. See *ibid* p. 6, and also Banco Santander, S.A. Resolution Plan for U.S. Operations Public Section December 16, 2015, p. 4.

[375] *See, e.g*. Charles Calomiris; Stephen Haber *Fragile by Design* Princeton University Press, 2014. See also Charles Calomiris 'The Costs of Rejecting Universal Banking: American Finance in the German Mirror, 1870-1914' in Naomi R Lamoreaux; Daniel M.G. Raff (eds.) *Coordination and Information: Historical Perspectives on the Organization of Enterprise* University of Chicago Press, 1992.

[376] Either if the debt issued at the top of the group is insufficient to absorb the group's losses, and/or different parts of the group can continue on a standalone basis, an MPE strategy may be preferable. Resolving Globally Active, Systemically Important, Financial Institutions A joint paper by the Federal Deposit Insurance Corporation and the Bank of England 10 December 2012, no. 3, p. 1.

[377] *See* Federico Lupo-Pasini; Ross P. Buckley 'International Coordination in Cross-Border Bank Bail-ins: Problems and Prospects' *European Business Organization Law Review* Volume 16, Issue 2 (2015), pp 203–226, who although signal a preference for SPE, also point out some of these coordination difficulties.

operations.[378] Thus, for non-US banks, the SPE approach at a US-level effectively means an MPE at a global level, with different holding companies for different countries or regions.

ii. "Internal TLAC," Problems of Interpretation, and the Resulting Pre-Determining of Intra-Group Funding

The previous point highlights how the rules on group resolution planning have led resolution authorities to position themselves *vis-à-vis* the ideal structure of banking groups. This point shows that there are other matters of principle and interpretation with regard to internal TLAC that remain open, and that the need to fill those gaps is leading resolution authorities to adopt similarly deterministic views on intra-group funding. These concern (i) the type of instruments that can be considered TLAC/MREL and their ranking, (ii) the extent to which internal TLAC/MREL levels must be met by pre-positioning instruments inside subsidiaries, as opposed to other forms of support, e.g. parent guarantees and (iii) the triggers for write-down and conversion.

Regarding the first matter, i.e. the kind of instruments and their ranking, internal TLAC must be equity, or debt susceptible of bail-in. However, this is a "prudential requirement", which merely stipulates *ex ante* the conditions the instrument must fulfil to be eligible as internal TLAC, not the *ex post* enforcement of the bail-in tool over them. The entities are thus responsible for the decision of how to comply with the rules and through which instruments, which may be designed as own-funds or debt, as long as they are subordinated to other kinds of debt, and do not affect the parent's control over the subsidiary.[379]

As said above, whether these conditions are fulfilled, however, can only be ascertained *ex post*, i.e. when the group reaches its point of non-

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[378] *See, e.g.* BNP Paribas 165(d) Resolution Plan Bank of the West IDI Resolution Plan. Public Section. December 31, 2015, p. 3. In spite of espousing an MPE strategy in its US plan, Santander US activities are organized around a US holding company. See Banco Santander, S.A. Resolution Plan for U.S. Operations Public Section December 16, 2015, pp. 2-3.

[379] New Article 45f (2) (a) of BRRD II, as per the Directive on Loss Absorbency requires internal TLAC liabilities to be ultimately bought by a resolution entity, to be MRE-eligible, and to rank below non-MREL liabilities (other than equity), among other requirements. Equity instruments that are TLAC-compliant are CET1 or other equity instruments, provided they are subscribed by group entities, or by other entities, as long as bail-in does not affect their control by their parent (article 45f (2) (b) BRRDII).

This could raise difficulties if debt instruments with a contractual subordination clause, though not eligible for own funds requirements, have been issued to third parties, e.g. if the contract subordination clause suggests that they should also rank below all ordinary liabilities.

viability. Since the rules do not back the *ex ante* requirement with an *ex post* determination of the ranking of the instrument (as they do with external MREL[380]) there is room for uncertainty. This concerns cases where the entity has issued contractually subordinated debt (or ordinary debt subject to conversion into equity) that is held by third parties, in which case the problem may not be the internal TLAC itself, but the debt held by third parties.

Another problem may be the status of internal TLAC relative to intra-group "operational debt", such as intra-group loans, deposits, derivatives, etc. Liabilities originated between related parties are subject to statutory subordination in some countries (e.g. Germany or Spain).[381] EU rules provide that, when certain liabilities are not considered as TLAC/MREL, but are subject to subordination by insolvency rules, because they are intra-group debt (or debt with related parties) the requirement that MREL instruments be "subordinated" shall not be assessed by reference to those excluded liabilities.[382] Thus, the determination of MREL levels shall be done independently of the debt subordinated for being intra-group. Yet, on an *ex post* setting where resolution tools have to be deployed, "operational" intra-group debt would rank *pari passu* with internal TLAC, but its bail-in may disrupt the group's operations.[383]

Regarding the second matter, i.e. ways to comply with internal TLAC/MREL rules, this can be done by pre-positioning instruments in the subsidiary, i.e. the subsidiary issues equity or debt instruments, subscribed by the parent or the resolution entity, or through a financial commitment by the parent to "come to the rescue", e.g. a parent guarantee. The former is better to allay authorities' fears, since the loss-absorbing resources are already there, but is costly, and can result in "misallocation risk".[384] The latter is better for banking groups, which will

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380 See Article 108 (2) BRRD II.

381 See Section III.B.2., *supra.*

382 Article 72b (2) 4th para.

383 Since subordinated debt is all intra-group debt, one may argue that this problem is a relatively minor one. However, we can imagine a situation where internal TLAC is held by the parent company, while part of the operational debt is held by sister companies, in which case the authorities in the parent company's home jurisdiction might object to the parent's absorption of the full cost of the "upstreaming" of losses, while intra-group loans, derivatives, or cash and collateral arrangements (which they may see as one of the sources of risk) remain untouched.

384 That is, the risk that the pre-positioned internal TLAC at material subsidiaries does not match the actual distribution of losses incurred. See FSB Review of the Technical Implementation of the Total Loss Absorbing Capacity (TLAC) Standard 2 July 2019, p. 45.

not wish to bear the cost of issuing the instruments or immobilizing recourses beyond the projected needs of local operations.[385]

On pre-positioning, TLAC/MREL can be issued *directly*, i.e. from the subsidiary to the resolution entity, or following the existing chain of legal entity ownership ("daisy chain"), e.g. if Resolution Entity A owns 100% of subsidiary B, which holds 100% of subsidiary C, C could issue TLAC to be subscribed by A (direct issuance) or B ("daisy chain"). The former provides greater transparency, and faster bail-in execution, while the latter ensures that there will be no change of ownership.[386]

Guarantees are another admissible way to comply with TLAC requirements, in theory. Under global standards, to be TLAC-compliant these guarantees must fulfil several conditions regarding the guarantee itself, the collateralisation agreement, and the collateral itself.[387] EU rules in cases where the parent and subsidiary are part of the same resolution group, and located *in the same State*, and the parent complies with TLAC/MREL, allow the possibility to (i) waive internal TLAC/MREL if the parent *declares* that it guarantees the subsidiary's commitments, and there is no impediment for the transfer of funds or repayment of liabilities from parent to subsidiary,[388] and also to (ii) comply with TLAC/MREL requirements by means of a formal collateralised guarantee where the amount of the guarantee is the same as the amount of the requirement, the value of the collateral is at least 50% of the value of the guarantee, and other requirements that try to ensure the guarantee's enforceability.[389] US authorities include parent guarantees as

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[385] TLAC Termsheet no. 19; EBA *Final Report on MREL* pp. 137.

[386] See, e.g. FSB Guiding Principles on the Internal Total Lossabsorbing Capacity of G-SIBs ('Internal TLAC') Consultative Document 16 December 2016, p. 19. See also FSB Review of the Technical Implementation of the Total Loss Absorbing Capacity (TLAC) Standard 2 July 2019, p. 27, for the (direct/indirect) options followed by authorities in the EU, US, UK, or Singapore

[387] These include the following: (i) the amount of the guarantee must be at least equal to the amount of internal TLAC for which it substitutes, (ii) the value of the collateral must, following conservative haircuts, be sufficient to fully cover the amount guaranteed; (iii) the guarantee must be drafted in a way that does not affect the loss-absorbency of the subsidiaries' other capital instruments, such as minority interests; (iv) the collateral must be unencumbered, and not used to back any other guarantee; (v) the collateral maturity must fulfil the same requirements as external TLAC, i.e. residual maturity of at least 1 year; and (vi) there must be no legal, regulatory or operational barriers for the transfer of the collateral from the resolution entity to the subsidiary. TLAC Termsheet no. 19.

[388] This applies both in cases where the parent is a "resolution entity", and when the parent is not a resolution entity (i.e. the resolution entity is, e.g. the parent's parent, and is located in a different State). See article 45f (3) and (4) BRRD II.

[389] Article 45f (5) BRRD II. No reference is made to the TLAC requirement that the guarantee must be drafted to not affect the loss-absorbency of other capital instruments.

part of the intra-group funding strategy (see *infra* IV.B.3), but only within the US.

One possible difficulty could arise with collateral re-use, which is contemplated as a right of the collateral taker.[390] Collateral re-use gives rise to the duty to return equivalent collateral,[391] but this is a personal obligation, which poses a risk in times of scarcity of collateral.[392] EU rules require the collateral to be "unencumbered", and in particular not used to back another guarantee,[393] but the potential scenarios are three: (i) if the collateral is transferred to the subsidiary, which re-uses it; (ii) if the same collateral is used to secure different mutual obligations between different group members; or (iii) if the parent re-uses collateral taken from a client or a third party under a different transaction to secure its guarantee with its subsidiary. Because the implications of collateral re-use are still poorly understood, little is said in the rules about requirements of immobilizing, "tracing" or "sourcing" collateral. It seems that the collateralisation requirement would be considered fulfilled in the first scenario, even if the subsidiary may lose the collateral; clearly not fulfilled in the second scenario; and most likely fulfilled in the third scenario, although the case would be less straightforward.[394]

Regarding the third matter, i.e. the triggers for the activation of bail-in, international TLAC principles outline the importance of adequate triggers but are skimpy about the details,[395] except to indicate that it should be possible to bail-in "internal TLAC" without putting the

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[390] *See* article 5 FCD, or Section §9-207(c)(3) of the US Uniform Commercial Code (UCC).

[391] See, e.g. FCD article 5 (2).

[392] Javier Solana, *All that Glitters is not Gold: the Re-Use of Securities Collateral as a Source of Systemic Risk* PhD Thesis, University of Oxford, Faculty of Law (2017), pp. 142-56, 178-87.

[393] Article 45f (5) (e) BRRD II.

[394] Consider the requirement that the collateral must be "unencumbered", and in particular 'is not used as collateral to back any other guarantee' is not breached if the parent merely has a personal obligation to return equivalent collateral in case of re-use. More difficult may be the case of re-hypothecation of clients' assets, since some courts have concluded that these assets are simply held in trust by the dealer-custodian and clients have a right which can be exercised upon insolvency. See In the matter of Lehman Brothers International Europe, [2009] EWHC 3228 (Ch); [2010] EWCA Civ 917; and [2012] UKSC 6. The 'maturity' requirement applies to the collateral, not to any potential issues with its return. The main difficulty would come from the requirement that there must be no legal, operational or other difficulties to transfer the collateral.

[395] TLAC principles state that: *'Eligible external TLAC should contain a contractual trigger or be subject to a statutory mechanism which permits the relevant resolution authority to effectively write it down or convert it to equity in resolution'.* TLAC Termsheet no. 14, p. 17.

subsidiary in formal resolution proceedings.[396] Triggers are relevant because, even if the relative ranking and hierarchy of the debt instruments were clear, the clarity of the picture may be upset if different instruments are activated through different triggers, especially if one debt instrument ranking *pari passu* or below, a second instrument, e.g. Tier-3 non-preferred debt is hierarchically superior to, say, subordinated debt, and yet its conversion into equity may be triggered before subordinated debt is touched, or if, absent contractual triggers, it is not possible to bail-in debt without putting the entity into resolution. Initial EU rules, for example, only permitted *debt* (unlike equity) to be bailed-in if the entity were put into resolution, but not before.[397] New rules, on the other hand, provide the possibility of pre-resolution bail-in for *both* equity and debt if the entity fulfils the conditions for resolution, and unless bail-in is exercised with respect to the capital or liabilities the entity will no longer be viable.[398]

A final, and perhaps major, source of difficulties, may be the treatment of TLAC/MREL-eligible debt by EU authorities outside of areas with a harmonized regime. Such cases may include cross-border groups, whereby the debt issued under the laws of one jurisdiction needs to be subject to bail-in under the laws of a different jurisdiction. Such issues, however, have more to do with the cross-border recognition of bail-in decisions and will be examined in a succeeding article.

iii. Source-of-Strength and Intra-Group Support: Impact on the Bail-In Hierarchy and the Push Towards Central Planning

The two previous points show a pattern: group-resolution planning requires choosing among different options (group structure, intra-group funding instruments and organization). This raises the question of

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[396] Rules for 'internal TLAC' only indicate that *'internal TLAC that comprises capital instruments must comply with the relevant provisions of Basel III, including those in relation to write down and conversion 'at the point of non-viability'*, but they add that *'Internal TLAC must be subject to write-down and/or conversion to equity by the relevant host authority at the point of non-viability, as determined by the host authority in line with the relevant legal framework, without entry of the subsidiary into statutory resolution proceedings'.* TLAC Termsheet no. 19. This is confirmed in point no. 6 c.

[397] Article 59 BRRD, as originally drafted.

[398] Article 59 BRRD II, as reformed by the Directive on Loss-Absorbency and Recapitalization. The provision replaces the reference to 'capital instruments' with a reference to 'capital instruments and eligible liabilities' (heading) and clarifies that bail-in powers can only be exercised independently of resolution action when absent such bail-in the entity will no longer be viable (section 3). Such bail-in can only be exercised with regard to certain types of liabilities. See article 59 (1a) and article 45f (2) (a) BRRD II.

whether some options are generally better than others. Resolution authorities make policy choices, and, in so doing, constrain and predetermine banks' choices, which raises matters of principle, both with regard to the interpretation of the rules, and to the limits of the authorities' exercise of powers. This point shows the same pattern by asking a related question: is a parent obliged, as a matter of law or policy, to financially assist its subsidiaries?

It is one thing to say that the law requires organizing intra-group funding to facilitate orderly resolution, and quite another to argue that such funding must flow from the parent to its subsidiaries. And yet, there is some legal basis for this. The best example is the US "source-of-strength" doctrine, originally envisaged by the Fed under its powers to approve transactions[399] and recently codified by the Dodd-Frank Act.[400] Under this doctrine, supervisors could require a bank holding company to be a "source of strength" to its subsidiaries, including in times of liquidity scarcity.[401] The doctrine was originally validated by the US Supreme Court in *Lincolnwood* in the context of the authorization of acquisition transactions.[402]

Yet, saying that a parent company has to be a source of strength in that it must not weaken its subsidiaries' financial position is not the same as saying that financial authorities can compel the former to financially assist its subsidiaries. Thus, after it was initially validated in theory, the Fed tried to use the doctrine to impose upon a troubled bank holding company the duty to use the money obtained from the sale of non-bank subsidiaries to recapitalize some of its ailing subsidiaries, an attempt that was successfully challenged before the Fifth Circuit Court in *McCorp*.[403]

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[399] See the analysis of the traditional doctrine in Leonard Bierman; Donald Fraser "The Source-of-Strength" Doctrine: Formulating the Future of America's Financial Markets" 12 Ann. Rev. Banking L. (1993) p. 269; Kieran J. Fallon "Notes. Source of Strength or Source of Weakness? A Critique of the "Source-of-Strength" Doctrine in Banking Reform" Vol. 66 N.Y.U. L. Rev. (1991) p. 1344. For a more recent study, comparing the former and current approaches, see Paul L. Lee "The Source-of-Strength Doctrine: Revered and revisited. Part I" *The Banking Law Journal* Vol. 129 No. 9 (October 2012) p. 771, and its Part II in *The Banking Law Journal* Vol. 129 No. 10 (December 2012) p. 867.

[400] Section 616(d) Dodd-Frank Act.

[401] *See*, e.g. Leonard Bierman; Donald Fraser "The Source-of-Strength" Doctrine" supra note 397, p. 269.

[402] The Court accepted that the Board had the power to impose upon the acquirer of a bank the need to be a source of strength for its subsidiary as a condition for acquisition. *Board of Governors of Fed. Reserve System v. First Lincolnwood Corp.*, 439 U.S. 234, 238 (1978).

[403] *Board of Governors of the Federal Reserve System v. MCorp Financial, Inc. affd in part and rev'd in part,* 112 S. Ct. 459 (1991).

The case was granted certiorari by the Supreme Court, which held that the Circuit Court lacked jurisdiction based on procedural grounds.[404] This left open the issue about the scope of the Fed's mandate.

The current statutory formulation legitimizes authorities' power to require the parent to be a source-of-strength.[405] Yet, this answers the question of policy, i.e. this is a goal to organize the authorities' exercise of powers, but it does not answer the question of principle of how much discretion does this leave authorities to micro-manage intra-group funding structures, and in particular whether authorities can impose the parent company a duty to financially assist the subsidiaries including when this compromises the parent beyond its point of non-viability, or whether they can dictate which subsidiaries to assist or how to structure the assistance, over the views of the parent's board. This would seem to interfere with the bank's freedom of enterprise. Should the matter arise in an *ex post* resolution scenario the courts could review the exercise of powers under an "arbitrary and capricious" standard, where authorities would be required to justify their actions, with or without a cost-benefit analysis (CBA),[406] or on a "balancing" or "proportionality" assessment, which would weigh the finality of the measure against the interference with rights.[407] In addition to this, parent company creditors may raise legal challenges to the execution of financial assistance by the parent company through doctrines of fraudulent transfer or breach of fiduciary duty.[408]

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[404] According to the Supreme Court, the court could only review the Federal Reserve Board decision when it was a final decision, which the one concerned in the *McCorp* case was not. See Board of Governors of the Fed. Res. Sys. v. MCorp Fin., Inc., 112 S. Ct. 459 (1991).

[405] Section 616(d) Dodd-Frank Act adds a new Section 38A to the Federal Deposit Insurance Act. Subsection (a) of the new Section 38A states that: 'The appropriate Federal banking agency for a bank holding company or savings and loan holding company shall require the bank holding company or savings and loan holding company to serve as a source-of-financial strength for any subsidiary of the bank holding company or savings and loan holding company that is a depository institution.'

[406] Metlife v Financial Stability Oversight Council (FSOC) US Dist. C. D. Col. Civil Action No. 15-0045 (2016). See *supra* 4.1.3.

[407] This could be undertaken under a "proportionality" test, typical of European jurisdictions, or under the various forms of "balancing" more typical of US courts. See Moshe Cohen-Eliya; Iddo Porat "American balancing and German proportionality: The historical origins" *International Journal of Constitutional Law*, Volume 8, Issue 2, (2010) pp. 263-286, for a comparison.

[408] Benton E Gup (ed.) *Handbook for Directors of Financial Institutions* Massachusetts, Elgar, 2008, p. 64.

The friction between policy and principle, however, is mitigated as we move from the *ex post* scenario of execution of resolution tools to the *ex ante* scenario of resolution planning. In that context, it no longer looks excessive for authorities to require banking groups to organize their affairs in a way that facilitates the flow of financial assistance from the top-down. Actually, it seems a logical next step to an SPE strategy (*supra* IV.B.1), and it helps to rationalize the decisions over the ways to comply with internal TLAC/MREL. This tendency can be observed clearly in the US. The 2017 Guidance for 2017 Resolution Plans introduced the concepts of Resolution Capital Adequacy and Positioning ("RCAP"), Resolution Liquidity Adequacy and Positioning ("RLAP"), and Resolution Capital (and Liquidity) Execution Needs ("RCEN", and "RLEN").[409] The idea is to require entities to "preposition" sufficient resources to meet capital and liquidity needs (RCAP, RLAP) during "business as usual" to anticipate a stress scenario, and, when such stress scenario arrives, to make real-time projections of capital and liquidity needs (RCEN and RLEN),[410] and, if necessary, activate a parent support agreement,[411] typically channeled through a Funding Intermediate Holding Company (Funding IHC)). In anticipation of *ex post* bankruptcy challenges, US resolution authorities required major banks to include a detailed legal analysis of the potential challenges to the planned provision of capital and liquidity to the subsidiaries, and the mitigants to those challenges.[412] Such mitigants have taken the form of contractually binding mechanisms (CBM) including clear triggers synchronized with the (centralized) capital/liquidity methodologies, security interests, and collateral, and penalties for non-compliance.[413] These have taken the form of Secured Support Agreements (SSA), which constitute the framework of reference for the major US banking groups, such as Bank of America,[414] Citigroup,[415] Goldman Sachs,[416] JP Morgan Chase,[417] or

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[409] FDIC and Fed Guidance for 2017 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015.

[410] *Id*.

[411] Federal Reserve FDIC, Guidance for 2017 §165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015 p. 10.

[412] *Ibid*.

[413] FDIC and Fed Guidance for 2017 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015 § IV (Governance mechanisms).

[414] Bank of America Corporation 2019 Resolution Plan Submission Public Executive Summary pp. 9-10, 18-20.

[415] Citigroup Inc. 2019 Resolution Plan Public Section, July 1, 2019, pp. 4-5, 15-16.

[416] The Goldman Sachs Group, Inc. 2019 Resolution Plan Public Section, pp. 19-20.

Morgan Stanley.[418] Yet, the brief information in the public section of those plans does not include a discussion of the actual challenges and mitigation techniques.

A side effect of the source-of-strength doctrine, and its expansion into the *ex ante* planning stage is the push it entails towards operational centralization. By requiring firms to centrally plan their capital and liquidity needs, financial authorities have incentivized them to centralize management, or management and funding, and normally at the level of the parent holding company. Citigroup, for example, besides pre-positioning capital and liquidity, relies on access to a pool of centrally managed resources.[419] Bank of America relies on a mix of secured and unsecured liabilities through a centralized, globally-coordinated funding strategy.[420] Goldman Sachs relies on a Capital and Liquidity Support Agreement, based on a specific sub-holding (Funding IHC), dependent of the top parent company (GS Group). This arrangement combines the holding (prepositioning) of liquid assets by material group entities, with centralization through the holding of liquidity surplus by Funding IHC.[421] A similar arrangement characterizes JP Morgan Chase,[422] and Morgan Stanley.[423] This can create operational rigidities (e.g. if the entity that has the resources is not the one with the best expertise to make decisions on resource allocation), and while providing a neat picture for a single jurisdiction and authority, the push towards centralization can create friction when more than one jurisdiction and authority are involved.

The source-of-strength doctrine may be a US creation, but the questions it addresses also arise in the EU framework, where authorities have broad powers in regard to (i) the assessment of resolvability;[424] and (ii) early intervention.[425] Yet the EU system for intra-group support measures is not discretion-based but rules-based. First, the rules that regulate intra-group financial support agreements (IGFSAs) include a list of requirements to be fulfilled by those agreements, which need to take

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417 JP Morgan Chase 2019 Resolution Plan Public Filing pp. 17-20.
418 Morgan Stanley 2019 Resolution Plan Public Section, pp. 17-20.
419 Citigroup Inc. 2019 Resolution Plan Public Section July 1, 2019 p. 68 (resources provided by Citibank NA, and managed by Citi Treasury). See also Citigroup Resolution Plan July 2015, p. 30.
420 Bank of America Corporation 2019 resolution Plan Submission. Public Executive Summary, p. 43.
421 Goldman Sachs Group Inc 2019 Resolution Plan Public section, June 28, 2019, pp. 18-22, 43.
422 JP Morgan Chase 2019 Resolution Plan Public Filing, pp. 20-21, See also p. 17 to see the group arrangement.
423 Morgan Stanley 2019 Resolution Plan. Public Section pp. 32-36.
424 Articles 17-18 BRRD.
425 Articles 27-30 BRRD.

into account the interest of all participating entities and the public interest to not undermine financial stability, or the resolvability of the providing institution.[426] Second, the rules regulate two procedures. One is to approve the agreement, which requires an application by the group parent, the authorisation by the consolidating supervisor and other competent authorities,[427] and approval by the shareholders of every group entity.[428] The other procedure is to approve the actual provision of financial support under the agreement, which requires a reasoned decision from the management of the providing and receiving entities, and notification to competent authorities, which have a right to oppose.[429] The combination of substantive and procedural requirements secures a robust framework of legality and legitimacy.

This tighter approach by EU rules does not answer all open questions, however. Intra-group support *may* be adopted by financial groups,[430] which means there is no statutory source-of-strength duty, something in line with the more neutral EU position between SPE and MPE strategies. Furthermore, the rules do not state that intra-group support can *only* be provided under cover of a regulated IGFSA. Group entities can conclude arrangements on funding, including centralised funding, which are not covered by IGFSA rules, provided they are conceived for cases where none of the entities meets the conditions for early intervention.[431] Also, an IGFSA is not a precondition to provide *ad hoc* support, even in the case of financial difficulties.[432] Finally, the incentives for such agreements are limited. From a supervisory perspective, competent authorities *may* temporarily waive prudential

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[426] The conditions under article 23 (1) BRRD include the need of a reasonable prospect that the agreement will redress financial difficulties, the need that the agreement preserves the financial stability of the group as a whole, and is in the interest of the providing entities, the need that the agreement reflects the risk of default and loss-given default, and benefits and costs, the need of a reasonable prospect of loan repayment (which means the need to evaluate collateral) the need to not jeopardise the providing entity's liquidity, solvency, or resolvability, make it breach prudential rules, or undermine financial stability. See EBA Guidelines specifying the conditions for group financial support under Article 23 of Directive 2014/59/EU EBA/GL/2015/17, 9 July 2015.

[427] In case of disagreement the rules contemplate the intervention by the EBA. See article 20 BRRD.

[428] Article 21 BRRD.

[429] The management of the providing entity and the receiving entity have to approve the financial support (through a *reasoned* decision) and notify the competent authorities, which may oppose. Again, the rules contemplate an intervention by the EBA in case of disagreement between competent authorities. See articles 24-25 BRRD.

[430] Article 19 (1) BRRD.

[431] Article 19 (2) BRRD.

[432] Article 19 (3) BRRD.

requirements on liquidity, solvency or large exposures to the providing entity, but are by no means obliged to do so.[433] From a company law perspective, financial support under cover of an IGFSA has the benefit of expedience, as it has been pre-approved by shareholders, but also entails rigidity and transaction costs.

This still leaves open the most important question (which takes us to square one), about the relationship between the *ex-ante* framework on planning and the *ex-post* framework of entities' rights and authorities' powers. Although a first reading of the rules may suggest that every *ex-post* measure has to be accounted for in the *ex-ante* planning, this is not the case from the entities' perspective. Nor is it the case from the authorities' perspective. Competent *supervisory* authorities may, as part of their powers, request the implementation of measures contemplated in the recovery plan, but can do many other things, including changes in the business strategy, legal or operational structures, removal of senior management and installation of temporary administration, etc.[434] For our purposes, the authorities may require the entity to *update* the recovery plan, in light of changed circumstances.[435] Add to this the fact that the *supervisory* competences include the possibility of imposing extra prudential buffers[436] and that early intervention measures include requiring the entity to negotiate a debt restructuring,[437] and the ensemble of provisions could be used by supervisors to require a parent company to increase financial support to its subsidiary with fresh money and, absent that money, through a restructuring of intra-group debt. If the measure is not contemplated by the recovery plan, this could be correspondingly updated.

These issues have a high significance in the context of resolution, bail-in and the insolvency hierarchy. Resolution powers, including bail-in powers, are broad, but their use is limited by (i) the exceptional situations in which they can be exercised, and (ii) the fact that bail-in takes the group's liability structure as given. The source-of-strength doctrine in the US, and the use of pre-resolution powers in the EU framework to eliminate obstacles to resolvability or for early intervention purposes, can dramatically alter this balance. They could support an interference analogous to a bail-in without having to put the entity into resolution or reach the point of non-viability, without taking the liability

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433 Article 23 (1) (g) and (h) BRRD.
434 Articles 27 (1) (a) – (h), 28 and 29 BRRD.
435 Article 27 (1) (a) BRRD.
436 Article 104 (1) (a) CRD. See also article 27 BRRD, for the reference to article 104's supervisory competences as part of the toolkit for early intervention.
437 Article 27 (1) (e) BRRD.

structure as given, and without any regard for the fiduciary duties applicable to the parent company directors.

In our view, this use would contravene the EU framework, where the powers of resolution authorities are constrained by clear rules, principles and procedures. Thus, the more reasonable interpretation is to consider the exercise of pre-resolution powers by supervisory authorities as limited by *ex ante* planning measures, such as the recovery plan and the IGFSA. Changes in the plan should respond to a real change of circumstances, be well justified, and should not be a way to alter the liability structure or impose greater intra-group funding obligations, which should be voluntary and constrained by fiduciary duties.[438] The US system is more mandate-based, which means that, as long as the authority acts within its mandate, the action will not be illegal *per se*. This, however, would still subject the decision to require the parent to support its subsidiary with extra funding to justification under an "arbitrary and capricious" standard. In practice, however, it is likely that the review standard for both types of measures will be a legitimacy-based "enhanced justification" [439] as the means to subject decisions with an important policy component to adequate judicial review.

V. CONCLUSION

In this article, we have described the tensions that arise between bank resolution frameworks and priority rules in insolvency law at the level of policies and principles. We have also presented an analytical framework to explore how these tensions will give rise to practical problems when bank resolution authorities implement the new bank resolution rules. This framework identifies three layers of complexity. First, the application of these rules in the context of banking groups. Second, the existence of *ex-ante* (crisis prevention) and *ex-post* (crisis management) tools. And third, the need to apply bank resolution rules to cross-border banks. In this article, we have examined the practical problems that can arise when looking at the first two levels in isolation, as well as when superimposing both layers. In a succeeding article, we will examine how the application of bank resolution rules at the cross-border level leads to further complications as a result of underlying

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[438] We admit that this is easier said than done. This would leave open the question of how to limit supervisory authorities' use of the point of non-viability assessment as a threat to coerce intra-group support outside the IGFSA framework.

[439] *See* Section 2.3, *supra* for a discussion on the importance of the notion of "legitimacy" to assess the legality of measures in this context.

tensions with insolvency law. We will also reflect on how these tensions are shaping the face of global banking today.