THE LEGAL STRUCTURE OF COMMERCIAL BANKS AND FINANCIAL REGULATION

Víctor Livio Enmanuel Cedeño Brea

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DOES ORGANIZATIONAL FORM MATTER FOR THE DESIGN OF BANK REGULATION?

Víctor Livio Enmanuel Cedeño Brea

COVER: WASILY KANDINSKY, SEVERAL CIRCLES (EINIGE KREISE) 1926 (PUBLIC DOMAIN)

The Legal Structure of Commercial Banks and Financial Regulation –

Does organizational form matter for the design of bank regulation?

De juridische structuur van commerciële banken en financiële regelgeving –

Is de organisatievorm van belang voor het ontwerp van bankregulering?

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Para Gaby y Emmanuel, con todo mi amor

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Fortunately for me, my friend's dismal predictions were not entirely accurate. After the onslaught of the financial crisis, I have been lucky enough to work, study, research and write in the topic of my interest: financial regulation. I am more than grateful for these opportunities. Moreover, the last years have also given me the chance to meet and work with wonderful people that have had an enormous impact on my professional and academic endeavors.

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ABBREVIATIONS

AT1	Additional Tier 1 Capital
BCBS	Basel Committee on Banking Supervision
BHC	Bank Holding Company
BRRD	Bank Recovery and Resolution Directive
CET1	Common Equity Tier 1 Capital
CoCos	Contingent Convertible Capital Instruments
CRR	Capital Requirements Regulation
CRDIV	Directive on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms
DFA	the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
D-SIB	Domestic Systemically Important Bank
ECB	European Central Bank
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FSB	Financial Stability Board
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
G20	Group of Twenty Finance Ministers and Central Bank Governors
IBR	Internal Based Rating approach to capital requirements
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
LORCA	Spanish Saving Banks' Corporate Governance Law (*Ley de los Órganos Rectores de las Cajas de Ahorros*)
LTF	Legal Theory of Finance
MPE	Multiple Point of Entry Resolution
NSFR	Net Stable Funding Ratio
PRA	Prudential Regulatory Authority of the United Kingdom
OECD	Organization for Economic Cooperation and Development

RFB	Ring-fenced Body
ROE	Return on Equity
RWAs	Risk Weighted Assets
SCE	European Co-operative Society
SE	European Company (*Societas Europaea*)
SIB	Systemically Important Bank
SMEs	Small and Medium Enterprises
SPE	Single Point of Entry Resolution
SRM	Single Resolution Mechanism
SRRs	Special Resolution Regimes
TARP	Troubled Asset Relief Program
TBTF	Too-big-to-fail
TBTS	Too-big-to-save
TFEU	Treaty on the Functioning of the European Union
TLAC	Total loss absorbing capacity
TUB	Italian Consolidated Banking Rulebook (*Testo Unico Bancario*)
USA	United States of America
UK	United Kingdom

Chapter One

Do the Different Ways that Banks Are Legally Organized Matter for Financial Regulation? – An Overview of the Thesis

'The burgeoning study of the "economics of organization" turns on two propositions – organizations matter and organizations are susceptible to analysis'.[1]

Oliver Williamson

What do people exactly mean when they refer to *banks*? Do they have a production function in mind? Or rather a place where deposits are received and loans are granted? It is possible that the term evokes a brick-and-mortar institution or maybe an office space, with tellers, relationship managers, cash machines and a large vault stocked with piles of cash.

Certainly, banks are not monoliths. They are legal entities constituted as networks of contracts undertaken between their different organizational constituents and stakeholders. However, aside from notable exceptions, limited academic and policy attention has been placed on the legal organization of banks in the aftermath of the 2007-2008 global financial crisis. This leads to the overarching questions that underpin this research project: if and how the legal structure of commercial banks is important for the design of financial regulation?

[1] Oliver E Williamson, 'Why Law, Economics and Organization' (2005) 1 Annual Review of Law and Social Science 369.

This dissertation analyzes the legal configuration of banks in the aftermath of the latest financial crisis. The following case studies and anecdotes aim to provide some context into the discussion that this thesis undertakes.

On 15 September 2008, investment bank Lehman Brothers filed for Chapter 11 Bankruptcy protection in the United States (US). Lehman Brothers' failure marked one of the crucial moments of the 2007-08 financial crisis. The US government announced a set of measures designed for providing up to USD $700 billion as part of the Troubled Asset Relief Program (TARP). A few days after Lehman's collapse, the two remaining US investment banks announced that they were changing their legal structure and converting into bank holding companies (BHCs). The move was largely seen as a way to access federal funding – and even though their main business lines did not change – it marked a significant paradigm shift in the way that investment banks in the US are structured.

In February 2012, while the effects of the financial crisis were still being felt in many jurisdictions, the European Commission setup a high-level expert group with the objective of examining potential reforms to the European Union's (EU) banking sector. The group became known as the 'Liikanen Group', because Commissioner Michel Barnier appointed Bank of Finland Governor, Mr. Erki Liikanen, to chair the group. In a certain sense, the Liikanen Group was convened as a response to a comparable group of wise men assembled in the United Kingdom, led by Sir John Vickers, who had been given a similar mandate in June 2010, and rendered their final report in September 2011.[2] After the onslaught of the 2008 financial crisis, examining the structure of banking seemed to have become a very important item in the agenda for revamping international financial regulation.

[2] Officially called the 'Independent Commission on Banking' (ICB), but colloquially referred to as the 'Vickers Commission'. See Independent Commission on Banking, 'Final Report: Recommendations' (September 2011) <http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf> accessed 6 December 2016.

On 2 October 2012, the Liikanen Group presented its final report. Amongst other key points, the Liikanen Report concluded the need: '[…] to require the legal separation of certain particularly risky financial activities from deposit-taking banks within a banking group'. The Report added that the: '[s]eparation of these [risky] activities into separate legal entities within a group is the most direct way of tackling banks' complexity and interconnectedness'.[3]

In December 2012, a few months after the Liikanen Report was published, some of the leaders of the European co-operative, mutual and banking sectors met in Brussels for the 5th Convention of European Co-operative banks. The meeting was a platform for discussing the challenges that some post crisis regulations posed to non-joint stock banks. In this meeting, Arnold Kuijpers, the Director of Corporate Affairs of Rabobank Group – a Dutch network of 123 local co-operative banks – expressed his concerns over the challenges that the most recent global capital and liquidity rules (commonly known as 'Basel III') implied for co-operative and other types of non-joint stock banks.[4]

The preceding anecdotes share a common unifying thread. It is apparent that they are all related to the banking sector and the consequences of the latest financial crisis. But at a more granular level, they also highlight the connection between financial regulation (institutions) and the different ways that commercial banks are legally structured (organizations). Put in broader terms, they directly relate to the interaction between law, economics and organization.

But what does analyzing the structure of banking exactly entail? Does it merely relate to the economic functions that banks undertake? Or does it have to do with a particular business model or rather a set of activities that banks provide to society and to the general

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[3] High-level Expert Group on reforming the structure of the EU banking sector ('Liikanen Group'), 'Final Report' ('Liikanen Report') (October 2012) i-iv. <http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf> accessed 6 December 2016.

[4] 'Leaders Discuss New Regulations at European Co-operative Banks Convention' *International Co-operative Alliance* (December 2012) <http://ica.coop/en/media/news/leaders-discuss-new-regulations-european-co-operative-banks-convention> accessed 6 December 2016.

public? Or could a better understanding of the legal structure of commercial banks also be relevant for making banking safer?

When the most recent global financial crisis reached its nadir in the year 2008, many financial institutions entered into distress or outright failed. In many instances, banks and other types of financial institutions required recapitalization or liquidity lifelines from States, which in turn relied on the use of public finances in order to bail out the banks.[5] In the words of US Senator Christopher Dodd: '[m]any [banks] were saved because the Government resorted to an array of loans, guarantees, and capital injections to keep these large, complex financial firms afloat'.[6]

While academic and public policy discussions focused on the *types* of banks in question (eg whether they were *commercial* or rather *investment* banks, or whether they provided *universal* or *narrow* services), inquiries into the underpinning legal structure of those banks have been limited. Thus, one can argue that – aside from the structural reforms discussed and implemented in leading jurisdictions – questions regarding banks' legal organization and its relation to the design of financial regulation have been generally under-attended to.[7]

This thesis focuses on the relationship between the ways that commercial banks are legally organized and financial regulation. The project mainly focuses on commercial

[5] See Randall D Guynn, 'Are Bailouts Inevitable?' (2012) 29 Yale Journal on Regulation 121, 123-129 (on the economics of bank bailouts).
[6] United States Senator Christopher Dodd's Opening Statement at the 'Regulation and Resolving Institutions Considered Too Big to Fail' Hearing before the United States Congress Senate Committee on Banking, Housing, and Urban Affairs (6 May 2009).
[7] For example, a recent study by the European Association of Co-Operative Banks (EACB) and the TIAS School for Business and Society states that in the publications of important standard setting bodies and regulators like the IMF, the ECB and the BIS: 'the effects of different organisational forms and/or business models on banking market structures remain relatively underexposed'. See Hans Groeneveld 'A Snapshot of European Co-operative Banking' (April 2016) 3
<http://www.globalcube.net/clients/eacb/content/medias/publications/annual_reports/20160411_HG_EACB_FINAL_Snapshot.pdf> accessed 6 December 2016.

banks as opposed to other types of financial institutions, like investment banks (securities brokers), insurance companies, or investment funds.[8]

The book's central idea discusses whether and how the way that banks are legally organized matters for the design of financial regulation. Any firm can be legally configured using a plethora of organizational forms.[9] Commonplace organizational forms include, but are not limited to: public and close corporations, limited liability companies, co-operatives, mutual associations, nonprofit entities, and other forms of unincorporated types of commercial exchange.

The main objective of the thesis is to integrate some of the legal and economic insights drawn from the study of existing bank organizational forms to the design of financial regulation. Using the words of Prof. Oliver Williamson, Nobel laureate and economist, cited at the beginning of this chapter, the book purports to show that banks – as organizations – matter and that they are susceptible to analysis. In this sense, the law plays a role in the way that organizations are structured. As such, the legal aspects of bank organization also matter and merit scholarly examination.

1. RESEARCH QUESTIONS AND OBJECTIVES

Can a better understanding of bank legal forms provide some insights for revamping financial regulation after the onslaught of the 2007-08 global financial crisis? Can

[8] Throughout the thesis, unless otherwise stated, all references to banks should be construed as referring to commercial banks (also called 'clearing banks', in the United Kingdom). This includes institutions that conduct deposit-taking activities with the objective of on-lending the monies to third parties and perform the functions of regulated financial intermediation and payments services. Consequently, the organizational forms used to setup investment banks (securities brokers or merchant banks, as they are known in the UK) and other types of financial institutions, like hedge funds, investment funds, insurance companies, etc. fall outside the scope of this analysis. However, some wider implications of the analysis in relation to non-bank financial institutions are briefly discussed as part of the conclusions presented in chapter seven.

[9] 'Legal' or 'organizational forms' is the label used throughout the rest of the book. It refers to the different types of legal entities or structures available for organizing economic activities. In legal doctrinal analysis it is often called: *tipo societario* or *forma jurídica*, in Spanish; *forme ed enti giuridici* – in Italian; *forme juridique* in French; and *Rechtsformen*, in German.

organizational law – understood as a broad set of different laws that govern economic enterprise, contracts and property rights – prove to be a suitable policy lever for designing more effective financial regulation? Why haven't questions regarding legal structure played a greater role in the ongoing agenda for revamping international financial regulation? Is it because they are completely irrelevant or simply underestimated? These are some of the central research questions that this thesis purports to answer.

Each chapter asks secondary and equally important related questions, such as: what are the predominant legal forms used for organizing commercial banking activities in major jurisdictions today? What economic features make a co-operative bank different to a corporate bank, or different to a mutual bank? What is the relationship between bank capital, liquidity and leverage standards, and organizational forms? Do international standard setting bodies, like the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB), take into account non-joint stock banks when they design, propose and implement capital and liquidity standards? Do the inherent features of some bank organizational forms enhance their *resolvability*?

The central idea that this thesis purports to show is that questions regarding legal forms are not trivial for the design of financial regulation. After all, banks and financial conglomerates are either standalone entities or groups of legal entities. While larger cross-border banks are often organized as corporations, many local banks are incorporated using other legal forms, such as co-operative associations, mutual societies, trusts and non-profit entities. Thus, when designing and implementing new rules, financial regulators, supervisors and international standard setting bodies should take heed to the fact that – across different countries – commercial banks are set-up using a variety of legal structures. Moreover, the rules governing these legal structures vary from country to country.

The thesis argues and concludes that bank legal forms matter for financial regulation. The book studies three specific instances were the interplay between legal forms and financial

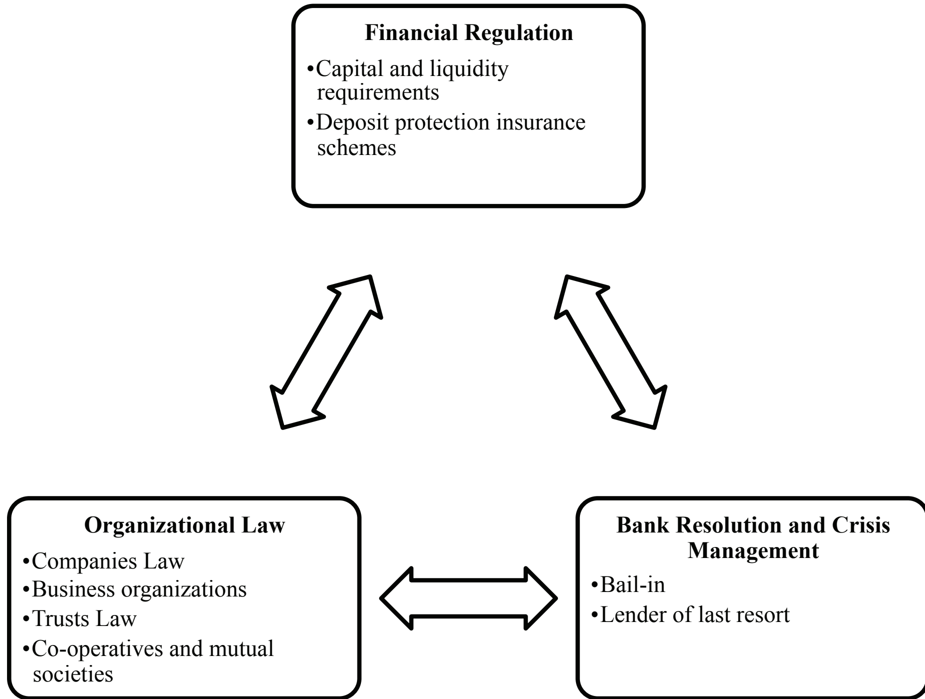
regulation is thought to be significantly important. These are: (1) capital, liquidity and leverage standards (chapter four), (2) bank resolution and crisis management (chapter five) and (3) for ongoing banking structural reforms (chapter six).[10] Figure 1 purports to depict the linkage between organizational law and financial regulation.

More specifically, the thesis argues that the legal structure of banks is important because each type of organizational form entails a 'package' of economic attributes and a hierarchy of both creditors' and owners' rights (property rights). The economic features inherent to different legal forms interact with the incentives created by financial regulations, such as capital and liquidity requirements, deposit protection insurance schemes and bank resolution regimes. In order for financial regulation to be effective, it should acknowledge the incentives and the rules that the law allocates to different bank stakeholders through organizational laws.

[10] Other equally important aspects have not been directly analyzed. These include: taxation rules, labor laws, securities regulation and competition policy.

Figure 1

Linkage between Legal Form and Financial Regulation



2. MOTIVATION

After the onslaught of the 2007-08 global crisis, international financial regulation remains in state of flux. In response to the latest crisis, academics and policymakers have placed significant attention to changing the domestic institutional financial supervisory architecture.[11] Essentially, the focus has been on re-designing how financial regulators

[11] For a general overview see Eilis Ferran, 'Institutional Design: the Choices for National Systems' in Niamh Moloney, Eilis Ferran, Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP 2015).

and supervisors are institutionally set-up.[12] Parting from the classical legal doctrinal taxonomy, such institutional reforms would fall within the domain of what is traditionally associated with public law.

Notwithstanding, questions related to the different ways that commercial banks are legally organized seem to continually receive less academic and policy attention. These matters would be the mirror image of the aforementioned institutional reforms – but within the sphere of the private law of finance.[13] That is, asking whether and how the legal forms that banks adopt interact with financial regulation, such as deposit protection insurance schemes, bank resolution and bail-in tools, and capital and liquidity rules. Consequently, making the financial sector more robust could require policies that address both the supervisory structure and the legal organization of banks. This means the interplay between the private and the public law of finance. A combination of both public and private law reforms could be needed in order to promote a sustainable financial architecture.

The structure of banks and banking groups has received some attention with the advent of so-called 'banking structural reforms'.[14] Bank structural reforms remain patchy, uncoordinated and do not always tackle legal structure and its consequences at the same level of detail that this study purports to undertake. The distinctive approach of this

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[12] Notable examples include: France, Germany, the United Kingdom, the United States of America, Belgium, Ireland and also in the Eurozone. See Ferran, 'Institutional Design: the Choices for National Systems' (n 11). See also E Fernandez-Bollo, 'Structural Reform and Supervision of the Banking Sector in France' [2013] OECD Journal Financial Market Trends <http://www.oecd.org/finance/Bank-reform-supervision-France.pdf> accessed 6 December 2016; IMF, 'France: Financial System Stability Assessment' (2012); J Sanio, 'The New Single Regulator in Germany' in T Kuppens et al. (eds), *Banking Supervision at the Crossroads* (Edward Elgar 2003); Luca Enriques and Gerard Hertig, 'Improving the Governance of Financial Supervisors' (2011) 12 European Business Organization Law Review 357.

[13] John Armour et al. acknowledge that with regards to financial regulation: '(…) outcomes may doubtless be shaped by private law — in particular, the degree to which property law facilitates the partitioning of assets'. See John Armour, Daniel Awrey, Paul Davies, Jeffrey Gordon, Colin Mayer and Jennifer Payne, *Principles of Financial Regulation* (OUP 2016) 12.

[14] The thesis argues that banking structural reforms focus on functional aspects rather than on legal organization *per se*. In other words, more attention is placed on what banks *do* rather than on *how* they are legally structured to carry out their activities. A broader discussion of banking structural reforms is included as part of chapter six.

research project is that it tries to delve deeper into the intricacies of the most salient legal and economic attributes that comprise different organizational forms used for structuring commercial banking. The study also attempts to go further than the traditional 'branch versus subsidiary' analysis that is commonplace in the banking literature, by examining – aside from the business corporation – the different ways in which banks can be organized.

The main contribution of this thesis is attempting to provide an explanation of exactly how legal forms matter for the design financial regulation. Financial regulation warrants an analysis of legal forms for several reasons. First of all, banks and banking groups are either stand-alone entities or clusters of legal entities. That is, they are incorporated as subjects of law according to pre-established existing organizational structures.[15] Each type of organizational form is a nexus *of* and *for* multiple contractual relations between a firm's stakeholders. This means that they allow for transactions and contracts to occur. Thus, the law determines different patterns of ownership (property rights) and incentives for each type of business organization. Financial regulation interacts with and sometimes changes or rearranges these ownership patterns.

One example of this is the subrogation of deposit insurers (and ultimately, taxpayers) in the creditor hierarchy of a bailed out bank. Thus, a better understanding of the way that financial regulation interacts with legal forms could provide some guidance for designing more effective rules that create the right incentives for different bank stakeholders to act according to the risks that they take. In other words, a better understanding of legal forms – and not just of the corporate legal form – could provide some insights for tackling moral hazard and fostering market discipline amongst bank stakeholders and constituencies.

Another reason why financial regulation warrants an analysis of legal forms is that banks are not always corporations (joint-stock companies). It is often the case that many

[15] This holds true for both bank subsidiaries, which are independent legal entities, and branches (that share the legal personality of their parent entity).

academic studies assume that most banks are corporations that issue stocks and have shareholders as their main type of monitoring agents and residual risk-bearers. This study tries to add value by including an analysis of the different ways that banks are legally organized across some jurisdictions. The variety in existing legal forms means that they have different incentive structures. Failing to include non-corporate banks into the discussion and the design of financial regulation can lead to implementation gaps and legal uncertainty when the rules are applied across the board to all legal forms.

What is more, assuming that all banks are corporations leaves out an important 'institutional' detail of how banks are organized in different countries. Failure to include banks' legal and institutional setting could lead to mistakes in the rule making process. As Ronald Coase brilliantly put it, it can leave one studying: '(…) consumers without humanity, *firms without organization*, and even exchange without markets'.[16]

3. PLACING THE THESIS WITHIN THE LITERATURE

This research project fits within the confines of several strands of recent academic literature and policy debate. Foremost, it can be interpreted as a contribution related to the ongoing discussions on banking structural reforms in the wake of the 2007-08 global financial crisis.[17] Structural reforms are a salient item on the ongoing agenda for revamping international financial regulation. Banking structural reforms have been discussed and implemented in many leading jurisdictions, including: the United States of America (US), the United Kingdom (UK), France, Germany, and in the European Union (EU). These reforms acknowledge that legal structure could be a policy lever for making banks more resolvable, better capitalized and for reducing the social costs and negative spillovers of bank failure.

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[16] (Emphasis added) see Ronald H Coase, *The Firm, The Market and the Law* (University of Chicago Press 1988) 3.

[17] For a general overview of structural banking reforms see Financial Stability Board, 'Structural Banking Reforms – Cross-border Consistencies and Global Financial Stability Implications' (2014) <http://www.financialstabilityboard.org/wp-content/uploads/r_141027.pdf> accessed 6 December 2016. See also Rosa M Lastra, *International Financial and Monetary Law* (2nd edn, OUP 2015) 142-146.

Before bank structural reforms entered into the spotlight, several authors had already raised interesting questions – either studying the diversity of bank legal forms, or further analyzing the linkage between the legal organization of banks and financial regulation. Henry Hansmann described and categorized the legal and institutional structures observed for arranging banking activities in the US.[18] Moreover, there is a longstanding theoretical and empirical academic discussion regarding the organizational choice of banking through the establishment of subsidiaries, affiliates or branches.[19]

After the latest financial crisis, at least two notable economists have championed proposals for the organizational revamping of banking activities. Firstly, British economist John Kay has presented his proposal for what he calls 'narrow banking'.[20] In addition, US economist Laurence Kotlikoff has proposed his limited purpose-banking model, which consists in the reshuffling of commercial banks (and all financial institutions) as mutual funds.[21] Both proposals are considered to be notable structural models presented with the objective of legally organizing commercial banks in a different

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[18] Henry Hansmann gives an account of the legal and organizational evolution of the savings bank industry in the United States. In later work regarding the ownership of enterprise, Professor Hansmann discusses the historical progression of the legal organizational structure for financial firms with more detail – including banks and insurance companies. See Henry Hansmann, 'The Economic Role of Commercial Nonprofits: The Evolution of the Savings Bank Industry' in H Anheier and W Seibel (eds) *The Third Sector: Comparative Studies of Nonprofit Organizations*, (de Gruyter 1989); Henry Hansmann, 'Ownership of the Firm' (1988) 4 Journal Of Law, Economics and Organization 267; Henry Hansmann, *The Ownership of Enterprise* (Belknap Press of Harvard University Press 1996). See also Henry Hansmann, 'The Organization of Insurance Companies: Mutual Versus Stock' (1985) 1 Journal of Law, Economics, and Organization 125.

[19] See Almudena de la Mata Muñoz, 'The Future of Cross-Border Banking after the Crisis: Facing the Challenges through Regulation and Supervision' (2010) 11 European Business Organization Law Review 575; Tobias H Tröger, 'Organizational Choices of Banks and the Effective Supervision of Transnational Banking Institutions' (2013) 48 Texas International Law Journal 177.

[20] John Kay, 'Narrow Banking: The Reform of Banking Regulation' [2009] Centre for the Study of Financial Innovation <http://www.johnkay.com/wp-content/uploads/2009/12/JK-Narrow-Banking.pdf> accessed 6 December 2016.

[21] Laurence Kotlikoff et al., 'Limited Purpose Banking: Moving from Trust me to Show me Banking' (2012) 102 American Economic Review, Papers and Proceedings 113. See also Laurence Kotlikoff, *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking* (John Wiley and Sons 2010).

way. Neither proposal delves with great detail into matters of legal organization. Both proposals have also been considered to be radical in their nature.[22] Even though they have received noteworthy recognition in some academic circles, they have not yet been influential in policymaking and financial reforms.

Post crisis studies related to bank organizational forms or banks' institutional details include Eva Hüpkes' examination of the relationship between bank legal structure and resolution.[23] Gustaf Sjoberg credits Prof. Rosa M. Lastra with having originally proposed harmonizing European banks' organizational structure using the *Societas Europaea*.[24] Moreover, in the latest edition of her treatise on 'International Financial and Monetary Law', Prof. Lastra acknowledges that: '[t]he legal form of banks and the advent of limited liability (considering also the history of double liability shares in the USA and partly paid shares in the UK) should be reviewed further'.[25]

In a recent paper, David Bholat and Joanna Gray have also argued that organizational form could be a source of systemic risk.[26] Their view challenges the so-called '(legal) reductionist view' of associating banks solely with the corporate form.[27] Some of theses ideas can also be linked to Eric W Orts' proposal of returning to a 'legal theory of the firm'. Orts argues that: 'business firms are created and governed through legal institutions' – adding that: 'without law, business firms cannot exist'.[28]

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[22] Martin Wolf, 'Why and How Should We Regulate Pay in the Financial Sector?' in *The Future of Finance: The LSE Report* (London School of Economics 2010).
[23] Eva Hüpkes, '"Form Follows Function" – A New Architecture for Regulating and Resolving Global Financial institutions' (2009) 10 European Business Organization Law Review 369, 371.
[24] Gustaf Sjoberg, 'Handling Systemically Important Banks in Distress-Some Thoughts from a Swedish Perspective' (2011) 12 European Business Organization Law Review 227, fn 96.
[25] Rosa Lastra, *International Financial and Monetary Law* (n 17) 142, fn 121. Prof. Lastra adds that: '(…) an in-depth study of whether other forms of corporate organization, such as a mutual or a cooperative, might more effectively curb excessive bank risk-taking' was beyond the scope of her treatise. This thesis attempts to address this particular gap in the academic literature.
[26] David Bholat and Joanna Gray, 'Organizational Form as a Source of Systemic Risk' [2013] Economics: The Open-Access, Open-Assessment E-Journal 1.
[27] ibid.
[28] Eric W Orts, *Business Persons – A Legal Theory of the Firm* (OUP 2013) x-xi.

Moreover, the central idea of the thesis – that law and legal forms are important for finance and economic exchange – can be traced back to Ronald Coase, who in his Nobel Prize Lecture stated that the 'legal system' has 'a profound effect on the working of the economic system and may in certain respects be said to control it'.[29] This is also a common theme found in the law and finance literature (widely known as the 'legal origins theory' or simply 'LLSV') as well as the more recent legal theory of finance ('LTF').

The legal origins literature construes legal systems as bundles of information transmitted across human populations.[30] These bundles – including basic legal infrastructure such as organizational forms – were simply transplanted from some countries to others. Part of the LLSV literature concludes that for their examined variables, countries grouped under the common law label outperform countries belonging to the French, German and Scandinavian clusters. LLSV provides some empirical evidence that legal origins gave way to particular economic rules that in turn resulted in better economic outcomes for common law countries. The variable most closely related to legal forms under this literature would be the development of company and securities laws, that in turn offered the best stock market development, greater investor protection and particular corporate ownership structures.[31] However, corporate law is only a *subset*[32] of organizational law – which also includes the law related to partnerships, co-operatives, mutual associations and nonprofit organizations.

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[29] R H Coase, 'The Institutional Structure of Production' (1992) 82 American Economic Review 713, 717-718.
[30] For a general overview of the LLSV literature see Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, 'Law and Finance After a Decade of Research' in *Handbook of the Economics of Finance*, vol 2 (Elsevier 2013); Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, 'The Economic Consequences of Legal Origins' (2008) 46 Journal of Economic Literature 285. See also Rafael La Porta, Florencio López-de-Silanes, Andrei Shleifer and RW Vishny, 'Law and Finance' (1998) 106 Journal of Political Economy 1113; Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, 'What Works in Securities Laws?' (2006) 61 Journal of Finance 1; Rafael La Porta, Florencio López-de-Silanes and Andrei Shleifer, 'Corporate Ownership Around the World' (2006) 54 Journal of Finance 47.
[31] La Porta et al., 'Law and Finance After a Decade of Research' (n 30) 433.
[32] Borrowing the terminology used by Easterbrook and Fischel who have stated that 'corporations are subsets of firms'. See Frank Easterbrook and Daniel Fischel, The Economic Structure of Corporate Law (Harvard University Press 1996) 10.

On the other hand, the LTF proposed by Katharina Pistor and others considers law as a constitutive part of finance – which in turn is formed by a complex cobweb of contractual rapports and obligations.[33] Thus, Pistor proposes an examination of the law *in* finance.[34] It could be argued that legal forms are a significant part of this complex network of rapports, since the creation of different types of banks (as legal persons) provides benefits to their stakeholders and to society as whole.

Some of the ideas discussed throughout the book could also be framed in terms of the New Institutional Economics ('NIE') framework. In particular, the book hinges upon the so-called conceptual 'golden triangle' of NIE, made up of 'transaction costs, property rights and contracts'.[35] The interaction between legal forms and financial regulation is reminiscent of Douglass North's distinction between *organizations* and *institutions*. North has argued that: 'institutions, together with the standard constraints of economic theory, determine the opportunities in a society'. On the other hand, according to North, 'organizations are created to take advantage of those opportunities'.[36] In this study, organizations include different types of bank legal forms, like corporations, co-operatives and mutual societies. Some of the institutions or rules of the game that are analyzed include: deposit protection insurance schemes, bank resolution regimes and capital and liquidity rules.

The analysis of legal forms and capital requirements included in chapter four of the thesis can also be placed within the literature related to the most recent set of capital, liquidity and leverage standards (Basel III rules and CRR/CRD IV in the European Union). Chapter 5, which covers the relationship between bank legal form, creditor rank and resolution, can be linked to still ongoing academic and policy discussions on bank resolution and crisis management tools.

[33] See Katharina Pistor, 'A Legal Theory of Finance' (2013) 41 Journal of Comparative Economics 315.
[34] Katarina Pistor, 'Law in Finance' (2013) 41 Journal of Comparative Economics 311, 311-314.
[35] Claude Menard and Mary M Shirley, 'The Future of New Institutional Economics: From Early Institutions to a New Paradigm' (2014) Journal of Institutional Economics 541, 544.
[36] Douglass North, *Institutions, Institutional Change and Economic Performance* (CUP 1990).

The thesis' main topic also intersects with other areas of academic interest, including comparative studies of the law of co-operatives and mutual associations[37], and the literature of alternative banking, asset partitioning and more generally, ideas related to the economic analysis of legal organizational forms.

In sum, many of the ideas discussed in this book are inspired by, related to and also build-on recent and ongoing academic and policy debates. Thus, the central topic of this thesis is worthy of further examination.

4. METHODS

This thesis combines legal research methods with some tools, insights and frameworks from the economic analysis of law and NIE. Each core chapter of the thesis applies one or more methods. Chapter 3 relies on a functional comparative analysis of the main types of legal forms used to organize banking activities in six jurisdictions. The functional method, which is ubiquitous in comparative legal studies, mainly focuses on the similarities or equivalences between analogous institutions in order to draw some insights.[38]

Part of the methodological added value of this thesis is the attempt to apply some insights from organizational law and economics to study the relationship between legal forms and financial regulation. From the economic analysis of law, several chapters of the thesis apply Hansmann's *ownership structure*[39], as well as the 'asset partitioning' framework

[37] See Antonio Fici, 'An Introduction to Cooperative Law' in Dante Cracogna et al. (eds) *International Handbook of Cooperative Law* (Springer 2013) 10.
[38] See Konrad Zweigert, 'Methodological Problems in Comparative Law' [1972] Israel Law Review 465. It is useful to note that this method differs from the functional method of Law and Economics, associated with the Virginia School of economic analysis as discussed by F Parisi and J Klick. See Francesco Parisi and Jonathan Klick, 'Functional Law and Economics: The Search for Value-Neutral Principles of Lawmaking' (2004) 79 Chicago-Kent Law Review 431.
[39] Hansmann, 'Ownership of the Firm' and Hansmann, *Ownership of Enterprise* (n 18).

proposed by H. Hansmann, R. Kraakman and R. Squire[40] to the economic structure of commercial bank legal forms (chapter three), to bank resolution and creditor rank (chapter five) and to ring-fenced bodies in the UK (chapter six).

The aforementioned frameworks have certainly not been selected because they are the *only* methods that can be applied to the questions tackled. However, in the case at hand they are useful in providing a systematic starting point for analysis because they add clarity regarding the ownership structure and identity of different bank stakeholders (including: owners, creditors, depositors – a special group of creditors – and potentially, even taxpayers). In sum, the aforementioned frameworks help to see banks less as monoliths or anthropomorphized entities, and more as different groups of economic agents with often-conflicting interests. As such, the selected frameworks offer an alternative perspective to unravel some of the problems tackled, including a view of how the partitioning of assets interacts with other rules promoted by financial regulation.

5. THESIS STRUCTURE

The rest of this book consists of six additional chapters. Each core chapter is preceded by a summary and a list of keywords that signpost its content.

The second chapter introduces the concept of legal forms and explains how they fit into the wider agenda for revamping financial regulation after the last global economic crisis. More concretely, it purports to show how the discussion on legal forms presented in this

[40] See generally Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387; Henry Hansmann and Reinier Kraakman, 'Organizational Law as Asset Partitioning' (2000) 44 European Economic Review 807; Henry Hansmann, Reinier Kraakman and Richard Squire, 'Law and the Rise of the Firm' (2006) 119 Harvard Law Review 1333; Henry Hansmann, Reinier Kraakman and Richard Squire, 'The New Business Entities in Evolutionary Perspective' (2007) 8 European Business Organization Law Review 59. See also H Hansmann and U Mattei, 'The Functions of Trust Law: A Comparative Legal and Economic Analysis' (1998) 73 New York University Law Review 434. See also: Henry Hansmann and Richard Squire, 'External and Internal Asset Partitioning: Corporations and Their Subsidiaries' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (forthcoming OUP 2017).

thesis is different to other contemporary concepts, such as the ongoing banking structural reforms, calls to 'break up big banks[41]' or to regulate banks' business models.

Chapter three focuses on the economic structure of existing types of organizational forms. It applies a framework originally set forth by Prof. Henry Hansmann, in order to identify some of the most salient ownership features that commercial banks exhibit. The chapter applies said framework with the objective of providing an overview of and compare the main categories of legal forms used to organize commercial banks in several of the leading jurisdictions examined. These jurisdictions include: the United States of America, the United Kingdom, Spain, France and Italy. The chapter also covers the pan-European legal forms promoted by the EU's legal framework. Once the main categories of legal forms are identified, their main attributes and features are then analyzed against the foil of the business corporation (ie joint stock companies or companies limited by shares).

Chapter four studies the connection between regulatory capital, liquidity and leverage standards, and bank legal forms. This chapter asserts that the existing international capital standards – namely, Basel III – are mainly directed to large corporate banks. Non-corporate banks, like mutual societies and co-operative banks, are treated in a footnote of the latest version of such standards. Basel III's definition of the highest quality form of capital, called Common Equity Tier 1 ('CET1'), supports this claim. Many legal forms, such as mutual banks (eg British building societies) and some nonprofit banks (like the Spanish *Cajas*), do not issue common or ordinary shares. Consequently, the chapter concludes that international financial standard setting bodies, such as the BCBS and the FSB, should pay greater attention to divergences in existing organizational structures in order to prevent certain unintended consequences, such as legal uncertainty and

[41] See for example: Douglas J Elliott, 'Ten Arguments Against Breaking Up the Big Banks' in Andreas Dombret and Patrick S Kenadjian (eds), *Too Big to Fail III: Structural Reform Proposals – Should We Break up the Banks?* (De Gruyter 2015) 119; Andreas Dombret, 'Cutting the Gordian Knot or Splitting Hairs – The Debate About Breaking Up the Banks' in Andreas Dombret and Patrick S Kenadjian (eds), *Too Big to Fail III: Structural Reform Proposals – Should We Break up the Banks?* (De Gruyter 2015) 5. See also: David Shirreff, *Break Up the Banks!* (Melville House Printing 2016).

implementation gaps in the application of capital standards to different types of banks across jurisdictions.

Chapter five aims to describe how legal forms matter for special bank insolvency procedures – widely known as resolution regimes. The relationship between organizational forms and resolvability has not been extensively explored in the current literature. The main question that this chapter seeks to answer is if a better understanding of bank legal forms and creditor ranks could help overcome challenges for cross-border resolution across the European Union. The chapter answers this question in the affirmative, arguing that since organizational forms can be construed as patterns or hierarchies of creditors' and owners' property rights – during bank resolution – such patterns matter for the apportionment of losses through some of the different tools developed for crisis management. Because creditor rank (loss apportionment) is directly linked to organizational form, the latter is bound to be important during bank resolution.

The sixth chapter examines some of the most important bank structural reforms that have been discussed and implemented in leading jurisdictions as a response to the latest financial crisis. In particular, the study focuses on the case of bank ring-fencing and ring-fenced bodies (RFBs) that is currently being put into practice in the UK. The chapter purports to show how the 'asset partitioning' framework developed in the field of organizational law and economics can be applied to gain some insights for better understanding British type bank ring-fencing. The chapter also uses positive economic analysis of law in order to describe some of the unintended consequences that ring-fencing could have outside of the UK – particularly, in light of conflicting structural reforms carried out in other jurisdictions – and most recently in the aftermath of the referendum held in the UK on 23 June 2016, where a majority of voters decided for the UK to leave the EU.

The final chapter summarizes and presents the thesis' main findings. This conclusive chapter also raises some additional concerns and discusses some wider implications not directly covered throughout the book – either because such concerns fall outside of the

scope of the project, or because they respond to different methodological frameworks. Shortcomings and limitations are also identified and acknowledged. The concluding chapter closes pointing out some potential areas for future research.

A final caveat is in order from the outset. This book argues that legal forms are an important – but not the *only* – variable that should be considered when reforming financial regulation after the latest global economic crisis. The ongoing agenda for revamping international financial regulation consists of a multipronged set of reforms. In this sense, the project focuses on one, albeit very specific factor, without the intention of neither losing sight of nor underplaying the importance of a much bigger – and more complex – panorama. The objective of this thesis is to raise awareness regarding the importance of existing legal and organizational structures for designing financial regulation. The thesis does not purport to measure the magnitude or to overstate the importance of legal forms. Nor does it claim that legal organization is the predominant variable that needs to be taken into account for calibrating financial regulatory reforms and addressing the major economic problems experienced during the latest crisis. However, a good understanding of such legal issues could prove to be an insightful policy tool for tackling some of banks' underlying economic problems or at least for designing more effective regulation to address such problems in the future.

The following chapter introduces the concept of organizational forms that is used throughout the thesis and purports to explain its relationship to commercial banks and overall structural reforms in the aftermath of the 2007-2008 global financial crisis. The chapter also aims to distinguish how legal forms are different to other variables of recent policy interest, such as structural or functional separation of certain activities, chartering or regulatory licensing and banks' business models.

Chapter Two

The (Banking) Firm, the Market and the Flaws: Organizational Forms and Why They Matter

SUMMARY

What are legal organizational forms and how do they relate to the economic problems experienced during the 2007-2008 global financial crisis? This chapter sets out to define the concept of legal forms as used throughout the rest of the thesis. In particular, the chapter contrasts legal forms from other distinct but related variables, such as: bank licensing, bank business models and banking structural reforms. In addition, the chapter also purports to explain how legal forms relate to the broader context of the financial crisis and some of the main items included in the ongoing agenda for revamping global financial regulation. The reform agenda for revamping the global financial framework is still unsettled. The costs and fiscal exposures of the recent economic downturn have been cumbersome. Several years past the pinnacle of the credit crunch, worldwide economic recovery is still sluggish. The negative externalities and spillovers generated by the crisis spread internationally. The slump also challenged many preconceptions regarding the regulation and supervision of financial institutions. This chapter provides a brief overview of the current state of affairs regarding global financial regulation.

KEYWORDS: Bank organizational forms, financial crisis, financial regulation.

‘To look at investor-owned firms in isolation, as the existing literature has largely done, is often misleading. We learn much more about them by comparing them with other forms of enterprise’.

Henry Hansmann, *The Ownership of Enterprise* (1996).

1. INTRODUCTION

The economic meltdown that resulted from the 2007-2009 financial crisis has been socially costly on a global dimension. The crisis has taken a toll on growth and financial stability in many jurisdictions.[42] The economic slump also spread to the public coffers of some countries.[43] The results have been pervasive sovereign debt difficulties and delays in the implementation of the necessary reforms, all of which have dampened worldwide economic recovery.[44]

This chapter purports to provide a general overview of what commercial bank organizational forms are and how they relate to other concepts, such as bank chartering, business models and banking structural reforms. Moreover, the chapter also purports to discuss how organizational forms fit within the wider framework for revamping global financial regulation in the aftermath of the 2007-2008 financial crisis.

The rest of the chapter is comprised of three additional sections. The second section describes some of the most salient economic problems experienced during the 2007-08 financial crisis. Tackling these problems is a major part of the ongoing financial

[42] International Monetary Fund (IMF), ‘World Economic Outlook Report’ (October 2013). <http://www.imf.org/external/pubs/ft/weo/2013/02/pdf/text.pdf> accessed 6 December 2016.

[43] Marco Committeri and Francesco Spadafora, ‘You Never Give Me Your Money? Sovereign Debt Crises, Collective Action Problems, and IMF Lending’ (2013) IMF Working Paper WP/13/20, 35.

[44] See International Monetary Fund (IMF), ‘Global Financial Stability Report Restoring Confidence and Progressing on Reforms’ (October 2012) 75, 108.

regulatory reforms. The third section discusses what organizational forms are and describes how they are different to other concepts, like business models, functional separation and bank chartering. A final section concludes.

2. THE FINANCIAL CRISIS AND REGULATORY REFORMS

The current overhaul of the international architecture of financial regulation consists of a series of reforms promoted by a group of influential jurisdictions and standard setting bodies. These reforms aim to address the identified root economic problems highlighted by the latest crisis. Although there is growing consensus regarding some topics within the response agenda, its implementation is unconcluded. This has been attributed, amongst other things, to a 'lack of agreement on specific issues, where a coherent global consensus has yet to emerge and the pull of national interests remains strong'.[45]

2.1. Revamping Global Finance

The economic crisis exposed many of the fragilities of the international monetary and financial system. Financial market integration and cross border interconnection have accentuated the need to preserve so-called 'global public goods', such as the worldwide payments system, economic growth and financial stability.[46] The transnational nature of these global public goods comes from the fact that their enjoyment and upholding is no longer confined within national borders.

As Charles Goodhart and Rosa Lastra point out:

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[45] David Lipton, 'Speech on Financial Sector Regulatory Reform' (2013) Chartered Financial Analyst (CFA) Society of Washington Annual Dinner, Hall of the Americas Ballroom, Organization of American States, Washington <http://www.imf.org/external/np/speeches/2013/031213.htm> accessed 6 December 2016.

[46] Joel P Trachtman, 'The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation' (2010) 13 Journal of International Economic Law 719, 721. See also Martin Wolf, 'The World's Hunger for Public Goods' *Financial Times* (24 January 2012) <http://www.ft.com/intl/cms/s/0/517e31c8-45bd-11e1-93f1-00144feabdc0.html#axzz2XbooyGiL> accessed 6 December 2016.

> [t]he cross-border expansion of banks (via mergers and acquisitions, joint ventures or the establishment of branches and subsidiaries) and the effective supervision of institutions operating in various jurisdictions present numerous challenges for financial regulators and supervisors.[47]

Financial instability in any jurisdiction can – and has proven to – quickly spillover into other countries through the contagion transmission conduits.[48]

As a result of the internationalization of banking activities, financial regulation and supervision have become a transnational concern. As with other public goods, coordination problems arise. The development of universal financial rules has been called a 'slow and patchy phenomenon' afflicted by*:* '(1) the lack of a clear legal mandate; (2) a reactive rather than a proactive character; and (3) the vested interests national governments still have in the supervision of their financial sectors'.[49] The resulting institutional an legal arrangements for international financial regulation are characterized by three aspects: (1) high levels of interconnectedness of financial systems, (2) soft law rules, principles and standards, which are (3) developed by a small group of countries through transnational organizations and forums that are responsible for setting the agenda of financial regulatory trends. Thus, it is important to introduce some of the main actors involved in the design and implementation of global financial regulation.

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[47] Charles Goodhart and Rosa M Lastra, 'Border Problems' (2010) 13 Journal of International Economic Law 3.

[48] Rolf Weber considers that: '[t]he channels of contagion – whether on the domestic, regional or global level– are multifaceted, with the interbank market, payment and settlement systems and capital markets being the most obvious'. See Rolf Weber, 'Multi-layered Governance in International Financial Regulation and Supervision' (2010) 13 Journal of International Economic Law 683.

[49] Rosa M Lastra, 'Principles of Financial Regulation' in *Liber Amicorum for Gaspar Ariño Ortiz – Derecho Administrativo y Regulación Económica* (Wolturs Kluwer España 2011).

2.2. Banking Regulation Trendsetters

The ongoing financial reform process is being led by a group of supervisory institutions from a few developed countries, which interact through agenda-setting forums and organizations. These jurisdictions include the home countries and regions that host the most important and vibrant global financial markets and participants. Namely: the Group of Twenty ('G20') countries, led by the United States ('USA'), the United Kingdom ('UK') and the leading jurisdictions that constitute the European Union ('EU').

The USA, the UK and the EU are in the process of implementing their influential domestic institutional and legal reform proposals. The USA undertook widespread statutory reforms through its Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the 'Dodd-Frank Act 2010' or 'DFA'). The UK set up the Independent Commission on Banking ('ICB' or 'Vickers Commission'), chaired by renowned economist John Vickers. The ICB was commissioned to resolve the so-called 'British dilemma of banking' consisting of how to maintain the UK as a competitive financial center without recurring to taxpayer fuelled bank bailouts in the future. The ICB issued its report in 2012, recommending amongst many other things to ring-fence the core activities of British commercial banks in order to segregate deposit taking from riskier trading activities.[50]

As a response to the domestic initiatives undertaken by the USA and the UK, the European Commission set-up its own High Level Expert Group on Reforming the Structure of the EU's banking sector. The team was dubbed the 'Liikanen Group' because the Governor of the Bank of Finland, Erkki Liikanen, chaired it. The Liikanen Group's Report was presented in October 2012 and contained noteworthy proposals for reforms, in order to tackle the current challenges that affect financial activities in the aftermath of the crisis.[51]

[50] Independent Commission on Banking (ICB), 'Final Report' (September 2012).
[51] High-level Expert Group on Reforming the Structure of the EU Banking Sector, 'Final Report' ('Liikanen Report') (October 2012) <http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf> accessed 6 December 2016.

The aforementioned economic powerhouses also lead in the worldwide financial reform process through some established forums and standard-setting bodies. The key standard setting bodies for commercial banking are the Basel Committee on Banking Supervision (hereinafter, 'BCBS' or the 'Basel Committee'), and the Financial Stability Board ('FSB'). The IMF and the Bank for International Settlements (BIS) also play important roles as full-fledged international organizations, often working alongside the FSB and the BCBS in financial policy design and discussions.

The FSB is one of the most recent and lesser-known financial forums.[52] It is the successor of the G-7's Financial Stability Forum that was created in order to provide a regulatory response to the Latin American, Asian and Russian financial crises of the 1990s. [53] The FSB is currently backed by the G20, while the BIS in Basel, serves as it secretariat. The FSB was established to: 'coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability'.[54] Its main purpose is to promote international financial stability.[55]

One of the distinctive features of the FSB as a multilateral standard setting forum is that its membership includes both domestic monetary and supervisory institutions as well as other international financial organizations – including other standard setting bodies, like the BCBS. Other notable FSB members include: the IMF, The World Bank, the European

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[52] Lawrence Schembri, 'Born of Necessity and Built to Succeed: Why Canada and the World Need the Financial Stability Board'. Remarks by Lawrence Schembri, Deputy Governor of the Bank of Canada, CFA Society (Ottawa), Ottawa, Ontario (24 September 2013).
[53] ibid.
[54] Financial Stability Board <http://www.financialstabilityboard.org/about/overview.htm> accessed on 6 December 2016.
[55] FSB's Articles of Association art 2. See Financial Stability Board (FSB), 'Articles of Association of the Financial Stability Board' (28 January 2013) <http://www.financialstabilityboard.org/publications/r_130128aoa.pdf> accessed 6 December 2016.

Central Bank (ECB), the BIS, the OECD, amongst many other international organizations.

The decisions of the FSB are taken by consensus. [56] The Plenary is the highest decision making body. According to the FSB Charter, seat assignments within the Plenary reflect 'the size of the national economy, financial market activity and national financial stability arrangements of the corresponding Member jurisdiction'.[57]

On the other hand, the BCBS[58] defines itself as: 'the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters'. [59] The BCBS is headquartered in Basel. The BIS serves as its secretariat. Its mandate is to: 'strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability'.[60] The Basel Committee does not enjoy a legal personality of its own. Its decisions lack binding authority, and according to its constitutive Charter, it 'relies on its members' commitments' in order to achieve its mandate.[61]

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[56] FSB Charter art 9. See Financial Stability Board (FSB), 'Charter of the Financial Stability Board' (June 2012) <http://www.fsb.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf> accessed 6 December 2016.

[57] ibid art 11.

[58] Professor Charles Goodhart provides a detailed account on the history and development of the BCBS, since its inception as one of the permanent committees established by the central banks of the G10. See Charles Goodhart, *The Basel Committee on Banking Supervision A History of the Early Years: 1974–1997* (Cambridge University Press 2011). For an official account by the BSBC, see Basel Committee on Banking Supervision, 'A Brief History of the Basel Committee' (July 2013) <http://www.bis.org/bcbs/history.pdf> accessed 6 December 2016.

[59] Charter of the BCBS art 1. See Basel Committee on Banking Supervision (BCBS) 'Charter of the Basel Committee on Banking Supervision' (January 2013) <http://www.bis.org/bcbs/charter.pdf > accessed 6 December 2016.

[60] ibid art 1.

[61] ibid art 3, s 5.

The Basel Committee is better known than the FSB. This may be as a result of the media exposure that the Basel Committee gets. Since 1988, the Basel Committee develops and updates its 'Basel Principles on Banking Supervision'.[62]

The BCBS's current membership comprises bank supervisors and central banks from 27 jurisdictions. The main criterion for accession to BCBS membership is: 'the importance of national banking sectors to international financial stability'.[63] Like the FSB, decisions within the Committee are taken by consensus among its members. The BCBS's constitutive Charter establishes various structures in order to consult and collaborate with the regulators and the central banks of non-member countries. Some of the important consultation structures within the BCBS are: the Basel Consultative Group (BCG), the Financial Stability Institute (FSI) and the International Conferences of Banking Supervisors (ICBS).

2.3. Sources of Market Failure Underpinning the 2007-08 Financial Crisis

In turn, some of the market failures that were exposed during the latest global crisis are described. These issues relate to the main items that makeup the ongoing response agenda. Rosa Lastra and Geoffrey Wood have divided the possible causes of the financial crisis described in the literature into ten non-exclusive categories:

> (a) macro-economic imbalances; (b) lax monetary policy; (c) regulatory and supervisory failures; (d) too-big-to-fail ('TBTF') doctrine and distorted incentives; (e) excesses of securitization; (f) unregulated firms, lightly regulated firms, and the shadow banking system; (g) corporate governance failures; (h) risk-management failures, excessive leverage, and excessive complexity; (i) the

[62] See Basel Committee on Banking Supervision (BCBS), 'Core Principles for Effective Banking Supervision' (September 2012) <https://www.bis.org/publ/bcbs230.pdf> accessed 6 December 2016.
[63] BIS Charter art 4.

usual suspects: greed, euphoria, and others; and (j) faulty economic theories.[64]

The following subsection further narrows down the focus of attention, concentrating on the following economic problems: (i) moral hazard and other information problems, (ii) global public goods, and (iii) negative externalities.

2.3.1. Moral Hazard: Too-big-to-fail and Systemically Important Banks

For some years before the 2007-08 financial crisis, bank supervisors and regulators were well aware of the existence of banks considered too-big-to-fail (or 'TBTF').[65] Banks became TBTF because of the general perception that their failure or financial troubles could provoke significant economic disruptions for a country. These considerations were mostly due to the size, overall interconnectedness or financial importance of TBTF banks. Because of the assumption that governments would bail them out in case of failure, TBTF banks could engage in excessive risk-taking and careless lending at the taxpayers' expense. Thus, TBTF banks were wrought with moral hazard.[66] The prospect of an expected governmental rescue ultimately meant that bank supervisors were tacitly underwriting their risky activities. This risk was underpriced.

When the crisis unraveled, new magnitudes and related dimensions of TBTF surfaced. There were some large, complex financial institutions that could not be orderly wound-

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[64] Rosa M Lastra and Geoffrey Wood, 'The Crisis of 2007-09: Nature, Causes and Reactions' (2010) 13 Journal of International Economic Law 531, 537-538.

[65] The US Financial Crisis Inquiry Commission's (FCIC) Final Report credits the phrase to then US Representative Stewart McKinney of the State of Connecticut. During a hearing related to the proposed bailout of the distressed bank Continental Illinois (circa 1984), Mr. McKinney responded: 'We have a new kind of bank. It is called "too-big-to-fail"– TBTF – and it is a wonderful bank'. See US Financial Crisis Inquiry Commission's (FCIC), 'The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States' (January 2011) <http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf> accessed 6 December 2016.

[66] Gary Gorton considers that: '[t]he problem of moral hazard arises in several ways, when there is an implicit promise of insurance (…), and when there is the expectation that the government will act'. Gary B Gorton, *Misunderstanding Financial Crises: Why We Don't See them Coming* (OUP 2012).

down ('too complex to resolve'). Other institutions were 'too complex' or 'too interconnected' to fail or to prosecute. In addition, many countries found that the combined assets of some of the banks operating under their jurisdiction surpassed their national GDPs. This made any bailout prospect prohibitively expensive, or even unaffordable, giving rise to the 'too-big-to-save' ('TBTS') related problematic. By growing too big, TBTF banks exposed that some treasuries had become too frail.

The bankruptcy of investment bank Lehman Brothers on 15 September 2008 had adverse economic consequences. When Lehman Brothers filed for bankruptcy, the Dow Jones industrial average fell 504.48 points.[67] T. Hoshi recounts that an important money market fund also announced that it would not be able to redeem its securities at par value.[68] These ill-fated occurrences prompted US regulators to rescue international insurer AIG. A few months before, the US authorities had also provided liquidity assistance and had orchestrated a convoy rescue for Bear Stearns, another investment bank.[69] These events revealed that commercial banks were not the only entities that had become systemically important. The moral hazard of implicit governmental guarantees had spread to non-bank market participants, like insurance companies and securities dealers.[70]

Even though it was not a deposit-taking institution, the Lehman Brothers bankruptcy became one of the largest in US History.[71] The proceedings exposed that some of these TBTF non-banking institutions had also become cross-border, highly interconnected and complex to wind-down. This gave way to a new set of problems: the rise of Large and Complex Financial Institutions ('LCFI'), also known as Systemically Important Financial

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[67] Alex Berenson, 'Wall St.'s Turmoil Sends Stocks Reeling' *New York Times* (New York City, 15 September 2008) < http://www.nytimes.com/2008/09/16/business/worldbusiness/16markets.html?_r=0> accessed 6 December 2016.
[68] T Hoshi, 'Financial Regulation: Lessons from the Recent Financial Crises' (2011) 49 Journal of Economic Literature 120.
[69] JPMorgan subsequently purchased Bear Stearns.
[70] Rosa M Lastra, 'Systemic Risk, SIFIs and Financial Stability' (2011) 6 Capital Markets Law Journal 197, 199.
[71] See Sam Mamudi, 'Lehman Folds with Record 613 Billion Debt' *Wall Street Journal* (New York, 15 September 2008) <http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss> accessed 6 December 2016.

Institutions ('SIFIs') or whenever strictly referring to banks: Systemically Important Banks ('SIBs').

International standard setting bodies set out to tackle the moral hazard and TBTF/TBTS problems that can affect large financial institutions. The FSB defined SIFIs as 'financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity'.[72] When SIFIs pose a threat to worldwide financial stability and economic activity, they are referred to as global or 'G-SIFIs'. The FSB disclosed an initial list of 29 G-SIFIs. On July 2013, the FSB also published a list of Global Systemically Important Insurers ('G-SIIs').[73] Since then the lists are updated on a yearly basis. Table 1 presents the most recent list of G-SIBs (at the time of writing).

Other standard setting bodies have also taken steps directed at addressing the threats posed by SIFIs. The BCBS, which is a standard setting body mainly concerned with commercial banks, issued its framework for dealing with global systemically important banks ('G-SIBs'). G-SIBs are essentially commercial banks of systemic dimensions.[74] In order to deal with the threats that domestic systemically important banks pose to some jurisdictions, the BCBS issued its 'Framework for Dealing with Domestic Systemically Important Banks ('D-SIBs').[75] The FSB also published a complementary report with the aim of extending the G-SIFI framework to domestic SIBs.[76]

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[72] See Financial Stability Board (FSB), 'Policy Measures to Address Systemically Important Financial Institutions' (4 November 2011) <http://www.financialstabilityboard.org/publications/r_111104bb.pdf> accessed 6 December 2016.

[73] Financial Stability Board (FSB), 'Global systemically important insurers (G-SIIs) and the policy measures that will apply to them' (18 July 2013) <http://www.financialstabilityboard.org/publications/r_130718.pdf> accessed 6 December 2016.

[74] Because SIFIs can also included non-bank financial entities.

[75] Basel Committee on Banking Supervision, 'A Framework for Dealing With Systemically Important Banks' (11 October 2012) <http://www.bis.org/publ/bcbs233.htm> accessed 6 December 2016

[76] Financial Stability Board (FSB), 'G-SIFI Framework to Domestic Systemically Important Banks: Progress Report to G-20 Ministers and Governors' (16 April 2012) <http://www.financialstabilityboard.org/publications/r_120420b.pdf> accessed 6 December 2016.

Table 1
2016 List of Global Systemically Important Banks

Agricultural Bank of China	BNP Paribas	Goldman Sachs	Mitsubishi UFJ FG	Société Générale
Bank of America	Industrial and Commercial Bank of China Limited	Group Crédit Agricole	Mizuho FG	State Street
Bank of China	Citigroup	HSBC	Morgan Stanley	Sumitomo Mitsui FG
Bank of New York Mellon	Standard Chartered	ING Bank	Nordea	UBS
Barclays	Credit Suisse	JP Morgan Chase	Royal Bank of Scotland	Unicredit Group
China Construction Bank	Group BPCE	Deutsche Bank	Santander	Wells Fargo

(Source: FSB)

The FSB's multipronged approach to the threats that G-SIFIs pose to international financial instability include:

> (i) a methodology for assessing the global systemic importance of banks based on five broad sets of indicators (size, interconnectedness, lack of substitutes, cross-jurisdictional activity and complexity); (ii) additional loss absorbency capacity for banks that is in line with the degree of global systemic importance; (iii) a new international standard for resolution regimes and additional measures to improve the authorities' capacity to resolve SIFIs; and (iv) measures for more intensive and effective supervision.[77]

2.3.2. Global Public Goods: Financial Stability and International Payment Systems

Many commentators and policy reports conclude that one of the main lessons from the recent crisis was a change in the understanding of systemic risk and its effect on financial stability.[78] The IMF defines systemic risk as 'the risk of disruptions to the provision of financial services that is caused by an impairment of all or parts of the financial system, and can cause serious negative consequences for the real economy'.[79] Systemic risk can be a significant source of financial instability. Systemic risk has been categorized into two dimensions: a cross-sectional dimension, which is a snapshot of the existing

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[77] Financial Stability Board (FSB), International Monetary Fund (IMF) and Bank for International Settlements (BIS), 'Macroprudential Policy Tools and Frameworks: Progress Report to G20' (27 October 2011) 13.

[78] Gabriele Galati and Richhild Moessner, 'Macroprudential Policy – A Literature Review' Bank for International Settlements (BIS) Working Papers n 337 (February 2011). See also International Monetary Fund (IMF), 'Key Aspects of Macroprudential Policy' (10 June 2013) <http://www.imf.org/external/np/pp/eng/2013/061013b.pdf> accessed 6 December 2016.

[79] IMF, 'Key Aspects of Macroprudential Policy' (n 78) 6.

vulnerabilities in any given point in time; and a time dimension, which refers to how systemic risk changes with the economic cycle.[80]

The recent experience with systemically important banks spawned developments in the way that financial supervisors understand and confront systemic risk. The main shift was towards a 'stronger emphasis on mitigating risks in the financial system as a whole'[81] instead of focusing on the safety and soundness of individual institutions. This approach has been labeled *macroprudential* supervision.

Before the onslaught of the financial crisis, the main emphasis of financial regulation and supervision was largely focused on: (i) prudential regulation and (ii) conduct of business rules. These sets of rules focused on consumer protection and the safety, soundness and practices of individual institutions (or a consolidated financial group). The (micro) prudential approach proved to misguided. The logic behind this was the so-called 'fallacy of composition': if individual institutions were sound, the aggregate financial system would be robust and stable.[82] By concentrating excessively on individual entities supervisors lost track of a broader perspective that included non-bank SIFIs, the shadow-banking sector and the cross-border aspects of systemic risk.

This experience shifted the systemic risk management paradigm towards macroprudential supervision. It can be quite difficult to precisely define what constitutes macroprudential supervision. This can be due to the fact that (at the time of writing) the concept is still being developed. Moreover, most of the tools that have been identified as part of the emerging macroprudential toolkit have long been associated with other areas of economic

[80] FSB, IMF and BIS, 'Macroprudential Policy Tools and Frameworks: Progress Report to G20' (n 77) 6.

[81] Bank of England, 'Instruments of Macroprudential Policy: A discussion Paper' (December 2011) 5.

[82] Osinki et al. define the fallacy of composition as: 'the concept that the whole is not the simple sum of its parts and therefore what is true for an individual bank will hold true for the banking and financial system as a whole. The outcome is that micro reasoning may lead to wrong conclusions at the macro level, even while that reasoning appears suitable for objectives at the micro level'. See Jacek Osiński, Katharine Seal, and Lex Hoogduin, 'Macroprudential and Microprudential Policies: Toward Cohabitation' IMF Monetary and Capital Markets Department (21 June 2013) 6.

policy, such as monetary, competition, fiscal policies and traditional prudential supervision.[83] According to some commentators, in spite of the macroprudential concept being a recent trend, monetary and supervisory authorities had long been using many of its tools.[84]

Macroprudential policy aims to tackle systemic risks. Its main objective is the preservation of financial stability, which is considered a global public good. The European Systemic Risk Board ('ESRB') states that: '[t]he ultimate objective of macro-prudential policy is to contribute to the safeguard of the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth'.[85]

Hanson et al. distinguish between microprudential and macroprudential supervision. They argue that while the former aims to make banks internalize losses on their assets in order to protect insured depositors and mitigate moral hazard, macroprudential supervision focuses on controlling the social cost of an aggregate reduction in asset prices in a financial system.[86]

In order to provide some additional clarity regarding the concept, Rosa Lastra has described the differences between microprudential and macroprudential supervision using the analogy of a forest and its trees.[87] A systemic-wide or macroprudential approach focuses on the whole forest, instead of the safety and soundness of individual trees. Paradoxically, the regulations and guidelines that the main regulatory trend-setters have developed for G-SIFIs and D-SIBs reveal that in some ways macroprudential supervision

[83] IMF, 'Key Aspects of Macroprudential Policy' (n 78) 8.
[84] Douglas Elliott et al., 'The History of Cyclical Macroprudential Policy in the United States' (2013) Finance and Economics Discussion Series – Federal Reserve Board WP 2013-29, 3.
[85] European Systemic Risk Board (ESRB), Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1) (2013/C170/01).
[86] Samuel G Hanson, Anil K Kashyap, and Jeremy C Stein, 'A Macroprudential Approach to Financial Regulation' (2011) 25 Journal of Economic Perspectives 3, 4-6.
[87] Lastra, 'Systemic Risk, SIFIs and Financial Stability' (n 70) 198.

can be construed as more intensive prudential supervision for domestic and globally important financial behemoths. This paradox is consistent with (one of) the IMF's definition(s) of macroprudential policy as: 'the use of primarily prudential tools to limit systemic risk'.[88]

Another important aspect of the macroprudential approach is the need for regulators to mind the so-called shadow-banking sector. The FSB has defined the 'shadow banking' or 'market-based' financing system as: 'credit intermediation involving entities and activities (fully or partially) outside the regular banking system or non-bank credit intermediation in short'.[89] In other words, market participants and transactions that fall outside of the traditional regulatory radar and achieved systemic importance.

The ongoing turn towards macroprudential supervision has also prompted changes in the domestic and international institutional arrangements for the preservation of financial stability. Foremost, the FSB has emerged as the main international agenda setting forum for the preservation of global financial stability. In addition to this, the IMF and other influential forums, have called on jurisdictions to adopt the necessary institutional and normative framework required in order to implement macroprudential supervision.

Many countries and regions have already taken important steps towards the configuration of their macroprudential supervisors. In the USA, the Dodd Frank Act 2010 created the Financial Stability Oversight Council (FSOC). The FSOC has the threefold mandate of: (i) systemic risk identification, (ii) promotion of market discipline geared at combating moral hazard; and (iii) responding against threats of financial instability.[90]

In the UK, the Financial Policy Committee (FCO) was created at the Bank of England ('BOE'), with the objective of performing systemic-wide supervision. In the EU, The

[88] IMF, 'Key aspects of Macroprudential Policy' (n 78) 6.

[89] See Financial Stability Board (FSB), 'Strengthening Oversight and Regulation of Shadow Banking Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities' (29 August 2013) <http://www.financialstabilityboard.org/publications/r_130829c.pdf> accessed 6 December 2016.

[90] Dodd Frank Act s 112.

European Systemic Risk Board ('ESRB') was created upon the recommendations of the High-Level Group on Financial Supervision in the EU (the 'De Larosière group').[91] Other countries like: Chile, Mexico[92], Brazil, South Africa, Korea and New Zealand[93] have also instituted their macroprudential supervisors.

2.3.3. Negative Externalities

As already was discussed in the introduction to this chapter, financial crises can be costly. The potential negative externalities of bank failure can spillover to other sectors of the economy – and also across jurisdictions. The latest financial crisis also proved to be particularly cumbersome for some taxpayers across the globe. The International Monetary Fund ('IMF') considers that while some of these costs are not completely sunk—and could even turnout to be modest— the fiscal exposures experienced during the height of the crisis were towering.[94] According to the IMF's estimates, the countries that were worst affected by the downturn lost between 4-6% of their GDP.[95] On average, countries committed up to 25% of their GDPs on the provision of governmental guarantees, pledges and other forms of State aid.[96] These costs and potential liabilities spurred the need to overhaul financial regulation in order to prevent future crises that could turn out to be fiscally cumbersome, or even prohibitively expensive for taxpayers.[97]

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[91] The High-level Group on Financial Supervision in the EU (de Larosière Group). 'Final Report' (2009).

[92] Rosa Lastra and Enmanuel Cedeno-Brea, 'Latin American Financial Reforms' (2013) working paper presented at the 92nd MOCOMILA – Committee on International Monetary Law of the International Law Association.

[93] IMF, 'Key Aspects of Macroprudential Policy' (n 78) 46.

[94] International Monetary Fund (IMF), 'A Fair and Substantial Contribution by the Financial Sector – Final Report for the G-20' (June 2010) 4.

[95] ibid 4.

[96] ibid 4.

[97] Some scholars like Prof. Charles Goodhart argue that bailouts need not always be costly to taxpayers, pointing out as an example the case of the US financial rescues through the Troubled Asset Relief Program (TARP). Prof. Goodhart calls this assumption a 'mantra' and considers that: '(…) when the dust settles, the authorities will generally find that they have made a nominal profit from exercises like TARP and injecting equity into RBS and Lloyds (…)'. Nonetheless, he does recognize that the exposure of large, complex financial institutions can be costly to society. See Charles Goodhart, 'The Squam Lake Report: Commentary' (2011) 49 Journal of Economic Literature 114, 119. See also Emilios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-ins' (2015) 1 Journal of Financial Regulation 3, fn 1.

Orderly bank resolution frameworks are essential in order to address the cross-border systemic risks that large systemically important banks pose to financial stability.[98] Special Resolution Regimes ('SRR') are exclusive bankruptcy proceedings for commercial banks and other SIFIs.[99] Regular insolvency rules have traditionally been considered inadequate to address some of the structural features involved in the failure of financial institutions.[100] In addition, many other insolvency practices used for banks, such as 'convoy rescues' and asset fire sales, have proven to be defective for minimizing the costs of bank failure.

Another important limitation of traditional insolvency regimes is that they are nationally based and tend to have a functional focus, centered on individual entities.[101] Consequently the developments of SRRs are an important challenge in order to mitigate the moral hazard that SIFIs pose across borders.[102] In addition, every State should have SRRs in place in their own jurisdiction in order to be able to effectively deal with bank failures.

3. WHAT ARE ORGANIZATIONAL FORMS?

The law provides for many ways to organize a firm. Legal or organizational forms refer to the different ways that economic agents can arrange their enterprises.[103] Organizational forms are often studied under the label of the 'law of business associations'. However, organizational law governs and regulates both for profit and nonprofit – as well as

[98] Edward Greene et al., 'A Closer Look at "Too Big to Fail": National and International Approaches to Addressing the Risks of Large, Interconnected Financial Institutions' (2010) 5 Capital Market Law Journal 117, 131.
[99] See Jonathan Edwards, 'A Model Law Framework for the Resolution of G-SIFIs' (2012) 7 Capital Markets Law Journal 122.
[100] Lastra, 'Systemic Risk, SIFIs and Financial Stability' (n 70) 212.
[101] Eva Hüpkes, '"Form Follows Function" – A New Architecture for Regulating and Resolving Global Financial Institutions' (2009) 10 European Business Organization Law Review 369, 371.
[102] Lastra and Wood (n 64) 549.
[103] See Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 3-7; Andreas Cahn and David C Donald, *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany*, the UK and the USA (CUP 2010) 24.

incorporated and unincorporated – legal vehicles used for setting up economic activities and arranging property rights and contracts.

Firms are formally established according to statutory or legal provisions that grant organizational forms their own distinctive features. Private (or close) and public business corporations, general and limited partnerships, community interest companies, trusts and mutual societies, charities and non-profit associations – even condominiums – are all contemporary examples of legal forms governed by different organizational laws.

From an economic perspective firms have been characterized as production functions, 'black boxes' or bundles of contracts.[104] These frameworks have provided the foundation for very powerful and valuable economic insights. On the other hand, the *legal* configuration of firms has not always been fully appreciated in policy debates. This can also be true for banks, which are often assumed to be (public or private) corporations owned by shareholders, disregarding the fact that historically – and even today – many banks are not legally organized under the corporate form.

Thus, company law is merely a subset of the much larger set of rules comprised by organizational law. Other laws and statutes that govern the organization of economic and social enterprise include, the law of co-operative and mutual societies, non-profit organizations, partnerships and even marriage. Different organizational laws establish what the specific attributes of legal forms are, how they are formed and governed, who are their main stakeholders and ultimate risk-bearers, as well as other aspects such as their taxation, insolvency and competition rules.[105]

[104] See generally Randall Kroszner and Louis Putterman, *The Economic Nature of the Firm: A Reader* (3rd edn, CUP 2009).

[105] For a discussion from the perspective of co-operative law, see Antonio Fici, 'An Introduction to Cooperative Law' in Dante Cracogna et al. (eds) *International Handbook of Cooperative Law* (Springer 2013) 9.

The next subsections aim to draw a distinction between bank legal forms and other related concepts, such as bank chartering, structural banking reforms and business models.

3.1. Organizational Forms and Bank Chartering

'Universal bank', 'commercial bank', 'savings bank', '*Sparkasse*', 'building society', *cassa di risparmio* are only a few of the labels that have become familiar to consumers of financial services worldwide. These regulatory denominations are different from organizational forms and they serve various important objectives. They generally signal public authorization to conduct financial intermediation. That is to take deposits from the general public and on-lend the funds to third parties. In many jurisdictions, they also inform the general public about the type of services that clients can expect to receive from different types of firms (eg opening current and savings account, cashing checks, obtaining loans, buying securities, purchasing insurance or a foreign currency, etc.).

Other similar signals – like the Federal Deposit Insurance Corporation's (FDIC) official teller signage in the USA – serve to make customers aware of the existence of certain levels of depositor insurance protection. However, these bank denominations are mostly functional. They are connected to the activities that different types of financial entities are authorized to carry-on.

In turn, financial entities are also legally organized or incorporated.[106] Incorporation is different to chartering. While a banking license allows a firm to conduct certain financial activities in a particular jurisdiction, incorporation entails other legal consequences, such as having a legal personality and being able to own property.

There is often a subtle difference between the functional banking license type and the legal form that an institution adopts. Legal forms carry other suffixes and labels that are

[106] The term 'incorporation' as used here refers to the personhood of all types of organizational forms – not just corporations.

also familiar to the general public, such as: '*società per azioni*', 'plc.', 'ltd.', '*cooperativa por acciones*'. Some legal forms can be flexible vehicles for setting up a wide array of business types. For example, a corporation can be used for setting up a co-operative. Notwithstanding, certain organizational forms are strictly associated with specific bank forms (ie building societies with mutual societies).[107] In the economic sense, organizational forms often underline the ownership configuration of firms.

While primarily, the organizational form of a bank is established before the firm is allowed to provide services to the public[108], it is bound to remain relevant throughout the regulatory and supervisory lifecycle. Banking *regulation* and *supervision* are two different concepts. R. M. Lastra distinguishes between banking regulation and supervision (*lato sensu*) by stating that the former refers to rulemaking, while the later is a process comprised of four stages: (a) licensing or chartering (market entry), (b) supervision (*stricto sensu*), (c) sanctioning and enforcement and (d) crisis management (which includes deposit protection insurance schemes, lender of last resort and bank resolution).[109] Thus, regulation is a continuous rulemaking process throughout a bank's business cycle. On the other hand, supervision (in the broad sense) comprises a four-stage process that starts and ends with market entry and exit respectively.

Legal form is not only important for bank licensing or authorization (market entry), but is also bound to be relevant during the complete lifecycle of a bank as a going concern. For example, most jurisdictions allow firms, including banks, to change their legal form. This means that organizational forms are not set in stone. In addition, legal form can be

[107] Further examples are presented in the next chapter, like the requirement that banks in Spain and Italy (other than co-operatives) be organized under the corporate form. In the Dominican Republic, for example, Multiple Services Banks (*bancos múltiples*) and Credit Entities (*entididades de crédito*) are also required to adopt the corporate form (*sociedad anónima* – previously called *compañía por acciones*), according to art 38 of the Dominican Monetary and Financial Law n 183-02.
[108] It is possible for a bank to change its organizational form once it has been licensed. For example, when a mutual bank transforms into a corporate bank (demutualization). These operations are typically subject to supervisory approval.
[109] Lastra, *International Financial and Monetary Law* (n 17) 112-123. See also Rosa Lastra, *Central Banking and Banking Regulation* (FMG London School of Economics 1996) 108-144.

especially important during crisis management or in the vicinity of insolvency, given that banks typically face special resolution regimes.[110]

3.2. Organizational Forms and Functional Segregation

An analysis of the relation between legal forms and financial regulation evokes some of the recent banking structural reforms undertaken in major jurisdictions, including the USA, the UK, the EU, Germany and France. However, they are somewhat related but different. Organizational forms refer to the way that banks are legally organized and not to the activities that they can and cannot perform.

The label of banking structural reforms, such as the 'Volcker rule' or 'Vickers type ring-fencing'[111], has been increasingly used when referring to a wide array of reforms aimed at separating some banking activities regarded as being riskier (eg dealing in certain kinds of securities) from others considered as being essential or critical – like deposit-taking, payments clearing and settlement, and lending to small and medium enterprises. The functional segregation of banking activities is not new. One notable example is the historical separation between commercial and investment banking that occurred in the USA in the aftermath of the New Deal and the Glass-Steagall Act 1934. However, the functional separation of activities seems to have regained consideration after the onslaught of the 2007-2008 financial crisis.

While some banking structural reforms – like UK type ring-fencing – take some aspects of legal organization slightly into account, others do not. For example, the so-called 'Volcker rule' in the USA merely restricts banks from engaging in proprietary trading or investing in hedge funds or private equity funds. The Volcker rule does not delve into deeper issues regarding how banks are legally organized, or whether they should ideally be corporations or non-corporate entities.

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[110] The relationship between legal forms and bank resolution is discussed with greater detail in chapter 6.

[111] Banking structural reforms are discussed with greater detail in chapter 6.

In the particular case of UK type ring-fencing, the proposed rules implemented so far simply state that for banks with deposits in excess of GBP 25 billion, deposit-taking activities should be apportioned into separate legal entities. However, no distinction is made regarding which types of legal forms should be used for organizing ring-fenced bodies. In other words, the rules do not prescribe whether ring-fenced bodies should be organized as corporations, co-operatives or nonprofit entities. One of the main arguments presented in this book is that such a discussion matters for the design of financial regulation.

3.3. Legal Forms and Business Models

Legal forms are also slightly different – but strongly related to banks' business models. According to Bülbül, Schmidt and Schüwer: 'banks' business models and their institutional features are interdependent and complementary to each other'.[112]

Organizational forms refer to how banks are legally set-up. On the other hand, business models refer to the financial structure and the activities that banks do.[113] This includes how they fund their activities (capital structure), and in what types of assets they invest their own and borrowed funds (securities and other derivatives, mortgages, consumer lending, securitization, etc.).

Business models and strategies can vary – and for some types of private banks – they are not necessarily linked to how banks are legally organized. Some banks pursue a pure 'retail strategy', other might pursue a universal banking model, while others dedicate themselves to investment banking activities.

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[112] Dilek Bülbül, Reinhard Schmidt and Ulrich Schüwer, 'Caisses D'épargne et Banques Coopératives en Europe' (2013) 111 Revue d'Economie Financière 159.

[113] See Adrian Blundell-Wignall, Paul Atkinson and Caroline Roulet, 'Bank Business Models and the Basel System: Complexity and Interconnectedness' (2013) 2 OECD Journal: Market Trends.

On the other hand, as is commonly the case with mutual and co-operative banks, and also with savings banks, there is a strong connection between their business models and legal forms. As is further discussed in chapter three, these banks are characterized by serving and transacting with their member-base and typically exhibit a regional or geographical scope of action (the so-called 'regional principle').[114]

4. CONCLUDING REMARKS

The underlying argument of this thesis is that legal forms matter for banking regulation. In other words, it states that banks are legal entities that are setup under organizational law and contracts. This legal configuration is bound to be important when devising bank regulation. Organizational law creates partitions of assets that re-arrange the patterns of property rights of different groups of bank stakeholders. Organizational law determines how legal entities are created, how they finance their activities and how they cease to exist. Thus, organizational forms are a distinctive variable that should be taken into account for the design and implementation of banking regulation.

Moreover, corporate law is insufficient to fully analyze the legal organizational aspects of banking. Many banks worldwide are not organized as corporations. Corporate law is merely a 'subset of organizational law'[115], which also includes the legal framework for arranging different types of enterprises. Organizational law comprises the legal rules that govern: (general and limited liability) partnerships, business trusts, (limited and unlimited liability) sole proprietorships, limited liability companies, nonprofit entities, charities, co-operatives and other types of mutual societies.

The next chapter describes how banks are organized in some leading jurisdictions. The chapter looks at the main economic attributes that bank legal forms have as well as their different converging stakeholders, incentives and interests.

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[114] Bülbül et al. (n 112) 159.

[115] Brian Cheffins, 'The Trajectory of (Corporate Law) Scholarship' (2004) 63 Cambridge Law Journal 456.

Chapter Three

The Legal and Ownership Structure of Commercial Banks

SUMMARY

How are commercial banks legally organized around the world? What are the main features and attributes of the predominant bank organizational forms? Do differences across bank forms matter for the design of financial regulation? This chapter analyzes the different ways that banks can be legally organized across six major jurisdictions, including: the European Union, Italy, Spain, the United States, the United Kingdom and France. The chapter finds that in these jurisdictions, banks are mainly organized as corporations, mutual and co-operative associations, and nonprofit entities. The chapter then fleshes out the salient features of the most important organizational forms used for structuring banking activities in order to functionally compare them against the foil of the business corporation. Methodologically, the study combines a functional comparative legal analysis informed by some insights from the economic analysis of law.

Keywords: Organizational forms, co-operative and mutual banks, limited liability, asset partitioning, entity shielding.

‘The process of contracting needs to be studied in a real world setting. We would then learn of the problems that are encountered and of how they are overcome and we would certainly become aware of the richness of the institutional alternatives between which we have to choose’.

Ronald Coase, ‘Nobel Prize Lecture’ (1991)[116]

1. INTRODUCTION

The 2007-09 financial crisis was associated to the bursting of real estate bubbles across several jurisdictions. In Spain, the mortgage crisis took a toll on several regional savings banks (called *cajas de ahorros*, in Spanish) that had successfully operated for over 180 years.[117] By the end of 2010, seven of these saving banks had formed a conglomerate business corporation (*sociedad anónima*) through a legal process that some commentators referred to as ‘cold fusion’.[118] The resulting entity was Bankia, at that point Spain’s biggest real estate lender.[119]

In July 2011, Bankia publicly listed its shares in the securities exchange (*Bolsa de Madrid)* and peddled them to its own customers, alongside other preference shares that it had issued.[120] Many clients exchanged their savings and pensions from deposits into Bankia’s securities. By 2012, Bankia had suffered major losses and was in need of a

[116] R H Coase, ‘The Institutional Structure of Production’ (1992) 82 American Economic Review 713.

[117] For a comprehensive account of the demise of the Spanish *cajas de ahorros* see Emili Tortosa, *Fulgor y Muerte de las Cajas de Ahorros* (Universitat de Valencia 2015); IMF, ‘The Reform of Spanish Savings Banks: Technical Note’ (May 2012) https://www.imf.org/external/pubs/ft/scr/2012/cr12141.pdf accessed 6 December 2016; Pablo Martín-Aceña, ‘The Savings Bank Crisis in Spain: When and How’ (2013) 66 ESBG Perspectives 85 < http://www.savings-banks.com/Who-we-are/History/Pages/MartinAcena.aspx> accessed 6 December 2016.

[118] Through the so-called ‘cold fusion’ several Spanish saving banks formed a new entity for sharing overhead costs while keeping their own internal structures and the legal personality of each constituting member entity.

[119] Johan A Lybeck, *The Future of Financial Regulation: Who Should Pay for the Failures of American and European Banks?* (CUP 2016) 273.

[120] These are shares that typically have an automatic right to fixed income. Unlike common stocks, which do not have this right. See Stephen M Bainbridge, *Corporate Law* (3rd edn, Foundation Press 2015) 36-37.

publicly funded bailout amounting to over EUR 22 billion.[121] Many customers who held Bankia's preferred stocks and securities lost all of their investments. Moreover, after the onslaught of the crisis that ensued, the number of Spanish savings banks diminished – from 79 entities in 1985, to only two *cajas* by the end of 2015.[122]

What led the Spanish savings banks (*cajas de ahorros*) to change their legal form? Was this organizational change part of their demise?

The legal changes undertaken by the Spanish savings banks are reminiscent of the wave of transformations that several building societies in the United Kingdom experienced from 1989 and onwards. The legal and ownership structure of building societies is legally different to that of Spanish savings banks. While the Spanish *cajas* had no residual owners, building societies are mutual organizations that are funded and jointly owned by their members.

Historically, building societies lent money to their members in order for the latter to build or purchase their houses (hence the name 'building' society). These loans were secured on residential property and were largely funded by members' deposits.[123] In 1989, the members of Abbey National Building Society decided to demutualize that entity – that is, to convert the institution from a mutual society into a public limited company (a listed corporation). In the following years, other building societies followed suit with their own

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[121] See Banco de España / FROB, 'Public financial Assistance in the Recapitalisation of the Spanish Banking System (2009-2013)' (2 September 2013) <http://www.frob.es/es/Documents/cayudas20614EN.pdf> accessed 6 December 2016.

[122] See Banco de España, 'Consulta de Datos Actuales de Entidades Registradas en el Banco de España' <http://app.bde.es/ren/app/Search?CFG=ConsultaEntidadesCon.xml&TipoFormato=XSL&Paginate=OPEN&TIPO=CA&DONDE=11&LEI=&ORDEN=2&RADIO=0> accessed 6 December 2016.

[123] Sub-s 3.2.4 explains the legal aspects of building societies with greater detail. See also Paul L Davies and Sarah Worthington, *Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 1-29.

demutualization processes.[124] Some of these former building societies, like Northern Rock and Alliance & Leicester, went on to fail during the 2007-08 financial crisis.

Meanwhile, in Switzerland, another group of banks were also undertaking transformations in early 2013. After more than two centuries of banking under the unlimited liability partnership form, Swiss private banks[125] Pictect and Lombard Odier announced their transformation into a legal structure endowed with limited liability for their managing partners and residual owners.[126] According to some commentators, the conversions were allegedly driven by the closing of Wegelin & Co. – Switzerland's oldest private bank – after being convicted for money laundering and tax evasion charges in the United States (US).[127] After 270 years Wegelin & Co. ceased to exist and its assets, operations and employees were rearranged through one if its corporate subsidiaries.

What is the underlying thread that binds theses cases together? Aside from their relation to banking, these cases share another – often-overlooked – unifying thread: the banks involved experienced important changes in the ways that they were legally organized.

Currently, the business corporation dominates as the organizational form of choice for most banks in leading jurisdictions around the world. However, this has not always been the case. Well into the 20th century, employee-owned firms (organized as partnerships) were commonplace in both the investment and the private banking industries. In previous

[124] For a summary of the historical process see Bank of England, 'Explanatory Notes - Building Societies' Balance Sheet' (December 2007) <http://www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/building_society_bs_07.aspx> accessed 6 December 2016.

[125] Private banks offer their services to an affluent clientele and were historically organized as partnerships (in some countries, unincorporated entities). Their general or managing partners were unlimitedly liable. Purportedly, this feature helped to better align the incentives between bank managers and their (often wealthy) clients.

[126] James Shotter, 'Swiss Private Banks End Partner Liability' *Financial Times* (London, 5 February 2013) <http://www.ft.com/intl/cms/s/0/436771ce-6f7b-11e2-b906-00144feab49a.html#axzz3pX64cWKl> accessed 6 December 2016.

[127] See Daniel Schafer and James Shotter, 'Lombard Odier Undergoes Transformation to Limit its Liabilities' *Financial Times* (1 May 2013) <http://www.ft.com/intl/cms/s/0/12269968-ae97-11e2-8316-00144feabdc0.html#axzz3pX64cWKl> accessed 6 December 2016.

times, other organizational forms, such as nonprofit entities, co-operatives[128] and mutual societies were prevalent providers of some consumer banking services, such as savings accounts and mortgages.[129] Nowadays, these non-joint stock banks have increasingly become less common. On the other hand, corporations seem to dominate banking.

The transition into the 21st century saw the rise of the corporation as the predominant legal vehicle for conducting business.[130] Even though many banks have migrated to the corporate form, its shortcomings have gained widespread attention in recent years. The corporation has been at the heart of heated academic and policy debates, even before the recent financial crisis. The downfall of companies such as Enron, Parmalat and WorldCom due to dubious bookkeeping practices and fraudulent activities gave rise to

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[128] Co-operatives are defined as 'democratic organizations controlled by their members, who actively participate in setting their policies and making decisions' based on the principle of one-vote-per member and as 'autonomous associations of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise'. See International Labor Organization (ILO), Recommendation Concerning Promotion of Cooperatives n 193 (2002) available online <http://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:R193> accessed 6 December 2016.

[129] Adam Smith had the opinion that business corporations (joint-stock companies) were ideally suited for the banking trade and other businesses that could be reduced to 'a routine or uniformity of method' that admitted 'little or no variation'. Alan Morrison and William Wilhelm Jr argue that the indispensability of human judgment and expertise made the partnership the organizational form of choice for investment banking until the flight towards other forms endowed with limited liability. For example, investment bank Goldman Sachs was historically referred to as 'the partnership'. See generally Alan D Morrison and William J Wilhelm Jr, *Investment Banking: Institutions, Politics, Law* (OUP 2007) 265-292. See also Charles D Ellis, *The Partnership: The Making of Goldman Sachs* (Penguin Books 2009).

[130] Sole proprietorships are still the dominant ownership structure in the US in terms of number of firms. However, corporations overpass both sole proprietorships and partnerships in receipts and net income. According to the US 2008 Census Data, while on estimate corporations accounted for only 18.49% of the total unaudited tax returns (nonfarm proprietorships were around 71.54% of all businesses and partnerships accounted for 9.95%), they were responsible for 81.28% of total business receipts and 57.66% of all net income in the US economy for that year. See U.S. Census Bureau, 'Statistical Abstract of the United States' (2012). <https://www.census.gov/compendia/statab/2012/tables/12s0744.pdf> accessed 6 December 2016.

important reforms regarding securities disclosure rules, corporate governance and accounting standards.[131]

In spite of such recent corporate reforms, the 2007-2008 financial crisis still ensued. This has led some authors to criticize not only banks – but also the current institutional standing of the modern business corporation.[132] What was at the time seen as a 'golden opportunity' for alternative lenders organized under non-corporate forms (mutual societies, co-operatives and nonprofits)[133] quickly buckled when many non-corporate banks decided to either demutualize, sell their assets to corporate banks, or simply went bankrupt.[134]

These facts lead to questions regarding the many ways that banks can be legally organized. Is the corporate form the ideal structure for organizing banks? In addition to the corporation, what other alternatives exist for organizing banking activities in leading jurisdictions? Were there any differences between the incentive structures of the Spanish savings banks (*cajas de ahorros*) and the British building societies? How are these legal forms different to corporate banks? And most importantly – if and how such organizational differences matter for the design of financial regulation? These are some of the central questions that this chapter purports to address.

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[131] For a comprehensive account, see the contributions in John Armour and Joseph McCahery (eds), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Hart Publishing 2006).

[132] See Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities* (University of Chicago Press 2006). See also Colin Mayer, *Firm Commitment: Why the Corporation is Failing Us and How to Restore Trust in It* (OUP 2013).

[133] 'The Co-op and the Mutuals Have failed us Almost as Badly as the Banks' *The Guardian* (London, 23 November 2013) <http://www.theguardian.com/business/2013/nov/23/co-operative-mutual-failed-badly-as-banks> accessed 6 December 2016.

[134] Notable examples include the 2013 public bailout of the Co-op Bank in the United Kingdom, as well as the ill fate of several former British mutual societies that converted into corporations in the 1990s. These institutions include not so distant bank failures, such as Northern Rock and Bradford & Bingley. David Bholat and Joanna Gray consider that: 'All eleven [British] building societies that demutualized in the 1990s have since lost their operational independence, either because they have been acquired by other banks, or because they have received a public bailout (…)'. See David Bholat and Joanna Gray, 'Organizational Form as a Source of Systemic Risk' (2013) 7 Economics: The Open-Access, Open-Assessment E-Journal, 7.

The chapter looks at the legal and ownership structure of different banks across jurisdictions in order to pinpoint the main set of generic features that the predominant organizational forms used for commercial banking have.[135] The study identifies and breaks down the essential ownership features exhibited by corporate, mutual and co-operative, and nonprofit banks in order to examine how they could interact with existing financial regulations – like deposit protection insurance schemes, bank resolution and prudential regulation. Mutual, co-operative and nonprofit banks are then compared against the foil of corporate banks.

The underlying rationale behind the use of the ownership analysis is the intuition that the dissection of the incentive structure of bank legal forms can help shed some light on existing tensions between banks as legal entities and financial regulation. This exploration can also provide some insights regarding which legal and economic features need to be taken into account for the ongoing financial reforms.

The rest of the chapter is divided into four additional sections. The second section presents an overview of the analytical framework used throughout the chapter – but also during the rest of the book. The third section expands the analysis by describing how banks can be legally organized and chartered in the European Union, France, Italy, Spain, the United Kingdom and the United States of America. The common generic features that underpin the economic structure of the main types of bank organizational forms are then identified and explained. The fourth section then compares the main features of mutual, co-operative and nonprofit banks against the foil of corporate banks. The final section concludes.

[135] The study primarily focuses on those commercial banks that take deposits from the general public in order to on-lend funds to third parties – regardless of whether they are owned by private parties or have been nationalized. The study excludes so-called ‘public’ or ‘State-owned banks’ that do not fund themselves by deposits and typically grant loans from a national budget or by issuing securities (eg the *Instituto de Crédito Oficial*, in Spain).

2. FRAMEWORK

This chapter conducts a positive analysis, based on the ownership structure of legal entities. In particular, it relies on some of Harold Demsetz's ideas on ownership, which consider the bundles of property rights that different bank constituencies have.[136] The framework also builds on and complements the so-called 'contractarian' theory of the firm, which sees them as nexuses both *of* and *for* contracts.[137] This perspective is also consistent with the emerging legal theory of finance (LTF) that considers law as a constitutive part of finance – which in turn is formed by a complex cobweb of contractual rapports and obligations.[138]

Organizational forms are typically viewed as off-the-rack, incomplete standard form contracts established by the law.[139] Each type of organizational form is a template endowed with its own set of generic attributes or features. The framework focuses on the economic structure of these contracts.[140]

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[136] Harold Demsetz, 'Toward a Theory of Property Rights' (1967) 57 American Economic Review 347.

[137] The firm as a 'nexus of contracts' was a seminal contribution of Michael Jensen and William Meckling. See Michael C Jensen and William H Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) Journal of Financial Economics 305. However, Jensen and Meckling mostly focused on the corporate form – which they acknowledge is 'simply one form of legal fiction that serves as a nexus of contracting relations (…)' – while precluding other important existing legal organizational forms. For critiques to this limited characterization see Tobias Tröger, 'Asset Partitioning, Debt-Equity Agency Conflicts, and Choice of Organizational Form' (2007) <http://ssrn.com/abstract=1068063> accessed 6 December 2016. Moreover, the interpretation of the firm as a 'nexus for contracts' entails the view of the firm as a common contracting party to many contracts. See Henry Hansmann, 'Ownership and Organizational Form' in Robert Gibbons and John Roberts (eds), *The Handbook of Organizational Economics* (Princeton University Press 2013) and later restated by Reinier Kraakman et al., *The Anatomy of Corporate Law: a Comparative and Functional Approach* (2nd edn, Oxford University Press 2009) 6.

[138] See Katharina Pistor, 'A Legal Theory of Finance' (2013) 41 Journal of Comparative Economics 315.

[139] Stephen Bainbridge, *Corporation Law and Economics* (Foundation Press 2002) 33. See also H Hansmann and R Kraakman, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387.

[140] See Eugene Fama and Michael Jensen, 'Agency Problems and Residual Claims' (1983) 26 Journal of Law and Economics 327.

While this ownership framework is ubiquitous in corporate law and economics, it provides a different perspective to more traditional civil law doctrinal classifications of firms.[141] Many other alternative analytical frameworks could be and have been considered and used (eg public choice, agency theory, etc.). However, this chapter focuses on the economic configuration that legal forms have in order to examine the interplay between the ownership structures of certain leading organizational forms and financial regulations, like deposit protection insurance schemes. The framework also provides a theoretical basis for subsequent analysis in the following chapters, which cover: capital and liquidity standards (chapter 4), bank resolution and creditor rank (chapter 5), and ring-fencing and other types of banking structural reforms (chapter 6).

This chapter describes and analyzes how deposit-taking institutions are legally organized in several European countries and in the United States. The European countries of choice include: France, Italy, Spain and the United Kingdom – as well as the existing organizational forms available under EU law. The functional method of comparative law allows the study of organizational types across several jurisdictions.[142] The features of each major type of bank legal form are then compared to the attributes of the business corporation.

Functional analyses of banking institutions have dominated the academic and policy debates on banking structural reforms in the aftermath of the recent financial crisis. However, existing functional distinctions seem to be more concerned with what banks are allowed to *do* (activities) than with the rules under which they are legally organized (legal form). The objective of this chapter is to raise some attention regarding the importance of legal form for the design of financial regulation.

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[141] For example, distinguishing between 'civil' and 'commercial' firms, or between *sociétés de capitaux* and *sociétés de personnes,* which are ubiquitous doctrinal classifications across some civil law legal systems. See Philippe Merle and Anne Fauchon, *Droit Commercial – Sociétés Commerciales* (19 edn, Dalloz 2016) 24-25.

[142] Using the functional method of comparative law means focusing on the similarities of bank organizational forms across jurisdictions. For the purpose of this chapter it entails focusing on the legal forms that fulfill the same tasks and functions and thus become comparable. See Konrad Zweigert, 'Methodological Problems in Comparative Law' [1972] Israel Law Review 465.

Henry Hansmann developed a comprehensive proprietary classification of firms.[143] The main distinction is between producer and customer owned firms. Producer-owned firms receive their inputs (capital, labor, technology) from their owners. This category includes producer-owned co-operatives (eg agricultural co-operatives), investor-owned firms such as the business corporation (which according to Hansmann is a form of producer owned co-operative[144]), and employee-owned firms, such as partnerships.

Customer-owned firms provide goods and services primarily to their owners or patrons. This category includes consumer-owned co-operatives, like wholesale supermarkets, clubs and some utility companies. Nonprofit enterprises are a third category of firms. Under the framework, the term 'nonprofit' is used differently as it is often colloquially employed. Nonprofits refer to firms that have no owners: that is, where patrons: '(a) often lack ownership units and voting rights, (b) face distributional constraints, and (c) are not entitled to receive residual property upon liquidation'.[145] In this sense of the term, most mutual and co-operative banks that operate for the benefit of their members cannot be considered to be true 'nonprofit' entities. The fact that mutual associations and co-operatives maximize the objectives and wellbeing of their members (instead of shareholder value) does not entail that they operate as nonprofits under the framework. The aforementioned taxonomy will be used throughout this chapter and the rest of the book.

An analysis of banks' ownership structures requires drawing certain distinctions between the constituencies involved in the impending discussion. These constituencies are defined by the literature as the individuals and firms that typically transact with a particular

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[143] See Henry Hansmann, 'Ownership of the Firm' (1988) 4 Journal of Law, Economics and Organization 267. See also Henry Hansmann, *The Ownership of Enterprise* (Belknap Press of Harvard University Press 1996).
[144] Hansmann 'Ownership of the Firm' (n 143)12-15.
[145] Henry Hansmann, 'The Economic Role of Commercial Nonprofits: the Evolution of the US Savings Banks Industry' in H Anheier and W Seibel (eds), *The Third Sector: Comparative Studies of Nonprofit Organizations* (de Gruyter 1989).

firm.[146] In recent years, the definition has been expanded to include stakeholders – or interest groups that are affected by the actions of the firm.[147]

Firms typically have owners, managers and board members, debtors and creditors. Because the discussion focuses on banks organized either as corporations, co-operatives and mutual societies, or nonprofit entities, the constituencies referred to throughout the chapter are: managers (including board members), (secured and unsecured) creditors, debtors, (insured and uninsured) depositors (a special type of unsecured bank creditor) and residual owners (also known as residual risk-bearers). Taxpayers are also important stakeholders for the analysis, since they often (and involuntarily) could end up providing some sort of fiscal backstop or become residual risk-bearers whenever banking institutions fail and are bailed out using public funds.

Banks' residual owners include shareholders, for the case of corporate banks. Mutual banks and co-operative banks typically do not have 'shareholders' as their residual owners because they are collective and jointly owned by their depositors-members. Commercial nonprofit banks are a special case covered by the literature, because – by definition – they are characterized as having no owners.[148]

3. A COMPARATIVE ANALYSIS OF BANK LEGAL FORMS

This section presents a functional comparative analysis of bank legal forms across several European jurisdictions and the US. The selected countries include: France, Italy, Spain and the United Kingdom. The rationale behind this selection is twofold. Firstly, some of

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[146] Hansmann calls them 'patrons'. See Hansmann, *The Ownership of Enterprise* (n 143) 12.

[147] See E Freeman, S*trategic Management: A Stakeholder Approach* (Pitman 1984). See also T Donaldson and Lee E Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications' (1995) 20 Academy of Management Review 65.

[148] Hansmann, 'The Economic Role of Commercial Nonprofits' (n 145). See also Henry Hansmann, 'Ownership and Organizational Form' in Robert Gibbons and John Roberts (eds), *The Handbook of Organizational Economics* (Princeton University Press 2013).

these countries host the most important financial institutions and markets in the world.[149] These jurisdictions are power-yielding countries that exert widespread influence in the design of financial regulations and standards. The second reason is practical. It responds to the availability of information and legal statutes (primary legal sources) in a language accessible in order to be able to conduct the analysis.

The scope of inquiry does not intend to explain the organizational laws of each country in great detail. Instead, it offers an observational snapshot of how banks in the selected countries are legally organized in the wake of the 2007-08 crisis. Some of the available organizational forms in these jurisdictions are now seldom used for banking (eg partnerships, limited partnerships, amongst others). As a result, the study is limited to a cross-sectional overview of the predominant organizational forms and bank types currently in existence.

3.1. The EU Framework for Enterprise and Credit Institutions

The EU has made significant efforts towards company law harmonization. The 1958 Treaty establishing the European Economic Community ('Treaty of Rome') laid the foundations for the right to establishment of companies and co-operatives across EU member states. Subsequent decades also saw an increasing number of directives and proposals aimed at harmonizing – not only the company laws of member countries – but also corporate governance matters and the provision of financial services.[150]

In spite of these integration efforts, EU member countries still retain a great say over their organizational laws. The resulting diversity is said to create potential arbitrage

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[149] In combination with Germany, these jurisdictions are home countries to 20 out of the 30 Global Systemically Important Banks (G-SIBs) identified by the Financial Stability Board (FSB). See Financial Stability Board (FSB), '2016 List of Global Systemically Important Banks (G-SIBs)' (21 November 2016) <http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf > 6 December 2016.

[150] For a detailed account, see Mads Andenas and Frank Wooldridge, *European Comparative Company Law* (Cambridge University Press 2009).

opportunities and forum shopping for seats of incorporation.[151] Differences in domestic insolvency regimes and creditor rank can also create distortions for bank resolution across the EU.[152]

3.1.1. Organizational Forms in the EU

In addition to the regulatory efforts for attaining European company law harmonization, the EU has also created two pan-European legal vehicles: (a) the European Company ('SE' according to its Latin name – *Societas Europaea*); and (b) the European Cooperative Society ('SCE' according to its Latin name – *Societas Cooperativa Europaea*).[153] In turn, these pan European legal forms are described.

In 2001 the European Commission adopted a regulation creating a public limited liability company, with the objective of 'adapting structures for production' in order to achieve the completion of the EU internal market.[154] The SE is functionally equivalent to the publicly traded business corporation.

Some commentators consider that the European Commission's main argument for creating the SE was facilitating cross-border mergers between companies incorporated in two different member countries.[155] However, the regulations did not cover important topics such as taxation and insolvency matters, which were left to the laws of each

[151] Paul Davies, *Introduction to Company Law* (2nd edn, OUP 2010) 302-304.
[152] As further analyzed under chapter five of this thesis.
[153] A third model is also being discussed: the European Private Company (SPE – *Societa Privata Europaea* – in Latin), which is modeled around the German GmbH (the precursor to the limited liability company – or LLC) and is targeted as an organizational form for small and medium size businesses (SMEs).
[154] Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European Company (SE).
[155] Paul Davies provides the example of a cross-border merger of 'Company A' incorporated in jurisdiction 'X', with 'Company B' incorporated in country 'Y'. The resulting entity could be either companies A or B, or a new 'Company C' (both A and B disappearing). However, these cross-border issued did not prevent takeovers to occur (the purchase of the shares of either company by the shareholders of the other). See Davies (n 151) 302-304.

member state.[156] In spite of this, very few European banks have decided to organize or migrate to the SE model.[157]

In a similar fashion to the SE, the European Cooperative Society (SCE) was created as an archetype so that co-operatives could operate across the European Single Market. In 1992, the European Commission submitted three regulatory proposals to the European Council for the establishment of supranational organizational forms aimed at the expansion of the so-called 'social economy enterprises'. These were essentially standard form pan-European alternatives to the business corporation.

The aforementioned proposals aimed at the creation of model European: (a) co-operative societies; (b) mutual insurance societies[158] and (c) nonprofit associations.[159] However, only the Statute of the European Cooperative Society was subsequently adopted in 2003.[160] The SCE Regulations entered into force in 2006. By that year, the European

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[156] See Horst Eidenmüller, Andreas Engert and Lars Hornuf, 'Incorporating under European law: the Societas Europaea as a Vehicle for Legal Arbitrage' (2009) European Business Organization Law Review 1.

[157] According to the European Trade Union Institute (ETUI), by 15 November 2015 there were 2525 registered and established SEs. Around 160 of these SEs were associated to the financial sector, mainly related to the insurance industry. See The European Trade Union Institute's (ETUI) European Company (SE) Database <http://ecdb.worker-participation.eu/index.php> accessed 6 December 2016.

[158] These were defined as: 'a permanent grouping of natural or legal persons whose members pool their knowledge or activities either for a purpose in the general interest or in order to directly or indirectly promote the trade or professional interests of its members'.

[159] The European Commission defines mutual societies as: 'voluntary groups of persons (natural or legal) whose purpose is primarily to meet the needs of their members rather tan achieve a return on investment. These kinds of enterprise operate according to the principles of solidarity between members, and their participation in the governance of the business. They are governed by private law. The profits and surpluses of a mutual are not used to pay a return on investment; they are rather used to improve the services offered to members, to finance and develop the business and to increase its own reserves. Within certain limits, they may be redistributed to members in any form. Unlike co-operatives, whose capital is represented by shares, the funds of mutuals are owned and managed jointly and indivisibly'. See European Commission, 'Mutual Societies in an Enlarged Europe' – Consultation Document (3 October 2003) <http://ec.europa.eu/enterprise/policies/sme/files/mutuals/mutuals-consult-doc_en.pdf> accessed 6 December 2016.

[160] See Council Regulation (EC) No 1435/2003 of 22 July 2003 on the Statute for a European Cooperative Society (SCE).

Commission had withdrawn the regulatory proposals for European mutual societies and associations because of a lack of widespread support.

An SCE's principal objectives must be 'the satisfaction of its members' needs and/or the development of their economic and social activities, in particular through the conclusion of agreements with them to supply goods or services or to execute work of the kind that the SCE carries out or commissions'.[161] Unlike the capital of a mutual society – which is the common property of its members – an SCE's capital is divided into ownership units called 'shares'.[162] Its minimum capital was set at EUR 30,000.

According to article 2 of the SCE Regulation, they can be formed:

> (a) by five or more natural persons resident in at least two Member States, (b) by five or more natural persons and companies and firms within the meaning of the second paragraph of Article 48 of the Treaty (current article 54 of the TFEU) and other legal bodies governed by public or private law, formed under the law of a Member State, resident in, or governed by the law of, at least two different Member States, (c) by companies and firms within the meaning of the second paragraph of Article 48 of the Treaty (current article 54 of the TFEU) and other legal bodies governed by public or private law formed under the law of a Member State which are governed by the law of at least two different Member States, (d) by a merger between cooperatives formed under the law of a Member State with registered offices and head offices within the Community, provided that at least two of them are governed by the law of different Member States or (e) by conversion of a cooperative formed under the law of a Member State, which has its registered office and head office within the Community if for at least two years it has had an establishment or subsidiary governed by the law of another Member State.

[161] ibid art 1.3.
[162] ibid art 1.2.

The aforementioned requirements accentuate the need of a so-called 'international element' for the formation of SCEs.

Like other co-operative types, the members of an SCE would typically be customers or suppliers ('patrons') that benefit from the activities that the co-operative conducts. As a result, they could be classified into producer-owned co-operatives and customer-owned co-operatives. In the case of co-operative banks, customers can either be depositors, borrowers or both. This is why banking co-ops are typically categorized as consumer-owned co-operatives.

The European Company ('SE') and the European Cooperative Society ('SCE') could be further considered as instruments for homogenizing bank legal forms across the EU. Gustaf Sjoberg credits Prof. Rosa M. Lastra with having once proposed harmonizing the EU corporate law for banks with the SE.[163]

Moreover, the introduction of the SCE seemed to expand the choice for European non-corporate bank forms. Even though this proposal is worth discussing with greater detail, one could argue that imposing a set of homogenous legal forms for arranging banking across Europe could contravene some of the EU's internal market principles – namely freedom of establishment and freedom to provide services.

The principle of freedom of establishment is contained in articles 49-55 of the Treaty of the Functioning of the European Union (the 'TFEU'). Article 49 of the TFEU states that: 'restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited'.[164] Article 56 of the TFEU

[163] See Gustaf Sjoberg, 'Handling Systemically Important Banks in Distress – Some Thoughts from a Swedish Perspective' (2011) 12 European Business Organization Law Review 227, fn 96.
[164] Consolidated Version of the Treaty on the Functioning of the European Union art 49, 2008 O.J. C 115/47.

establishes that this protection extends to legal persons such as firms and co-operatives[165] against 'restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State'.[166] The European Court of Justice has consistently upheld this protection to firms in some notable cases.[167] In December 2006, a Directive on Services in the Internal Market[168] was issued, but it excludes financial services from its scope.

3.2. Bank Organizational Forms in Selected European Jurisdictions

This subsection provides a succinct overview of the leading organizational forms used for organizing credit institutions across four EU countries: France, Spain, Italy and the UK (which at the time of writing, was still a member in spite having celebrated a referendum on 23 June 2016, where a majority of voters decided for the UK to leave the EU). The objective is to find a common set of functionally equivalent bank legal forms and describe their main ownership features. The features of non-corporate bank organizational forms are then compared to the salient features of corporate banks.

Historically, a so-called 'three pillar banking' model characterized many western European countries. This consisted in the existence of private (commercial banks),

[165] Article 56 of the TFEU states that: '[c]ompanies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States. "Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making'.
[166] TFEU art 49. Regarding the prohibitions or restrictions to the establishment of bank branches and subsidiaries see Almudena de la Mata Muñoz 'The Future of Cross-Border Banking After the Crisis: Facing the Challenges Through Regulation and Supervision' (2010) 11 European Business Organization Law Review 575.
[167] Case C-140/03 Commission v Greece [2005] ECR I-3177 §29; Case C-299/02 Commission v Netherlands [2004] ECR I-9761 §16; Case 81/87 *Daily Mail and General Trust* [1988] ECR 5483; Case C-212/97 *Centros* [1999] ECR I-1459 para 18; Case C-208/00 *Überseering* [2002] ECR I-9919 para 56.
[168] Directive on Services in the Internal Market 2006/123/EC of 12 December 2006.

mutual and cooperative banks, and nonprofit or savings banks.[169] Moreover, in spite of trends that tried to develop a set of pan-European organizational forms, each member country has retained its own sets of legal entities endowed with their own particular rules and features.

3.2.1 France

In France, the Financial and Monetary Code (*Code Monétaire et Financier)* regulates credit institutions (*établissements de crédit*). Articles L511-1 and 311-1 of the Financial and Monetary Code define credit institutions as those legal persons that habitually perform banking functions comprising: deposit taking from the public, credit operations and providing payments services.[170] Article L512-1 of the *Code Monétaire* also contemplates the existence of mutual and co-operative banks (*banques mutualistes ou coopérative*).[171] The French Commercial Code (*Code du Commerce*) creates legal business forms. The business corporation (*société anonyme*) is the organizational form of choice for most French banks. It is governed by article L225 of the Commercial Code.

French co-operative and mutual banks are organized under Law No. 47-1775 of 10 Sept. 1947 (and its subsequent modifications).[172] The original text of the law reduced the scope of co-operatives' objectives to 'price reduction, disintermediation, and the improvement of the quality of the goods transacted with patrons'. In 1992, a legal reform included 'the

[169] Dilek Bülbül, Reinhard Schmidt and Ulrich Schüwer, 'Caisses D'épargne et Banques Coopératives en Europe' (2013) 111 Revue d'Economie Financière 159.
[170] Article L511-1 states that: '[l]es établissements de crédit sont des personnes morales qui effectuent à titre de profession habituelle des opérations de banque au sens de l'article L. 311-1'. In turn, Article L311-1 defines banking operations as comprising: 'la réception de fonds remboursables du public, les opérations de crédit, ainsi que les services bancaires de paiement'.
[171] Paul Mentré and Antoine Mérieux, *Les Institutions D'Épargne en Europe et en France: Le Secteur Public et Mutualiste* (Association d'Économie Financière 2003).
[172] L. no. 47-1775, 10 sept. 1947 portant statut de la coopération, JO 11 sept., p. 9088. *See also* L. no. 92-643, 13 Juill. 1992 relative a la modernisation des entreprises coopératives, JO 14 juill., p. 9450.

improvement of the needs of their members' as part of co-operatives' statutory objectives.[173]

Three types of ownership units represent the funds owned by co-operatives. These include: (a) common ownership unit (*parts sociales A*), (b) preferred ownership units (*parts a avantage particulier*) and (c) priority units without voting rights (*parts à intérêt prioritaire dépourvues du droit de vote*). The terminology is used to distinguish these ownership interests to shares and other types of securities issued by joint stock companies and limited liability companies.

The members of co-operatives subscribe common ownership units. They carry the right to one vote per member – a feature that is common across co-operatives – because of the one-vote-per-member principle. Finally, priority units without voting rights are a special type of ownership interest aimed at third parties and issued in order to raise funds. As their name suggests, they carry no voting rights.[174]

3.2.2. Spain

There are three main types of credit institutions in Spain.[175] These are: corporate banks, credit co-operatives (*cooperativas de crédito*) and the – now almost extinct – savings banks *(cajas de ahorro*). The Bank of Spain (*Banco de España*) was their common supervisor, until the initial phase of the EU's Banking Union entered into force in November 2014.[176]

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[173] L. no. 92-643, 13 Juill. 1992 relative a la modernisation des entreprises coopératives, JO 14 juill., p. 9450.

[174] See generally David Hiez, *Coopératives: Création, Organisation, Fonctionnement* (Editions Delmas 2014).

[175] A fourth deposit-taking institution exists, which is the Confederation of Spanish Savings Banks (*Confederación Española de Cajas de Ahorros* – CECA). This is the governmental consultative agency for Spanish *cajas de ahorros*. In addition to its administrative functions, it is authorized to perform certain banking activities. However, it is not included in the functional analysis presented due to its administrative features. Neither is the *Instituto de Crédito Oficial*, which is mainly a State or 'public bank'.

[176] The European Banking Union is the European Commission's multipronged regulatory response to the 2007 financial Crisis. It consists of a 'single rulebook', a Single Supervisory

Article 2 of the Spanish Banking Law[177] requires that banks be organized as business corporations (*sociedades anónimas*) under the Spanish Business Corporations Act 2010 (*Ley de Sociedades de Capital*[178]). Organizationally, Spanish corporate banks have the general features that business corporations exhibit. Namely: legal personality, limited liability, delegated board management, share alienability and voting rights assigned according to the number of shares owned.

Article 129.2 of the Spanish Constitution declares that public authorities commit to promoting the co-operative organizational form through adequate legislation.[179] Spain has both a national Co-operative Law no. 27/1999 as well as regional co-operative statutes across all but one of the Spanish Autonomous Communities.[180] This means that autonomous communities have supplementary regulatory powers over credit co-operatives operating within their jurisdiction.

Article 104 of the National Co-operative Law No. 27/ 1999 recognizes credit co-operatives and points out that they are regulated through special rules. Law No. 13/1989 lays out more detailed rules for credit co-operatives.[181] Spanish credit co-operatives have the statutory objective of servicing the financial needs of their members and third parties through the exercise of the activities undertaken by credit institutions. Law No. 13/1989 on Credit Co-operatives asserts that these entities are endowed with their own legal personality and their members also

Mechanism (SSM) and a Single Resolution Mechanism (SRM). The latter are compulsory for all Euro Area Member States and are open to all other countries in the EU. The SSM became operational in November 2014, and since then the European Central Bank (ECB) has become the banking supervisor for all banks in the Euro Area.

[177] *Real Decreto* 1245/1995 of 14 July. As modified by *Real Decreto 256/2013*, of April 12.

[178] *Real Decreto legislativo 1/2010*.

[179] Spanish Constitution (*Constitución Española*), «BOE» No. 311, 29 December 1978.

[180] Carlos Vargas Vasserot, Enrique Gadea Soler and Fernando Sacristán Bergia*, Derecho de las Sociedades Cooperativas: Introducción, Constitución, Estatuto del Socio y Órganos Sociales* (La Ley 2014) 63. Only the Canary Islands lack their own Co-operative statute.

[181] As well as by Law No. 27/1999 of 16 de July, which regulates co-operatives in general.

benefit from limited liability up to the amount of their individual contributions.[182] Membership in credit co-operatives is open to both individuals and firms.

According to the Spanish Law no. 13/1989 on Credit Co-operatives, members are required to subscribe at least one membership share. Pursuant to the default legal provisions, each member is entitled to one vote, which is a common voting rule amongst co-operatives worldwide. This feature is a major difference between co-ops and corporations, where voting rights are typically assigned on a *one vote per share* basis.

However, the members of Spanish co-operatives can also agree to depart from this default voting rights rule by modifying a co-op's charter in order to assign voting rights according to other criteria (eg such as total number of subscribed shares).[183] In such cases, members' ownership interests (and votes) are capped at 2.5% and 20% of subscribed capital for physical and legal persons, respectively. The rationale behind capping votes is to prevent any one member from exercising full control of a co-operative.

The third type of legal form is the Spanish savings bank. Law No. 26/2013 of 27 December now regulates the Spanish savings banks called *cajas de ahorros*.[184] The *cajas* have existed and have been regulated in Spain since the 18th century.[185] However, as was previously mentioned, Spanish savings banks have had many institutional changes throughout the years.

Historically, the Spanish *cajas* originated from thrift pawnbroker institutions called *montes de piedad*, which are associated to catholic Europe.[186] Spanish *cajas* had no residual owners, but were rather setup as entities endowed with resources (donations) for

[182] Law No. 13/1989 on Credit Cooperatives art 1.
[183] Law No. 27/1999 art 107. See also Vargas Vasserot et al. (n 180) 215.
[184] Spanish Law No. 26/2013 of 27 December.
[185] International Monetary Fund, 'The Reform of Spanish Savings Banks: Technical Note' (May 2012).
[186] See Montserrat Carbonell-Esteller, 'Montes de Piedad and Savings Banks as Microfinance Institutions on the Periphery of the Financial System of Mid-Nineteenth-Century Barcelona' (2012) 54 Business History 363.

conducting their activities. Like other savings banks across Europe, they were devised as nonprofit associations, rooted in specific geographical areas, and with a dual objective of providing both services to their clients (retail clients and SMEs) and promoting community welfare programs.

The governance structure of the Spanish savings banks experienced many difficulties over recent years due to the increasing participation of public administration officers in their main governing bodies. Some scholars and commentators point to two specific reforms that set the groundwork for their demise. The first came in August 1977, with the Royal Decree Law no. 2290/1977, which placed the *cajas* on equal footing with corporate banks. This norm liberalized competition between saving banks and private banks by allowing the *cajas* to grow territorially (instead of being circumscribed to a specific location) and also allowed them to offer all of the same products and services offered by private corporate banks.

In 1985 the *Spanish cajas* experienced yet another important transformation through the *Ley de los Órganos Rectores de las Cajas de Ahorros* (commonly known as 'LORCA'). The LORCA introduced the presence of politicians and other local public authorities in the boards of the Spanish saving banks. In the words of Martín-Aceñas: 'The [cajas'] boards of directors fell into the hands of the local and regional (Autonomous Communities) corporations controlled by the political parties and the trade unions connected to them'. According to many commentators, the de-professionalization of the management in connection with their peculiar ownerless structures and with the elimination of the geographical and functional distinctions that differentiated *cajas* from commercial banks, would lead to severe agency costs during the 2007-2008 financial crisis.

Together, the aforementioned legislative changes led to a general watershed of the Spanish saving banks during and after the 2007-2008 financial crisis. Their legal and institutional form was extensively reformed and one can safely conclude that – with the exception of two entities – their original institutional configuration no longer exists.

The Spanish *cajas* currently provide consumer-banking services and also perform community welfare activities for the benefit of their depositors, their employees, charities or the regions where they operate. However, the banking unit and the entity that does the charitable works have been legally separated. Moreover, the ownership and governance structure of the Spanish *cajas* is different to that of other savings associations (particularly those in the US). Instead of being owned and controlled by their depositors (called *impositores* in the Spanish legislation), the mayor decision-making body for the Spanish *cajas de ahorros* is an Assembly comprised of 30 to 150 members. These members must reflect a *caja*'s constituencies including: its founding entities, its clients, employees and the beneficiaries of its social benefit activities.[187]

3.2.3. Italy

Article 47 of the Italian Constitution states that the Italian Republic '(…) encourages and safeguards savings in all forms. It regulates, co-ordinates and oversees the operation of credit'.[188] The consolidated Legislative Decree issued on 1st September 1993, No. 385 and its amendments (hereinafter, referred to as the consolidated 'TUB' – or *Testo Unico Bancario*) is the primary domestic legislation that organizes banking activities in Italy.[189] Banks are defined as firms authorized to conduct banking activities. In turn, these activities are defined by Article 10 of the TUB as taking deposits from the public and extending credit.

Before the entry into force of the first phase of the Banking Union in the EU, Italian banks were under the joint supervision and oversight of the Bank of Italy (*Banca d'Italia*), the Ministry of Finance and Economy, and the Inter-ministerial Committee for

[187] Spanish Law No. 26/2013 of 27 December art 4-14.

[188] From the official English translation by the Senate (*Senato della Repubblica*). 'Constitution of the Italian Republic' <https://www.senato.it/documenti/repository/istituzione/costituzione_inglese.pdf> accessed 6 December 2016. The original version reads: '*La Repubblica incoraggia e tutela il risparmio in tutte le sue forme; disciplina, coordina e controlla l'esercizio del credito*'.

[189] Testo Unico delle leggi in materia bancaria e creditizia. Decreto Legislativo 1 Settembre 1993, No. 385 (hereinafter, the 'TUB').

Credit and Savings or 'CICR' (*Comitato interministeriale per il credito e il risparmio*). These entities are jointly referred to as Credit Authorities throughout the TUB (*autorità creditizie*).[190]

In order to obtain a banking license, Article 14.1 (a) of the TUB requires that banks adopt either the corporate business form (*società per azioni*) or the limited liability co-operative legal form (*società cooperative per azioni a responsabilità limitata*).[191] The latter serves as the organizational form of choice for Italian co-operative banks (*banche cooperative*) that operate under two functional licenses: popular banks (*banche popolari)* and credit co-operative banks (*banche di credito cooperativo*).[192]

According to the TUB, popular banks (*banche popolari)* are co-operative banks with 200 or more members that can offer banking services to the general public. Their shares must be issued for EUR 2.00 or more. Each member has one vote, regardless of the number of shares that they own. No member can own more than 50% of the subscribed capital of a popular bank. In addition, theses entities can be authorized to demutualize in order to transform their legal form into business corporations.[193]

On the other hand, Italian credit co-operative banks (*banche di credito cooperativo*) are co-operative societies with a mutual benefit orientation. They are comprised of 200 or more members, and their objective is to provide financial services primarily to their membership base.[194] Like other co-operatives, members are entitled to exercise one vote, regardless of their total shareholding. In these institutions shares must have a face value between EUR 25 and EUR 500. Additionally, individual shareholdings cannot exceed EUR 50,000. Credit co-operatives banks can also transform their legal and functional forms in order to become corporate banks or popular banks.

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[190] TUB arts 2-9.

[191] Additional legal organizational forms are established in the Italian Civil Code. See *Codice Civile Italiano, R.D. 16 marzo 1942, n 262. Approvazione del testo del Codice Civile, Pubblicato nella edizione straordinaria della Gazzetta Ufficiale, n. 79 del 4 aprile 1942*.

[192] TUB arts 28-37.

[193] ibid arts 28-32.

[194] The Bank of Italy can waive this restriction for a limited period, attending to stability purposes. See TUB art 35.1.

A final remark is in place regarding the historical Italian savings banks, called *casse di risparmio*.[195] These were nonprofit entities, functionally equivalent to the Spanish *cajas de ahorros* and the French *casses d'épargne*. Thus, they constituted the third pillar – or nonprofit banks – in the Italian banking system. Because of banking reforms that took place in the year 1990 (through the so-called *Legge Amato*), most of these institutions were transformed into corporate banks, under the corporate (*società per azioni*) legal form.[196]

3.2.4. United Kingdom

In the United Kingdom, the Financial Services and Markets Act 2000 (FSMA) (as amended by the Financial Services Act 2012) does not contain a definition explaining what banks are.[197] However, the Bank of England's list of banks (up to February 2016) showcases that most authorized institutions were incorporated as either public or private business corporations.[198] In addition to corporate banks, there are building societies, co-

[195] This chapter does not purport to provide the full historical evolution of banking in each analyzed country. As a result, many functional forms of historical importance have been left outside of the analysis. In the case of Italy, for example, the *monti di credito su pegno* and *casse rurali et artigiane*. For a comprehensive historical account see Leonardo Giani, 'Ownership And Control Of Italian Banks: A Short Inquiry Into The Roots Of The Current Context' (2008) 6 Corporate Ownership and Control.

[196] See Giani (n 195).

[197] The UK's Prudential Regulatory Authority (PRA) defines banks in its Handbook as: '(*a*) a firm with a Part 4A permission (under FSMA) which includes accepting deposits and: (i) which is a credit institution; or (ii) whose Part 4A permission includes a requirement that it comply with the rules in General prudential Sourcebook and the Prudential sourcebook for Banks, Building Societies and Investment Firms relating to banks; but which is not a building society, a friendly society or a credit union; (b) an EEA bank which is a full credit institution'. References to credit institutions mean under Regulation of the European Parliament and the Council on prudential requirements for credit institutions and investment firms (Regulation (EU) No 575/2013) and amending Regulation (EU) No 648/2012.

[198] Bank of England, 'Bank & Building Societies Lists' (March 2016). <http://www.bankofengland.co.uk/pra/Documents/authorisations/buildingsocietieslist/buildingsocieties1602.pdf> accessed 6 December 2016.

operative banks and credit unions operating in the UK.[199] The Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) supervise these entities.[200]

Building societies are currently regulated under the Building Societies Act 1986-1997.[201] They are mutual entities defined as having the principal purpose 'of making loans which are secured on residential property and are funded substantially by its members'.[202] As their names imply, theses institutions historically emerged and developed as vehicles to pool money from their membership base in order allow some of them to save and others to take out loans in order to build or purchase their homes. However, today building societies are allowed to offer many of the same consumer banking services as corporate banks (although many do not provide current accounts). As of 1st August 2016, there were 45 building societies in the UK.[203]

Credit Unions are co-operative societies owned by their members. They are regulated by the Industrial and Provident Societies Act 1965, the Friendly and Industrial and Provident Societies Act 1968 and the Credit Unions Act 1979. The Credit Unions Act 1979 defines their objects and purposes as: '(a) the promotion of thrift among the members of the society by the accumulation of their savings; (b) the creation of sources of credit for the benefit of the members of the society at a fair and reasonable rate of interest; (c) the use and control of the members' savings for their mutual benefit; and (d) the training and education of the members in the wise use of money and in the management of their financial affairs'. Membership in a UK credit union is granted upon the fulfillment of certain criteria, including a minimum subscription of at least one share. Each share is

[199] In the insurance sector there are also friendly societies, whose 'principal purpose must include the provision on a mutual basis of insurance against loss of income arising out of sickness, unemployment or retirement'. See Paul L Davies and Sarah Worthington, *Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 1-29.

[200] The FCA serves as a registering authority and oversees competition and conduct of business rules. The FCA and the PRA are successors of the now extinct Financial Services Authority (FSA).

[201] Building societies have been regulated in the UK since an Act of 1874.

[202] Building Societies Act 1986 s 5 (1).

[203] Bank of England, Bank & Building Societies Lists (1st August 2016) <http://www.bankofengland.co.uk/pra/Documents/authorisations/buildingsocietylist1507.pdf> accessed 6 December 2016.

denominated with a £1 face value. Shares in a credit union are nontransferable. Each member is entitled to one vote in members' assembly meetings, thus adhering to the 'one-vote-per-member' rule.

In a similar fashion to other European countries, the UK also historically developed a three-pillar banking system. The third-pillar was comprised of a group of savings banks known as *trustee savings banks*, which dated back to 1810. Like other nonprofit savings banks, British trustee savings banks operated within a specific geographical area, had no residual owners and were managed by boards of trustees. In 1986, the group of decentralized, regional trustee and savings banks reorganized as a public corporation under the name of 'TSB Group plc'. In 1995, the TSB Group merged with another corporate bank and became known as Lloyd's TSB, thus ending the era of savings banks in the UK.

3.3. Bank Organizational Forms in the United States (US)

The US law of business associations is largely a matter of state jurisdiction.[204] Each state has its own statutes covering several basic forms, such as: business corporations, partnerships, co-operatives, nonprofits, amongst others. There are two notable exceptions to this rule. First, some firms – including banks – can be federally chartered. Secondly, the issue and public offering of securities falls under the jurisdiction of federal law. In this sense, companies and banks listed in the securities markets are subject to federal regulations.[205]

The banking licensing scheme for US banks follows this federal-state duality. However, it is much more complex than the EU system. Some banks are licensed under state law ('state banks'), while others are chartered under federal law ('national banks'). The

[204] Which has been revised by the Building Societies Act 1997, by the FSMA 2000 and by the Financial Services Act 2012.
[205] This includes corporate banks that list and issue shares, but can also include mutual societies and co-operative banks that issue debt instruments.

official organizational form designation for corporate, federally chartered banks is 'National Associations' or 'N.A.'. These entities are chartered and regulated by the Office of the Comptroller of the Currency (OCC). The Federal Deposits Insurance Corporation (FDIC) insures deposits across both national and state banks. This duality is associated with some of the historical developments of US banking laws.

In addition to investor-owned banks, there are three ownership structures for US banks: mutual savings banks, mutual savings and loans associations (MSLAs) and credit unions.[206] As Henry Hansmann indicates, mutual savings banks (hereinafter, 'US mutual savings banks') have a misleading name.[207] In spite of having the word 'mutual' in their denomination, these entities are described as commercial nonprofit banking institutions. US mutual savings banks do not have owners and are often managed by self-perpetuating boards of directors.[208] Credit unions and MSLAs are the final pair of US bank forms. Both are customer-owned co-operative societies.

3.4. Summary of the Cross-Border Comparative Analysis

In the analyzed selected jurisdictions banks are typically incorporated entities (eg they are not sole proprietorships[209] nor joint ventures). Nowadays, commercial banks are seldom organized as partnerships, limited partnerships[210] or other related forms of producer or employee-owned business associations.[211] Despite of the existing variety of bank denominations and functions across the studied countries, the legal forms analyzed can be categorized into three main types of organizational forms. These are: (1) investor-owned

[206] Hansmann, *The Ownership of Enterprise* (n 143) 246-264.
[207] ibid.
[208] Henry Hansmann, 'The Economic Role of Commercial Nonprofits: the Evolution of the US Savings Banks Industry' in H Anheier and W Seibel (eds) *The Third Sector: Comparative Studies of Nonprofit Organizations* (de Gruyter 1989).
[209] Even though a corporate bank can have a single major shareholder (like a bank holding company or an institutional shareholder, such as a pension fund or a private equity fund). A bank could also entirely own its subsidiaries.
[210] For example, limited partnerships (LPs), which are commonplace organizational forms for structuring private equity funds and also hedge funds.
[211] Such as limited liability companies (LLCs), limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs).

corporate banks[212], (2) customer-owned mutual and co-operative banks, and (3) commercial nonprofit or ownerless savings banks (in the fashion of the Spanish *cajas* or US mutual savings banks), which are increasingly less common.

This finding is consistent with the existence of the so-called ‘three pillar banking model’ that is characteristic of many European countries. Moreover, in most of the studied jurisdictions, specialized laws exist that regulate the creation and the features of the different types of legal organizational forms. Each jurisdiction has its own legal rules governing the creation of business corporations as well as co-operatives, mutual societies and nonprofit entities. This entails, that for example, in spite of the Spanish *sociedad anónima* being functionally equivalent to the English business corporation, it does not mean that both are regulated by identical rules. The same caveat applies to other types of bank legal forms.

In terms of size and performance, the participation of non-corporate banks across European countries is not negligible. For example, according to the European Association of Co-Operative Banks (EACB), in 2015 french co-operative banks serviced 115,700 clients, had over 326,800 full time employees, and commanded around 61.4% of the domestic market share of deposits and around 59% of the domestic market share for loans. In the UK, building societies serviced around 22.4 MM clients and held 18.3% of the domestic market share of deposits. While in other countries not specifically analyzed in this chapter, like Germany and Austria, co-operative banks are also relevant participants, commanding around 21.0% and 30.3%, respectively, of the market share in domestic deposits.[213]

Corporate banks are owned by their shareholders. Equity holders are entitled to residual value and are typically granted voting rights on a ‘one-vote-per-share’ basis. In corporate

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[212] Which can be a listed (public) company or a closely held corporation.
[213] See European Association of Co-Operative Banks, ‘Key Statistics as of 31-12-15’ available online at: http://v3.globalcube.net/clients/eacb/content/medias/key_figures/20161124_final__final_tias_eacb_2015_key_statistics.pdf accessed 6 December 2016.

banks, the owners need not transact with the corporation in order to receive a return for their investments. This means that bank shareholders are capital providers, and they are not required to be customers. In fact, modern financial regulations limit many transactions between banks and their major shareholders (related party transaction prohibitions). Capital flexibility is one of the major advantages that corporate banks are said to have over other organizational forms. This is because they can raise capital in order to expand their operations by selling shares to their existing shareholders (eg through a 'rights issue') or to the general public. Paradoxically, this feature can become impaired in the event of insolvency or financial distress, when fresh capital could be needed the most.

As the cross-country comparative analysis shows, the capital of some co-operative banks and credit unions can also be divided into shares or other type of ownership units. However, voting rights in co-ops are often capped at a maximum number of votes per member or are based on a 'one-vote-per-member' voting rule. Across jurisdictions, co-operative banks also follow the International Co-Operative Alliance's 'Co-operative Principles'.[214]

Mutual banks (such as building societies in the UK) are typically funded by deposits and retained earnings. One feature of some mutual banks is that their capital is not always divided into shares held by their depositors-members. Rather deposits form part of their equity capital, and all depositors jointly own this asset pool.

The members of co-operative banks are often entitled to receive part of the earnings of the bank in proportion to their ownership interest. This means in proportion to their contribution and the use of the bank's services (eg their shareholding). The situation can

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[214] These principles are: '(1) Voluntary and Open Membership, (2) Democratic Member Control, (3) Member Economic Participation, (4) Autonomy and Independence, (5) Education, Training and Information, (6) Co-operation among Co-operatives, and (7) Concern for Community'. See International Co-Operative Alliance, 'Co-Operative Principles' <http://ica.coop/en/whats-co-op/co-operative-identity-values-principles> accessed 6 December 2016. See also the ILO's Recommendation Concerning Promotion of Cooperatives n 193 (n 128).

be different in some mutual and nonprofit banks, where depositors are fixed claimants and receive a specific amount of interest on their savings. In some mutual entities, depositors do not have an individualized ownership interest (like shareholders and co-operative members do). Instead, depositors-members in mutual societies commonly own the pool of resources that the entity is endowed with and also get to vote in meetings.

Moreover, in both co-operative and mutual banks, ownership and membership are conflated. This means that members-depositors are the residual owners and the residual risk-bearers of the firms. In addition, membership affiliations are often established based on a common linkage – or 'unity of interest' – between members.

Finally, commercial nonprofit or savings banks are ownerless (or self owned) entities. This means that their depositors are not entitled to residual claims and generally do not have voting rights to elect directors and decide on important matters. Some of the examples studied include the Mutual Savings Banks in the US, and to a certain extent, the pre-crisis structure for the Spanish *cajas de ahorros*, which are now nearly extinct.

Nonprofit banks typically pay depositors fixed interest on their savings. In addition, they have legal statutory distribution constraints (ie do not distribute earnings) and instead profits are continually reinvested in order to purse the organization's objectives – which often include, social benefit or charitable activities. In addition, self-perpetuating boards of directors (or trustees) manage these entities, making them susceptible to specific types of agency problems. Table 2 summarizes the previously described findings of the comparative analysis.

Table 2

Summary of Existing Types of Bank Organizational Forms in Selected Jurisdictions

	INVESTOR-OWNED	**CUSTOMER-OWNED CO-OPERATIVE AND MUTUAL BANKS**	**NONPROFIT BANKS**
FRANCE	*Société anonyme* (S.A.)	*Banques mutualistes and Banques coopératives*	*Caisses/ associations d'épargne et de crédit*
ITALY	Società per azioni (S.p.A.)	*Banche Popolare and Banche di Credito Cooperativo* (BCC)	Casse di risparmio
SPAIN	Sociedad Anónima (S.A.)	Cooperativas de crédito	Cajas de Ahorros
UK	Public limited company (p.l.c.) Private limited company (Co. or Ltd.)	Building societies Co-operative banks Credit Unions	Trustee savings banks
US	Public and private corporate banks (Corp. or Inc.) National Associations N.A. Corporate Savings Banks	Co-operative banks Mutual Savings and Loans Associations (MSLAs) Credit Unions	Mutual Savings Banks

4. THE ECONOMIC STRUCTURE OF BANK LEGAL FORMS

Having identified and described the three main categories of organizational forms used for arranging banking activities across several leading jurisdictions, the following section compares their main attributes. The corporate form is used as a baseline for the comparison, since it is the best-known and most widely studied legal form.

Several leading corporate law academics agree that the flagship characteristics that business corporations exhibit across several jurisdictions are: '(a) legal personality, (b) limited liability, (c) share transferability, (d) centralized management under a board structure; and (e) shared ownership by contributors of capital'.[215] This 'corporate anatomy' has served to differentiate the business corporation from other types of organizational forms. Existing legal vehicles for structuring enterprise, like co-operatives and mutual associations, often combine or substitute variations of these attributes. Moreover, these features have important economic implications that characterize and distinguish different types of legal organizations.

The aforementioned features of the corporation are also strongly intertwined. For example, legal personality ('entity shielding') and limited liability ('owner shielding') are considered two sides of the same coin – known as 'asset partitioning' – by a notable strand of the law and economics literature.[216] In addition, ownership structure, share transferability and voting rights are related to how funds are raised and combined, how board members are elected as well as with corporate governance features across different types of banks. Furthermore, limited liability and the unrestricted transferability of shares

[215] Kraakman et al. (n 137) 5-16. Steven Bainbridge considers six very similar attributes, namely: '(a) formal creation, (b) legal personality, (c) separation of ownership and control, (d) indefinite duration, (e) transferability and (f) limited liability'. Bainbridge, *Corporate Law* (n 120) 1-8. For a discussion on the development of these core characteristics, see Andreas Cahn and David C Donald, *Comparative Company Law – Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA* (CUP 2010) 9-11.

[216] See Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387; Henry Hansmann and R Kraakman, 'Organizational Law as Asset Partitioning' (2000) 44 European Economic Review 807. Much of the following discussion draws on the 'asset partitioning' framework set forth in these seminal articles.

are recognized to allow investors to diversify risks without compromising their general property.[217] Thus, it is often the case that whenever discussing these features in the context of any type of legal organization one tends to jump from one to the other, describing how they interplay with each other.

Since banks are not always organized under the corporate form, it is useful to analyze if and how the referenced attributes are bundled across non-joint stock banks such as co-operatives, mutual associations and nonprofit banks. More importantly, the various combinations of these attributes (or the lack thereof) could interact differently with financial regulations – such as deposit protection insurance, for example – and could lead to diverse economic incentive structures and consequences for constituents in each type of bank.

In turn, the analysis of each one of the aforementioned attributes is carried out. The differences in these attributes are identified and described across corporate, co-operative, mutual and nonprofit banks. The chapter then explains if and how these structural differences matter for the design of financial regulation.

4.1. Legal Personality (Entity Shielding)

Incorporated and chartered banks typically have a standalone legal personality.[218] The same can be said of bank subsidiaries and affiliates that form part of a wider group comprised of different legal entities. Thus, legal personality cannot be considered to be an exclusive attribute of banks organized as business corporations, but is rather a common feature of several bank legal forms – including co-operatives, mutual and nonprofit associations.

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[217] In Henry Manne's words: '(…) the concept of limited liability also flows logically from the concept of the corporation as a capital-raising mechanisms'. See Henry Manne, 'Our Two Corporation Systems: Law and Economics' (1967) 53(2) Virginia Law Review 259.

[218] Bank branches and unincorporated representative offices are typical exceptions to this.

Having a stand-alone legal personality implies being a 'subject of law' – or put differently, having rights and obligations, being able to own property, capacity to enter into contracts, having standing to sue and be sued in court, etc. It also entails that incorporated banks have a different legal personality to their employees, managers and their residual owners[219] (eg shareholders in the case of corporate banks, and depositors-members in the case of co-operative and mutual banks). In other words, incorporated banks have their own identity, which is different to the identity of other entities within a banking group. Legal personality allows different constituents to use a bank as a 'common contracting party'.[220]

Treating banks – and entities in general – as *persons* is often described as a 'legal fiction' or convention that results from organizational laws, like corporate statutes, co-operative laws or the laws of mutual associations. Eric Orts considers that: 'firms exist as legal "entities" and "persons" because statutes and courts have recognized them as such for centuries and continue to do so today in almost all modern societies'.[221] As Orts adds, in spite of the use of the term 'fiction', the consequences of the recognition of banks as persons are very real.[222] Once a group of constituents – like shareholders or members – follow the rules to incorporate a joint-stock company or mutual association, and that entity then obtains a charter or license as a credit institution, the resulting bank operates as a distinct person, legally recognized by depositors, other banks, regulators, supervisors, courts, etc.[223]

According to one strand of the law and economics literature, organizational laws provide two important functions. Firstly, organizational laws create a menu of different types of off-the-rack standard forms that allow economic agents to organize their enterprises and be recognized as standalone subjects of law, which can enter into contracts and own

[219] Bainbridge (n 120) 2. The seminal case in English Law that recognizes the separate and distinct legal personality of corporations and their owners is *Salomon v Salomon* & Co. [1897] AC 22 HL.
[220] A concept used by Hansmann, 'Ownership and Organizational Form' (n 148) 6.
[221] Eric W Orts, *Business Persons: A Legal Theory of the Firm* (OUP 2013) 28.
[222] ibid.
[223] Orts (n 221) 32.

property.[224] Secondly, organizational laws allow establishing patterns of creditors' rights over the assets of a firm.[225] Typically, these contractual and ownership patterns are deviations from the default rules of creditor rank under the existing legislation. This is called 'entity shielding' or 'affirmative asset partitioning' in the literature.[226] Entity shielding is an economic consequence of having a legal personality. Together with limited liability (also called 'owner shielding' or 'defensive asset partitioning'), entity shielding forms the 'asset partitioning' framework.[227]

In the words of Hansmann and Kraakman, entity shielding: '(…) not only assigns to the corporation's creditors a prior claim on corporate assets, but also provides that, if a shareholder becomes insolvent, the shareholder's personal creditors cannot force liquidation of corporate assets to satisfy their claims upon exhausting the shareholder's personal assets'.[228] According to the 'asset partitioning' framework, two consequences stem from entity shielding: 'creditor priority' and so-called 'liquidation protection'. In turn, both creditor rank and liquidation protection are analyzed for the specific case of bank legal forms.

R. Kraakman et al., explain that having a standalone legal personality implies: '(…) the demarcation of a pool of assets that are distinct from the assets owned, singly or jointly, by the firm's owners'.[229] For banks, entity shielding means that the assets of the banks

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[224] The seminal article presenting this framework is Henry Hansmann and Reinier Kraakman, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387. Further building blocks are found in Henry Hansmann and Reinier Kraakman, 'Organizational Law as Asset Partitioning' (2000) 44 European Economic Review 807; Henry Hansmann, Reinier Kraakman and Richard Squire, 'Law and the Rise of the Firm' (2006) 119 Harvard Law Review 1333; Henry Hansmann, Reinier Kraakman and Richard Squire, 'The New Business Entities in Evolutionary Perspective' (2007) 8 European Business Organization Law Review 59. See also H Hansmann and U Mattei, 'The Functions of Trust Law: A Comparative Legal and Economic Analysis' (1998) 73 New York University Law Review 434. See also: Henry Hansmann and Richard Squire, 'External and Internal Asset Partitioning: Corporations and Their Subsidiaries' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (forthcoming OUP 2017).

[225] ibid. See also Bainbridge (n 120) 3.

[226] ibid.

[227] ibid.

[228] Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n 224).

[229] Kraakman et al., *The Anatomy of Corporate Law* (n 137) 6.

are different to the assets and the property of their residual owners – eg shareholders, in the case of corporate banks, or depositors-members, in the case of mutual and co-operative banks.[230] While for the case of nonprofit or savings banks, partitioned assets have no owners, but rather beneficiaries or beneficial owners (or can be seen as being self owned from the perspective of the nonprofit bank).[231] In any case, such assets are distinct from the assets of a nonprofit bank's founding patrons and also to the property of their beneficiaries or beneficial owners.

The creditor priority that results from 'entity shielding' is also relevant when referring to cross-border banking groups, comprised of multiple standalone legal entities that can be incorporated in different jurisdictions.[232] Each legal entity within a group will be entitled to its own assets and will have its own priority of creditors with varying hierarchies. In principle, the assets of each entity are preferentially 'pledged' for that entity's creditors – shielding such assets from the claims of the creditors of other group entities (including parent and *sibling* entities) as well as from the claims of the creditors of their owners, directors and managers. Thus the entity shielding (priority and liquidation protection) that results from having a legal personality is an important organizational feature that can have significant legal and economic consequences relevant to cross-border bank resolution processes, as well as for several structural banking reforms – like bank ring-fencing proposals in the UK (as further discussed in chapters five and six, respectively).

In spite of entity shielding being a common feature of all major bank organizational forms, creditor rank or priority rules vary across different types of banks. This is because the constituents for different types of bank legal forms also vary. For example, corporate banks have shareholders as residual owners (including common and preferred shareholders) alongside creditors (secured and unsecured) – and depositors (a special type of unsecured bank creditor).

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[230] Kraakman et al. state that this creditor priority rule is 'shared by all modern legal forms for enterprise organization'. ibid 7.
[231] Hansmann, 'Ownership and Organizational Form' (n 148).
[232] For a recent discussion of the implications see Hansmann and Squire 'External and Internal Asset Partitioning' (n 224).

On the other hand, in the case of co-operative and mutual banks there is a conflation between residual owners and depositors – implying that the creditor rank in these customer-owned entities is different to the creditor rank that corporate banks exhibit. The same applies to nonprofit banks that have no residual owners. These differences are further discussed under section 4.3 below.

Moreover, creditor rank can also be altered through legal rules that explicitly change the loss-bearing order of different bank constituents. Creditor rank can sometimes also be contractually agreed (eg offer and subscription of subordinate bonds).

The second consequence that stems from entity shielding is 'liquidation protection'. In the context of banks – and paraphrasing the language used by Hansmann and Kraakman – liquidation protection implies that if a bank's owner (ie an investor, a holding or parent company) or other group entities become insolvent, the owner's personal creditors (or the personal creditors of other group entities) cannot force liquidation of the bank and its assets in order to satisfy their claims once the owner's assets have been exhausted.[233]

A stylized example could further help explain how creditor rank and liquidation protection play out in the case of cross-border banking conglomerates. Assuming that 'XYZ Bank Holding Company' wholly owns and operates three incorporated banking subsidiaries across different countries: 'X Bank Plc', 'Y Co-operative Bank' and 'Z Bank Limited'. Figure 2 depicts the simplified organizational chart of XYZ Bank Holding Company.

Each one of the four legal entities in this example has its own hierarchy of personal creditors, which can include (insured and uninsured) depositors, bondholders, central banks, etc. Thus if 'X Bank Plc' enters into financial distress and ceases to honor its deposits, unpaid depositors cannot expect 'Z Bank Limited' to payout their deposits – even taking into account that both entities are part of the same banking group. Thus, the

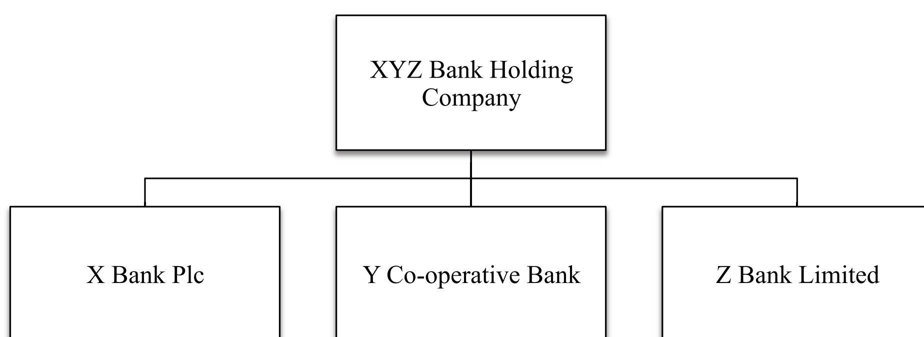
[233] Hansmann and Kraakmann, 'The Essential Role of Organizational Law' (n 224).

assets of 'Bank X plc' serve to bond its obligations *vis-à-vis* its depositors and creditors, while the assets of 'Z Bank Limited' are pledged for the benefit of its own creditors.

Turning to liquidation protection, and using the same setup, if 'XYZ Bank Holding Co.' enters into financial distress, its unpaid creditors cannot forcibly liquidate its banking subsidiaries in order for 'XYZ Bank Holding Company' to get its residual property back (assuming a positive residual value) and then trying to claim that residual value in order to satisfy existing debts. In that way, the assets of a legal entity are protected (for the benefit of its own creditors) against forced liquidation for the sole purpose that its owners' creditors can satisfy their claims.

Figure 2

Liquidation Protection and Creditor Rank



4.2. Limited Liability (Owner Shielding)

Limited liability has always been considered to be a salient feature of the business corporation, since it originally became commonplace in corporate statutes around the mid

19th century.[234] Limited liability has been called a 'fundamental principle of corporate law'[235] – especially with the objective of better distinguishing the corporation limited by shares from other competing business forms that lacked this feature, such as unlimited liability general partnerships and sole proprietorships.[236] Thus, limited liability has been extensively studied in the context of corporate law.

When referring specifically to banks and their constituents, limited liability 'is an attribute of the investment' rather than of the entity.[237] It entails that residual owners (eg shareholders and depositors-members) are not liable for banks' debts. Unless the law or courts allow it, bank creditors cannot try to satisfy their claims against a bank's owners.[238] However, banks' residual owners are not the only investors that benefit from limited liability. Fixed claimants, like unsecured depositors and bondholders, only risk losing whatever amount they have invested in a bank.

Limited liability is a feature shared by co-operative, mutual and nonprofit banks. When a co-operative or a mutual bank's liabilities exceed its assets, its depositors-members typically do not have a legal obligation to respond to the entity's creditors with their personal assets.[239] Attempting to collect debts owned by a co-operative or a mutual bank

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[234] Since the XVI century special statutes granted limited liability to companies and guilds chartered by monarchies for conducting business, trade and exploration in overseas territories (eg The East India Company), it took several centuries for limited liability to become readily available to all incorporated entities. Such was the case of the limited liability partnership (*en commandite*) in the French *Code de Commerce*, the first limited liability company statute in New York in 1811, and the Limited Liability Act 1855, in Britain. See Christine E Amsler, Robin L Barlett and Craig J Bolton, 'Thoughts of Some British Economists on Early Limited Liability and Corporate Legislation' (1981) 13 (4) History of Political Economy 774. See also S M Bainbridge and M T Henderson, *Limited Liability: A Legal and Economic Analysis* (Elgar 2016),

[235] Frank Easterbrook and Daniel Fischel, 'Limited Liability and the Corporation' (1985) 52 University of Chicago Law Review 89.

[236] Roberta Romano, *Foundations of Corporate Law* (2nd edn, Lexis Nexis 2013) 61.

[237] Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1996) 11.

[238] A discussion on 'corporate veil piercing' and other exceptions to the limited liability of banks is included under chapter six.

[239] For some unlimited liability co-operatives, members can be jointly and severally liable for the co-operative's debts.

from depositors could be prohibitively expensive or simply unfeasible.[240] Depositors-members could be geographically dispersed or insolvent.[241] What is more, depositor protection insurance schemes, which are commonplace in many jurisdictions, tend to further safeguard depositors – who residually own co-operative and mutual banks – from losses. Thus there is a certain duality regarding whether depositors-members in mutual and co-operative banks should be treated like residual owners or as insured creditors. The same can be said of nonprofit banks, which by definition lack owners for creditors to chase, but that have directors and can also have beneficiaries.

The fact that most corporate, mutual, co-operative and nonprofit banks enjoy limited liability has several implications. Foremost, from the academic literature it is well established that limited liability can potentially externalize risks[242] and can also be a source of moral hazard for firms' residual owners and managers.[243] Owner limited liability ('owner shielding') shifts some of the risk of business failure to creditors.[244] The aforementioned externality problem can affect banks' involuntary creditors the worst – eg deposit insurers and taxpayers in the case of bank bailouts – because unlike bank bondholders or depositors, they have not consented (*ex ante*) to shouldering the costs of bank failure.

The externality and moral hazard problems previously discussed can be exacerbated by banks' leverage structures and the 'too-big-to' set of problems ('too-big-to-fail', 'too-big-to-save', 'too-big-to-resolve', etc.) that have become prominent in recent years. Leverage refers to how much debt (borrowed funds) banks have in proportion to the amount of their own funds – or 'bonding assets' contributed by banks' owners. Excessive leverage

[240] While referring specifically to investors in public corporations, Henry Manne stated: 'There are practical difficulties as well, since the costs involved in assessing and collecting fractional liabilities from large numbers of small investors might frequently be greater than the anticipated recovery'. The preceding analysis can also be extended to the case of depositors-members in co-operative and mutual banks. See Manne (n 217).
[241] ibid. The same reasoning applies to shareholders in corporate banks.
[242] Romano (n 236).
[243] ibid.
[244] Easterbrook and Fischel 'Limited Liability and the Corporation' (n 235). See also Manne (217).

occurs because banks fund themselves mainly with deposits and other liabilities, and they often have a larger amount of borrowed funds than the sum of their own funds (capital). As C Hadjiemmanuil argues, as a bank's equity is depleted (its net worth approaches zero) the shareholders, owners and managers 'could have incentives lead them to gamble for resurrection, because they have very little to lose and everything to gain by speculating with the resources still left under their control'.[245]

Limited liability also has benefits. It is generally considered to reduce the cost of capital for public corporations and allows for risk diversification.[246] These benefits are closely linked to how residual property and income stream rights are legally characterized and whether they are transferable or not. For example, the fact that the capital of publicly owned corporations is divided into transferable securities called shares, means that these shares can be listed and traded in securities markets.[247]

Co-operative banks can also have their capital divided by shares (or other types of ownership units), but these shares are often not assignable and are also subject to particular voting rules – like the 'one-vote-per-member' rule or capped voting rights at a maximum number of votes per member. The differences in the bundles of economic and political rights that shares in a corporate bank and shares in a co-operative bank have, imply different incentive structures for the owners of each type of entity – as is further discussed under section 4.3.

The previously described situation contrasts sharply with the situation of mutual and nonprofit banks. In the case of mutual banks (eg building societies), which often do not issue shares, ownership is characterized by keeping a minimum balance deposited with the bank during a particular timeframe. Deposits are not transferable in the same way that

[245] Christos Hadjiemmanuil, 'Special Resolution Regimes for Banking Organizations: Objectives and Limitations' in Wolf-Georg Ringe and Peter M Huber (eds) *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation* (Hart Publishing 2014).
[246] Easterbrook and Fischel 'Limited Liability and the Corporation' (n 235).
[247] The shares of banks setup as close corporations are also transferable, but their transferability can be restricted in their bylaws or articles of incorporation (eg through preemption rights, rights of first refusal, etc.).

shares are (ie you cannot assign your savings account). On the far end of the spectrum, nonprofit banks, like the Spanish *cajas de ahorros*, lack owners. However, depositors and other beneficiaries are limitedly liable in those capacities.

Even though entity shielding and limited liability ('owner shielding') are both sides of the same 'asset partitioning' coin, they have very distinctive implications.[248] The difference between both types of asset partitioning lies in that: 'entity shielding protects the assets of the firm from the creditors of the firm's owners, while limited liability protects the assets of the firm's owners from the claims of the firm's creditors'.[249] This is why often entity shielding is described as the exact opposite of limited liability.[250]

When referring to the particular context of commercial banking, the latter differences can be characterized in the following way: entity shielding (legal personality) protects a bank's assets from the claims of the creditors of a bank's owners[251]; while the owner shielding provided by limited liability protects the property rights of a bank's owners (shareholders, depositors-members) from the claims of the bank's creditors. All of the identified organizational forms that are predominant in banking today have 'strong form' owner shielding and provide 'strong to complete levels' of entity shielding, according to the taxonomy used under the asset partitioning framework.[252]

However, as stated before, creditor ranks vary across bank legal forms and this should be taken into account whenever designing financial regulations that either hinge on or change these pecking orders.

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[248] Hansmann and Kraakman (n 224)
[249] Kraakman et al., *The Anatomy of Corporate Law* (n 137) 10.
[250] ibid. See also Hansmann and Kraakman (n 224).
[251] Owners are shareholders in the case of corporations and depositors in the case of co-ops and mutual societies.
[252] See Henry Hansmann, Reinier Kraakman and Richard Squire, 'Law and the Rise of the Firm' (2006) 119 Harvard Law Review 1333.

4.3. Shared Ownership by Contributors of Capital

As has been described in the preceding comparative analysis, the ownership structure of corporate and non-corporate banks is diverse. This is mainly because the legal characterization of residual ownership varies across different types of banks. Thus, examining the ownership structure of diverse bank legal forms can provide useful insights into the relationship between legal form and financial regulation.

Shareholders own both private and listed corporate banks. In the case of corporate banks, depositors and shareholders are typically two different groups of stakeholders. This means that there is a separation between 'ownership and consumption'.[253]

Shareholders are investors that contribute capital of the highest loss absorbency through the subscription of common or preferred (preference) shares. They can have a different risk profile to depositors. Common shareholders do not have a right to automatic income – like depositors and other fix claimants in corporate banks typically have. Thus, if dividends are not distributed, a corporate bank does not enter into default. Moreover, in many countries dividend payments are not tax deductible (while interest payments typically are).

Because of limited liability, bank shareholders have a 'loss floor' of a threshold of downside risk, but also an unlimited potential upside. This contrasts sharply with depositors, who are often (at least) partially insured. Banks can have several classes and types of shareholders – including those that own preferred (or preference) shares, which receive fixed dividends and are 'senior' (eg they get paid first) to common shareholders during liquidation and dividend payments (but are 'junior' to bank creditors, like depositors). Common shareholders are the last to get paid, *pro rata,* upon liquidation, should any residual value exist after all of a bank's creditors have been fully paid. Bank shareholders are also the first to endure the full brunt of losses whenever they occur.

[253] Henry Hansmann and Mariana Pargendler, 'The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption' (2014) 123 Yale Law Journal 948.

One cannot speculate nor generalize regarding the identities, characteristics and the risk profile of corporate banks' shareholders. Bank ownership can be at the hands of a reduced number of private investors (block-holders), wholly owned by a bank holding company, or it can be dispersed and atomized through small shareholdings across one or more jurisdictions. Bank shareholders can be individuals or small investors, but they could also be sophisticated institutional investors (like hedge funds, private equity funds, pension or sovereign wealth funds), a bank parent company or even a varying mix of different types of economic agents. Moreover, as investors, shareholders could either be risk neutral, risk loving or risk averse.

On the other hand, co-operative and mutual banks are owned by their depositors-members. Co-operative members can be fixed claimants (eg receive passive interest rate payments on their deposits) and at the same time can receive additional dividend payments whenever profits exist and are distributed. Co-operative [and mutual banks] are 'funded to a larger extent by retail deposits and to a lesser extent by wholesale funding in comparison with all other banks'.[254]

In the case of mutual associations, profits tend to accrue for the benefit of the bank's equity and are not distributed individually to depositors-members. In such cases, depositors-members typically get compensated through interest payments on their deposits – under market conditions that can be no more advantageous than the remuneration that depositors in corporate banks receive.[255] Unlike common shareholders – who do not have an automatic right to income – depositors have a legal recourse to claim interest payments when they are due.

[254] See Hans Groeneveld 'A Snapshot of European Co-operative Banking' (April 2016) 14 <http://www.globalcube.net/clients/eacb/content/medias/publications/annual_reports/20160411_HG_EACB_FINAL_Snapshot.pdf > accessed 6 December 2016.

[255] From the perspective of the bank, this characterization can also have some tax implications as interest payments are typically tax deductible, while dividend payments are not.

These differences between how ownership is legally characterized across different bank legal forms are subtle – but nonetheless – important. Mainly, they are important because they are directly linked to banks' capital structures and can also have implications for consumer protection. The identity of banks' owners can also be relevant when governments and politicians decide on whether to bailout banks or grant them other forms of state aid. For example, regulators could feel more inclined to inject capital into a bank owned by domestic pensioners than one owned by a foreign sovereign wealth fund.

A bank's capital structure refers to the mix of own funds (capital) and borrowed funds (liabilities) that they combine in order to conduct their activities. Residual owners – eg depositors, for customer-owned banks; or shareholders, in the case of corporate banks – endow banks with the capital and funds that they dedicate to their operations. Moreover, depositors (in corporate banks) and other types of creditors provide funds that form part of banks' liabilities. It is well known, that capital, liquidity and leverage are critical for banks.[256]

Moreover, as is further discussed in chapter four, when referring to banks, the word 'capital' carries a very specific meaning. It is more than just the difference between the assets and liabilities that appear in banks' balance sheets. Financial regulators and supervisors – under the influence of the Basel Committee – define what bank capital is. This definition has traditionally included both equity components – like common shares and retained earnings – as well as certain debt instruments, like subordinated (or 'junior') debt securities or contingent capital instruments ('CoCos').[257]

Capital formation, expansion and maintenance is directly linked to the legal characteristics of different bank organizational forms. It is often assumed that all banks issue *shares* or other types of securities that contribute to capital formation or that

[256] As is further analyzed in Chapter four, which studies the relationship between bank capital rules and ownership structure.

[257] CoCos are 'hybrid capital securities that absorb losses in accordance with their contractual terms when the capital of the issuing bank falls below a certain level'. See Stefan Avdjiev, Anastasia Kartasheva and Bilyana Bogdanova, 'Cocos: A Primer' (September 2013) BIS Quarterly Review 46. CoCos are further discussed in chapter 4.

facilitate raising capital. As has been discussed, mutual banks, for example, do not typically issue shares. Thus, different organizational features matter for designing financial regulations that do not distort competition or that could create an uneven playing field for some types of banks.

Moreover, the legal characterization of ownership interests is also linked to the position of different stakeholders in a bank's loss-bearing pecking order. Confusion or lack of knowledge regarding these issues can have implications for consumer protection. Depending of the type of bank in question, the distinction between what it means to be an insured depositor and an uninsured bank's residual owner can often be blurred. This confusion can be exacerbated across jurisdictions with different organizational legal frameworks, institutions – and even languages – as is the case of the EU's Single Market.

Recent historical examples of the latter issue can be found is the cases of demutualized British building societies and the transformed Spanish savings banks (*cajas de ahorros*) discussed at the beginning of the chapter. After demutualization, the members of UK building societies that accepted to exchange their deposits for shares went from being (at least partially insured) depositors to becoming uninsured shareholders. This change in their legal status meant that whenever losses occurred or a bank's stock dropped in value, their residual property rights would be affected. It also entailed that they no longer had rights to receive a fixed income for their ownership interest. The same analysis could be extended to the Spanish savings banks that transformed into corporate banks that then prompted customers to exchange their (partially) insured deposits for riskier securities, like preferred or common shares.

The preceding discussion on ownership structures also reveals different transaction costs between corporate and non-corporate banks. Corporate banks potentially carry higher transaction costs resulting from the conflicting and diverging identity and interests between owners (shareholders) and depositors. On the other hand, co-operative and mutual banks could purportedly benefit from transaction cost reducing 'unity of interest' through the conflation of owners and depositors and also through the 'common bond'

established as a prerequisite for membership.[258] According to the academic literature, unity of interests translates into reductions in transaction costs (governance and monitoring costs).[259]

However, there could be an upside to the duplicitous transaction costs that corporate banks seem to exhibit in terms of enhanced monitoring. This results from having two different groups of internal stakeholders (shareholders *and* depositors) purportedly observing the actions of managers and monitoring bank performance.[260] Co-operative and mutual banks do not receive the benefits from extra monitoring because of the conflation between owners and depositors, which implies that a single group of insiders (depositors-members) is in charge of the monitoring.

Another consequence of these ownership differences is that for customer-owned co-operative and mutual banks the protection offered by entity shielding is coupled to the governmental safety net offered by deposit protection insurance schemes. Such arrangements have become a common feature of many financial regulatory regimes – including all of the jurisdictions analyzed in this chapter.[261] The aforementioned elements entail that in the case of corporate banks, shareholders and depositors have limited exposure to losses resulting from bank insolvency.[262] While in the particular case of customer-owned co-operative and mutual banks, depositors-members, who are at the

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[258] Donald Wittman, *Economic Foundations of Law and Organization* (CUP 2006) 306-307.
[259] ibid.
[260] This analysis assumes that both shareholders and depositors have access to perfect and correct information and that they are sophisticated, interested and motivated enough to adequately monitor bank managers and their operations. Moreover, the moral hazard resulting from limited liability and deposit protection insurance could counteract their monitoring incentives.
[261] In the US, the FDIC standard insurance amount is USD 250,000.00 per depositor, per insured bank, for each account ownership category. Deposits in the EU are guaranteed pursuant to Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes. Before the onslaught of the financial crisis, deposits in the Eurozone were covered up to EUR 20,000. In 2010, the coverage was raised to EUR 100,000. In April 2014, the European Parliament adopted the Commission's proposal for a revision of the Directive 94/19/EC on Deposit Guarantee schemes. At the time of writing this review was still ongoing. In the UK, starting from 31 December 2010, the deposit compensation limit was GBP 85,000.
[262] In a corporate bank, shareholders' losses would be limited to the amount of their shareholding. Depositors would benefit from the threshold of insure amounts by the State, and would only suffer losses should their deposits exceed the insurable amount.

same time protected by deposit protection insurance, also benefit from a limited loss exposure.

This can be seen as two – slightly different – manifestations of moral hazard problems. The first case of moral hazard arises from organizational law and the owner shielding that limited liability provides. The second moral hazard problem develops from deposit protection insurance schemes. The combination that these two effects exert on members in a customer-owned co-operative or mutual bank could create incentives for them to neglect or reduce their efforts to monitor a bank's management. Moreover, deposit protection shifts residual risk bearing from the owners of customer-owned co-operatives, to the deposit insurer – and ultimately, to taxpayers. Because of the conflation between the identity of owners and depositors, the moral hazard problem affects the same group of people, potentially incentivizing member-depositor inertia. Whereas in the case of corporate banks, owners are affected by the moral hazard that stems from limited liability, while secured depositors can be affected by the moral hazard that originates from deposit protection insurance schemes.

Figure 3
FDIC Bank Claims Priority Structure
Under the 1993 National Depositor Preference
Amendment to the Federal Deposit Insurance Act

A practical example can help to better illustrate these different incentive structures and their economic consequences during bank insolvency procedures, commonly known as bank resolution.[263] Figure 3 depicts the bank claims priority structure in the US.

[263] A wider discussion on bank resolution is provided in chapter 5.

Shareholders are the residual claimants of a corporate bank– which means that they are entitled to receive any existing funds after all of the bank's liabilities are paid in full, according to the depicted order. Seen in the opposite sense, the pattern also shows that losses are first off-set against shareholders' equity. This means that bank shareholders are the first to suffer losses, but the last constituents to receive residual claims – should any exist – upon liquidation or after bank resolution.

This creditor rank is different for co-operative and mutual banks. Instead of being the first to take losses (like shareholders in corporate banks), depositors in co-operative and mutual banks are typically protected – up to a threshold – by deposit protection insurance. As a result, deposit insurance shields the owners of co-operative and mutual banks against certain losses. This protection essentially changes their loss-bearing order in the creditor rank (as will be further discussed under chapter 5). Borrowing Alan Parmiter's colorful terminology, it allows them to 'leapfrog from the back of the line to the front'.[264] This protection also shifts loss-bearing to other types of creditors – including taxpayers who have not consented *ex ante* to bailing out banks using public funds.

4.4. Shares, Transferability and Voting Rights

Bank legal forms provide different bundles or packages of property rights (financial and voting rights) for their constituents. As has already been discussed, the equity of corporate banks is divided into stocks or shares. Equity securities package some degree of basic common elements, like: transferability, voting rights, liquidation rights after bank dissolution, rights to dividend payments – as well as other rules like redemption and preemptive rights.

Common shares can be freely transferable (in the case of listed banks) or they can be transferable upon the adherence to certain rules contained in a corporation's by-laws or

[264] Alan R Palmiter, *Corporations* (7th edn, Wolters Kluwer 2012) 69.

articles of incorporation (eg in the case of close corporate banks). In some jurisdictions, co-operative banks also issue shares. While mutual associations and nonprofit banks are different in the sense that they do not issue shares – but can issue other types of securities that grant their holders different income stream rights, typically as fixed claimants and not as residual owners.

Voting rights can be subject to different rules.[265] Voting rights are associated to formal control, which allows owners to vote for the election of directors as well as deciding on the approval of other important matters, like amending a bank's articles of incorporation or corporate control transactions.

In order to better illustrate the differences between these ownership packages, one can refer to A. Hirschman's influential 'Exit, Voice and Loyalty' framework.[266] In particular, one can apply this framework to understand the choices that different bank stakeholders – like residual owners and depositors have – whenever they are not satisfied with management or they perceive a deteriorating quality in the services that they are receiving. According to Hirschman, owners could either 'exit' (by selling their shares or withdrawing their deposits) or they could express their dissatisfaction through their right to 'voice' concerns in general meetings (or other mechanisms).

Extending this framework to banks, 'voice' or voting rights are different across the identified organizational forms. In the case of public and close corporate banks, common stocks typically carry 'one-vote-per-share'. Thus, in principle, shareholders can increase their voting capacity by augmenting their shareholding.[267] Shareholders can increase their marginal voting rights by investing more money in a bank's capital.

[265] See generally David L Ratner, 'The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote"', (1970) 56 Cornell Law Review 1; Coleen A Dunlavy, 'Social Conceptions of the Corporation: Insights from the History of Shareholder Voting Rights' (2006) 63 Washington and Lee Law Review 1347; Hansmann and Pargendler 'The Evolution of Shareholder Voting Rights' (n 253).

[266] Albert O Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Harvard University Press 1970).

[267] Or through proxy voting, but this falls outside of the scope of analysis.

For co-operative banks, voting can be either on a *one-vote-per-member* basis or in other cases it can be granted on a *one-vote-per-share* basis – but is typically capped at a certain maximum number of votes per member (regardless of the amount that members have deposited in the co-operative bank). The rational behind this is that co-operatives are seen to be more democratic (eg less *plutocratic*[268]) than modern corporations and in order to prevent any one member from controlling the entity.

The same can be said of mutual associations, where voting rights are assigned contingent to the balance deposited with the bank during a particular timeframe. Voting rights are different in nonprofit banks, which lack residual owners and where decisions are often made by groups of different stakeholders – which can include depositors. Figure 4 graphically depicts the relationship between the number of votes and ownership interests across the three discussed types of voting rights rules.

Differences in voting rights (together with variations in economic or financial rights) imply diverging incentives for investment and ownership across organizational forms. This can be related specifically to deciding on important matters, like corporate control transactions, selecting board members and senior managers or investing additional capital whenever it is needed.

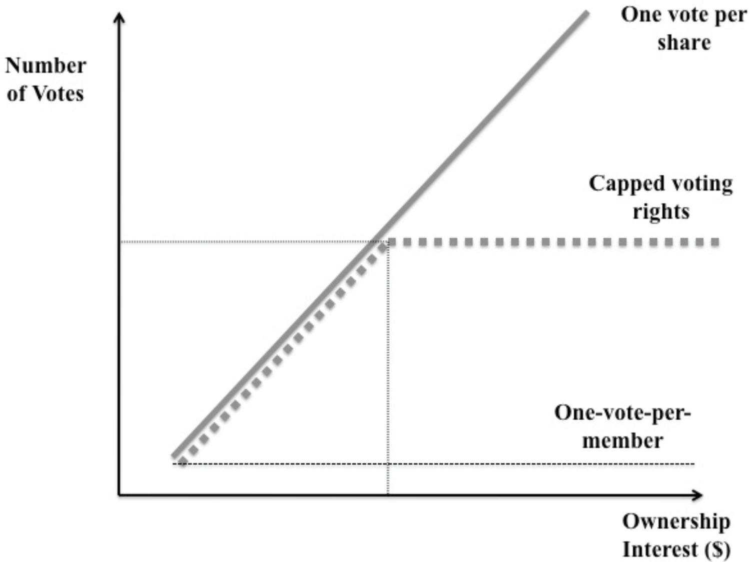
For example, investors in a listed corporate bank are aware that they could (in principle) increase their shareholding up to the required threshold for achieving corporate control. However, depositors in mutual and co-operative banks that are governed by different voting rules, might not have the same incentives to transact or deposit more money in a bank – particularly since it does not always marginally grant them greater voting power

[268] Henry Hansmann and Mariana Pargendler have argued that restricted voting rules in corporations 'generally served not to protect shareholders as investors, but to protect them as consumers' whenever they transacted with the firm. See Hansmann and Pargendler (n 253).

(more 'voice'). Thus, a 'one-vote-per-share' rule creates different incentives than a 'one-vote-per-member' or than a 'capped voting' rule.[269]

Figure 4

Bank Ownership and Different Voting Rules



Exit rights also vary across the studied bank legal forms. If shareholders (in both public and private corporate banks) cannot be influential by voting 'with their hands', they can opt to 'vote with their feet', and sell their shares.[270] One can assume that whenever shareholders sell their stock, they receive (at least) its fair market value at the time of the

[269] Another possible voting rule is what Henry Hansmann calls 'graduated voting': 'in which the number of votes exercisable by a single shareholder increased less than proportionately with the number of sharers owned'. See Hansmann and Pargendler (n 253).

[270] D Gordon Smith, 'The Role of Shareholders in the Modern American Corporation' in Claire A Hill and Brett H McDonnell (eds) *Research Handbook on the Economics of Corporate Law* (Edgar Elgar 2012) 52.

sale. Share transferability is often restricted in a co-operative bank. However, members can exit by withdrawing their deposits – getting to keep any recently paid out earnings.

In the case of mutual banks – where there are no shares and the bank's reserves and retained earnings do not accrue for the direct and individualized benefit of depositors, members can exit by withdrawing their deposits. The downside in these cases, however, is that their corresponding proportion in the accrued equity pool of a mutual bank cannot always be unlocked and withdrawn. Thus, residual or liquidation property rights are different for mutual banks, and unlocking this accrued equity pool has been identified as a potential incentive fueling demutualization processes.

Exit and voice are also different for nonprofit banks, which lack residual owners. Depositors and other beneficiaries typically do not have voting rights and they cannot appropriate the value that accrues to the banks' residual equity pools.

4.5. Centralized Management

Contemporary corporate, mutual and co-operative banks exhibit a separation between 'ownership and control'. While in the past, it was commonplace for some private and investment banks to be organized as partnerships (which conflate ownership and control), it has become increasingly less common. Bank management is normally delegated to a (single or dual[271]) board of directors, elected by banks' constituents. This separation also applies to 'ownerless', non-profit banks, where there is a separation between the banks' managers and directors, on the one hand, and their beneficiaries or beneficial owners, on the other.

[271] As Kraakman et al. specify, in some jurisdictions, corporate banks are governed by two-tier boards where 'top corporate officers occupy the board's second (managing) tier, but are generally absent from the first (supervisory) tier, which is at least nominally independent from the firm's hired officers'. See Kraakman et al. 'The Anatomy of Corporate Law' (n 137) 13.

As a consequence of this separation, banks are subject to many of the same tensions between different stakeholders that are ubiquitous in other firms. In spite of this, some commentators and policymakers have strongly argued that banks are different to other firms and that they require special governance rules.[272]

Moreover, when referring to bank corporate governance it is often neglected that banks are not always publicly traded companies. Thus, corporate governance is not only relevant for *corporate* banks. The OECD and the G20 recognize this omission in their 2015 Principles of Corporate Governance, when stating that: 'The Principles [of Corporate Governance] focus on publicly traded companies, both financial and non-financial (…)' and that 'to the extent that they are deemed applicable, they might also be a useful tool to improve corporate governance in companies whose shares are not publicly traded'.[273] The latter can also be applied to the case of non-corporate banks.

Bank corporate governance issues have received increased attention after the onslaught of the latest financial crisis.[274] Some issues that have received widespread attention include: the compensation and qualifications of executives, board members, senior – and even junior employees (like traders and relationship managers)[275], misaligned incentives between different stakeholders, risk management and financial crime compliance, etc.

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[272] See Marco Becth, Patrick Bolton and Ailsa Röell, 'Why Bank Governance is Different' (2012) 27 (3) Oxford Review of Economic Policy 437; Peter O Mülbert, 'Corporate Governance of Banks' (2009) 10 European Business Organization Law Review 411. Mülbert considers that: 'The economics and functions of banks differ from those of industrial firms (…)' and that 'these differences are reflected in corporate governance practices observed in the banking sector and in theoretical works on "the good corporate governance of banks"'.

[273] G20/ Organization for Economic Cooperation and Development (OECD), *Principles of Corporate Governance* (2015).

[274] See Hamid Mehran, Alan Morrison, and Joel Shapiro, 'Corporate Governance and Banks: What Have We Learned from the Financial Crisis?' (2011) Federal Reserve Bank of New York Staff Reports n 502 <https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr502.pdf> 6 December 2016.

[275] Mülbert (n 272).

As a response to the financial crisis, in 2010 the Basel Committee on Banking Supervision (BCBS) presented a third version[276] of its 'Principles for Enhancing Corporate Governance'.[277] In 2015, the BCBS revisited corporate governance issues and published its 'Corporate Governance Principles for Banks' in order to take account of connected work that had been carried out by the Financial Stability Board (FSB).[278]

The Basel Committee recognizes that its principles draw from the OECD's corporate governance guidelines. The latest version of the BCBS's 'Corporate Governance Principles for Banks' echoes the OECD's definition of corporate governance. Consequently, the principles come across as having been developed with corporate banks in mind. Differences in bank legal form are not explicitly taken into account. However, the Basel Committee does recognize that 'there are significant differences in the legislative and regulatory frameworks across countries which may restrict the application of certain principles or provisions therein[279]' and that the principles are 'intended to guide the actions of board members, senior managers, control function heads and supervisors of a diverse range of banks in a number of countries with varying legal and regulatory systems, including both Committee member and non-member jurisdictions'.[280]

In spite of being subject to many of the same agency costs, different types of banks have also exhibited their own specific governance problems pursuant to the organizational differences described in this chapter. For example, the conflation of depositors and owners in co-operative and mutual banks, and their unity of interest, is a transaction-cost

[276] The Basel Committee first published guidelines regarding bank corporate governance in 1999. It later revised the principles in 2006. See Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organizations' (September 1999) and Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organizations' (February 2006) <www.bis.org/publ/bcbs122.htm> accessed 6 December 2016.
[277] Basel Committee on Banking Supervision, 'Principles for Enhancing Corporate Governance' (October 2010) < http://www.bis.org/publ/bcbs176.htm> accessed 6 December 2016.
[278] See Basel Committee on Banking Supervision 'Corporate Governance Principles for Banks' (July 2015) < http://www.bis.org/bcbs/publ/d328.htm> accessed on 6 December 2016. The FSB had issued its 'Thematic Review on Risk and Governance' in February 2013, after conduction peer reviews on corporate governance across countries.
[279] Basel Committee on Banking Supervision, Corporate Governance Principles for Banks' (n 278) par 15.
[280] ibid.

reducing feature that is absent in corporate banks. Moreover, the fact that nonprofit banks are ownerless and depositors lack voting rights entails that they are prone to fall pray to self-perpetuating boards of directors. These are slightly different agency costs to the principal-agent problems that can occur in corporate banks, for example, because the voting rules are different in both types of organizations. Thus, the preceding analysis helps shed some light to the differences between bank organizational forms.

4.6. Summary

Table 3 presents and summarizes some of the main findings regarding the attributes of different bank legal forms. The table is intended to show a general anatomy of bank legal forms. Partnerships are included in this table in order to contrast how some of the studied features vary across other forms of business organization.

The variations across organizational attributes can help identify why the design of financial regulation needs to take legal form into account. The main differences across bank legal forms are: (1) the identity of banks' residual owners (eg whether they are shareholders, depositors or ownerless); (2) the legal rules underpinning different packages of banks' property rights (eg financial rights, capital structure, transferability and voting rules); and (3) the differences in the creditor rank that results from entity shielding.

The abovementioned features vary across bank legal forms. Moreover, they can be linked to financial regulation. For example: capital, liquidity and leverage rules dictate banks' capital structures. Moral hazard inducing deposit protection insurance schemes might be duplicitous when there is a conflation between bank owners and depositors. Creditor rank is bound to be important during bank resolution. And the liquidation protection and creditor rank that results from entity shielding can become a problem for multiple point of entry (MPE resolution). These scenarios are explained with a greater level of detail in the following chapters.

Table 3

Summary of the Main Attributes of Bank Organizational Forms

Ownership Features	Corporate Banks	General Partnerships	Mutual Banks	Co-operative Banks	Nonprofit Banks
Level of Entity Shielding	Strong entity shielding with liquidation protection	Weak entity shielding and weak liquidation protection	Strong entity shielding with liquidation protection	Strong entity shielding with liquidation protection	Complete entity shielding
Level of owner shielding	Strong owner shielding	Weak owner shielding	Strong owner shielding	Strong owner shielding	Lack owners
Property Alienability	Capital is divided into transferable shares	Capital is represented by ownership interest with restricted alienability	All members jointly own capital. Depositors can only withdraw their savings	Capital is sometimes represented by shares. However, they are not always transferable Members can withdraw their deposits	No ownership Depositors can withdraw their savings

Ownership Features	Corporate Banks	General Partnerships	Mutual Banks	Co-operative Banks	Nonprofit Banks
Identity of Residual Claimants	Shareholders	Partners	Members are joint residual claimants	Members have residual property rights	No one owns residual assets
Effective Control	Delegated management Board members need not be shareholders	Partners manage the business	Delegated manageme nt Board members need not be depositors	Delegated management Board members often required to be members for a predetermined timeframe before tenure	Delegated management Self-perpetuating boards of directors
Ownership	Investor ownership	Employee ownership	Depositor joint ownership	Member ownership Members can be depositors, borrowers or both	Unowned

Ownership Features	Corporate Banks	General Partnerships	Mutual Banks	Co-operative Banks	Nonprofit Banks
Formal Control	One vote per share	One vote per partner	Voting assigned to members according to their contributions (usually one vote per member or capped to a specific amount of votes per person according to deposits)	One vote per member	Voting rights assigned to governing bodies

5. CONCLUDING REMARKS

This chapter set out to answer two main questions: first, how are banks legally organized in certain leading jurisdictions? And secondly, if and how the attributes of existing bank organizational forms vary and can interfere with financial regulation? In order to answer both questions, the study first conducted a comparative functional analysis of the leading bank organizational forms in the European Union (EU), France, Italy, Spain, the United Kingdom and the United States. The study then compared the features of the identified existing bank legal forms against the foil of the corporate bank.

There are three predominant categories of bank organizational forms in the studied countries. These are: (1) investor-owned business corporations, (2) customer-owned mutual and co-operative associations (including credit unions); and (3) 'ownerless', nonprofit savings banks. Although these legal forms are functionally equivalent, they have specific and sometimes different attributes that result from national (and supranational) organizational laws.

Across the examined jurisdictions, leading bank organizational forms share some common features and attributes – like limited liability and delegated management. These features are explained with detail throughout the discussion.

However, the main insights from the comparison result from the differences across the attributes of bank legal forms. These differences are: (1) the identity of banks' residual owners (eg whether they are uninsured shareholders, insured depositors or lack owners); (2) the legal rules underpinning different packages of banks' residual property rights (eg financial rights, capital structure, transferability and voting rules); and (3) the differences in the creditor rank that results from entity shielding (further discussed in chapter 5).

There is a connection between a firm's ownership legal form and its capital structure. For example, in the case of corporations, residual ownership resides with shareholders. Shares or stocks represent shareholders' ownership interests. However, as this chapter described, banks are not always corporations, and consequently, not all banks issue common shares. This can result in some challenges for non-corporate banks because the most recent capital, liquidity and leverage standards (commonly known as 'Basel III') rely on common shares as the main source of loss absorbency. In turn, the next chapter analyses the linkage between organizational forms and bank capital requirements.

Chapter Four

Capital and Liquidity Standards: Does One-Size-Fit-All Types of Bank Organizational Forms?

SUMMARY

Do existing international bank capital and liquidity standards take into account the different ways that banks are legally organized around the world? This chapter examines the link between capital requirements and bank organizational forms. The main question it seeks to answer is whether capital requirements take into account the fact that – across jurisdictions – banks are organized using different legal forms. The chapter finds that the leading capital standards promoted in the Basel Accords seem to mainly target corporate banks. This design can give rise to uncertainty, inconsistencies, lacunae and implementation gaps whenever applying bank capital requirements to non-corporate banks in different countries. Moreover, it can also create an 'uneven playing field' between corporate and non-corporate banks. The analysis focuses on bank capital requirements and organizational forms in the European Union (EU). In the aftermath of the latest financial crisis, the reform of bank capital and liquidity rules has been one of the main responses for revamping global financial regulation. Capital requirements aim to curb excessive risk-taking and the moral hazard of too-big-to-fail banks, as well as to avoid publicly funded bailouts and implicit State guarantees. Since 1988, the world's capital standards are mainly specified by the Basel Committee on Banking Supervision (BCBS) – arguably one of the most important and influential standard setting bodies for all things related to international banking regulation. The latest version of the standards, known as Basel III, have been implemented in the EU through the Capital Requirements Regulation (CRR) and the Directive on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms (CRD IV). The chapter examines how the most recent redefinition of regulatory capital, in particular the so-called Common Equity Tier 1 capital (CET 1), seems to be primarily

designed for banks organized as companies limited by shares (joint stock companies). The chapter argues that when designing international standards and rules, financial regulators and international financial standard setting bodies should take heed and pay greater attention to the variety of bank organizational forms that exist in different jurisdictions.

KEYWORDS: Basel III, bank capital requirements, CET1, Co-operative banks, mutual banks.

‘When new regulation is being drafted by officials that have mainstream banks in mind, they don’t think about co-operative banks’. [281]

Arnold Kuijpers,

DIRECTOR CORPORATE AFFAIRS OF RABOBANK

‘Simply learning the precise meanings of some of the terms that are used, such as the word “capital”, can help uncover some of the nonsense’.[282]

Anat Admati and Martin Hellwig

The Bankers’ New Clothes (PUP 2013)

1. INTRODUCTION

Bank capital and liquidity requirements are one of the main items in the ongoing agenda for revamping international financial regulation. During the 2007-2008 financial crisis, pre-existing bank capital and liquidity levels were widely regarded as having been insufficient to effectively absorb the losses that were experienced throughout the sector.[283] Banks were also heavily leveraged, both on and off their balance sheets. Consequently, when losses materialized, many governments had to intervene in order to provide banks with capital and liquidity through State aid and other forms of implicit and

[281] ‘Leaders Discuss New Regulations at European Co-operative Banks Convention’ *International Co-operative Alliance* (December 2012) <http://ica.coop/en/media/news/leaders-discuss-new-regulations-european-co-operative-banks-convention> accessed 6 December 2016.

[282] Anat Admati and Martin Hellwig, *The Bankers’ New Clothes: What’s Wrong with Banking and What to Do About It* (Princeton University Press 2013).

[283] Some examples include: investment bank Lehman Brothers, Washington Mutual, UBS, Hypo Real Estate, Dexia, Royal Bank of Scotland group (RBS) and Lloyds TSB. The last five entities listed received governmental bailouts. Rossignollo et al. consider that: ‘(…) capital shortages verified in most financial institutions represent one of the most pernicious effects to be dealt with’. See Adrian F Rossignollo et al., ‘Market crises and Basel capital requirements: Could Basel III have Been Different? – Evidence from Portugal, Ireland, Greece and Spain (PIGS)’ (2013) 37 Journal of Banking and Finance 1323.

explicit guarantees.[284] All of this ultimately exposed taxpayers to the losses that stemmed from the financial system.

The large size of the banking system relative to GDP in many countries raised questions regarding some governments' availability to provide credible support during times of crises. While some banks in the USA were regarded as 'too-big-to-fail' (or 'too-systemic-to-fail'[285]), in other jurisdictions – including several European countries – banks were simply 'too-big-to-save'.[286] As J. Gordon and Georg Ringe have pointed out, this implied that many governments could not always credibly afford to bailout their biggest banks in the event of failure.[287] In some case, it simply was prohibitively expensive to do so given that aggregate assets in the banking system sometimes represented a significant share of – or even exceeded – a country's GDP.

The situation previously described highlights several vulnerabilities affecting the financial sector in the onslaught of the crisis. Foremost, the existing capital rules – based on the consensus of the 'Basel Accords' – proved to be in need of substantive reforms. Secondly, banks having insufficient capital levels could incentivize excessive risk taking, fueling moral hazard and further eroding market discipline. Moreover, as was witnessed in several European countries after the impact of the 2007-2008 economic meltdown, a large banking crisis can also have a negative impact on public finances. Consequently, it is understandable why reforming capital and liquidity standards has become an important response to the most recent financial crisis.

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[284] For example, the US implemented its 'Troubled Asset Relief Program' (TARP), which originally authorized expenditures of up to USD $700 billion. The authorized amount was later reduced to USD $475 billion by the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank Act').

[285] A concept coined by then economist and professor – and now Governor of the Reserve Bank of India – Raghuram Rajan. See Raghuram G Rajan, 'Prepared Statement for the Regulation and Resolving Institutions Considered "Too Big to Fail" Hearing before the United States Congress Senate Committee on Banking, Housing, and Urban Affairs' (May 2009).

[286] Jeffrey N Gordon and W Georg Ringe, 'Bank Resolution in Europe: the Unfinished Agenda of Structural Reform', in Danny Busch & Guido Ferrarini (eds), *European Banking Union* (OUP 2015).

[287] ibid.

Capital adequacy and liquidity requirements are at the heart of the still ongoing policy debates for revamping banking regulation. Needless to say, this does not mean that capital and liquidity requirements are expected to solve all of the problems experienced during the latest financial crisis. As Prof. Rosa Lastra has rightly pointed out in the past – in spite of their central importance – capital and liquidity standards are 'no panacea'.[288] Other factors are also important, such as: the quality of banks' assets, the nature of banks' liabilities, their off-balance sheet activities and the competence and compensation of their directors, managers and employees.

Nevertheless, revamping capital, liquidity and leverage requirements is still regarded as being important. If capital rules are too lax, banks and their stakeholders might not have enough incentives or 'skin-in-the-game' to curb moral hazard and avoid excessive risk-taking. On the other hand, there is widespread concern that if the capital rules are too stringent or their unintended consequences are disregarded, they could hamper growth by affecting lending to households, firms and infrastructure projects that have financing needs.[289]

After the onslaught of the 2007-08 global financial crisis many major jurisdictions – led by international financial standard setting bodies, like the Basel Committee on Banking

[288] Rosa M Lastra, 'Risk-based Capital Requirements and their Impact upon the Banking Industry: Basel II and CAD III' (2004) 12 Journal of Financial Regulation and Compliance 225.

[289] The European Commission and the Basel Committee have expressed their concerns about this tradeoff. On 15 July 2015, the European Commission launched a 'Public Consultation on the possible impact of the CRR and CRD IV on bank financing of the economy'. Moreover, the Basel Committee and the Financial Stability Board (FSB) have also launched a 'Macroeconomic Assessment Group' for evaluating the macroeconomic impact of the transition to stronger capital and liquidity requirements. See Macroeconomic Assessment Group, 'Final Report: Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements' (December 2010) <http://www.bis.org/press/p101217.htm> accessed 6 December 2016. Some academics – such as Admati and Hellwig – are critical of these purported tradeoffs between higher capital requirements and reduced lending that could potentially dampen the economic recovery. See generally Admati and Hellwig (n 282) chs 6, 11. See also Ana Admati and Martin Hellwig, 'The Parade of Bankers' New Clothes Continues: 28 Flawed Claims Debunked' (2014) Working Paper n 3031 <https://www.gsb.stanford.edu/faculty-research/working-papers/parade-bankers%E2%80%99-new-clothes-continues-23-flawed-claims-debunked> accessed 6 December 2016.

Supervision[290] ('BCBS' or the 'Basel Committee') – started to overhaul the existing bank capital standards. Since 1988, the BCBS sets out the main capital and liquidity standards. The Basel Committee is arguably one of the most influential global standard setting bodies for financial regulation of the last decades. The latest version of the revised Basel Accords that is currently being implemented is widely known as 'Basel III'.

This chapter examines the links between capital standards and banks' legal structures. The chapter's main research question is whether capital requirements entirely take into account the fact that across jurisdictions banks are organized using several different legal forms. The chapter finds that the leading capital standards promoted in Basel III seem to mainly target corporate banks. This conclusion is largely due to the fact that some commonplace organizational forms do not issue common shares. The analysis focuses on bank capital requirements and organizational forms in the EU. The chapter argues that implementation gaps, legal uncertainty, regulatory lacunae and divergent and inconsistent approaches could persist regarding capital and liquidity standards should financial regulators and international standard setting bodies fail to take organizational differences into account when designing and putting such rules into practice.

The rest of the chapter is divided into four additional sections. The second section presents a brief overview of the first two Basel Capital Accords. The third section explores Basel III and some of the new tools and measures that it introduces – with special attention to the concept of Common Equity Tier 1 capital ('CET 1'). The fourth section discusses the challenges that exist for defining CET 1 for non-joint stock banks. A final section summarizes the chapter's main findings.

2. BANK CAPITAL RULES: THE ROAD TO BASEL III

What is bank capital and why is it important? This section briefly discusses the rationale behind bank prudential regulation. It also seeks to provide a succinct background on the

[290] Chapter two provides a brief background on the Basel Committee on Banking Supervision (BCBS).

first two Basel Accords and their evolution. This preamble is relevant in order to explain how Basel III is different from its predecessors, but still does not sufficiently take into account the differences in bank legal forms across countries.

2.1. What is Bank Capital and Why is it Regulated?

Banks' total capital is a changing regulatory construct. Regulatory capital is different from shareholders' equity or capital according to conventional accounting terms. The latter is usually defined as the difference obtained by subtracting an entity's liabilities from its assets. On the other hand, regulatory capital also includes different types of securities – like subordinated debt and other financial instruments – which regulators count as capital for regulatory purposes.[291]

Regulatory capital is also different to bank reserve requirements.[292] As Admati et al. explain, while capital refers to the mix of funding that banks exhibit, '(l)iquidity or reserve requirements relate to the type of assets and asset mix banks must hold'.[293] Consequently, banks do not *hold* nor set capital aside. They simply have it – or not.

So what is bank capital and why is it so important to correctly define it? Regulatory capital refers to a certain mix of an entity's own funds, some types of borrowed funds and other liquid assets that regulators accept as capital because of their loss-absorbing features. Thus, regulators and financial standard setting bodies define what counts as

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[291] See Marco Pagano, 'Lessons from the European Financial Crisis' in Ester Faia, Andreas Hackenthal et al. (eds), *Financial Regulation – A Transatlantic Perspective* (Cambridge University Press 2015) 41-43. See also Kern Alexander, 'The Role of Capital in Supporting Banking Stability' in Niamh Moloney, Eilis Ferran, Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP 2015).

[292] Anat R Admati, Peter DeMarzo, Martin Hellwig and Pau Pfleiderer, 'Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Socially Expensive' (October 2013) <https://www.gsb.stanford.edu/sites/default/files/research/documents/Fallacies%20Nov%201.pdf> accessed 6 December 2016.

[293] ibid.

bank regulatory capital. Notwithstanding, shareholders' equity is still considered the superior form of regulatory capital.

Equity is essentially what banks' owners provide, as part of any entity's own funds, as well as future net earnings on those funds. Equity has always been considered to be a main component of regulatory capital. As opposed to banks' borrowed funds, like deposits, debt securities and central bank loans, which are considered to be insufficient and inadequate to curb excessive risk-taking (*ex ante*) and absorb losses (*ex post* whenever they occur).

There are several reasons why equity is widely regarded as bank capital of the highest quality. Firstly, equity holders absorb losses before any other claimants. Equity holders (residual owners) are the last to get paid whenever a bank is liquidated (assuming a positive liquidation residual value).

Secondly, equity holders are also last in line to receive income stream payments, once employees, creditors, taxes and other obligations have been paid. Unlike creditors, common equity holders do not have an automatic right to income (dividends) from a bank. This entails that management or regulators can restrict dividend payouts to owners without a bank entering into default. Moreover, because of affirmative asset partitioning (entity shielding) – specifically a feature called 'liquidation protection[294]' – banks' owners (or the owners' creditors) cannot simply deplete a bank's own funds at the expense of the bank's creditors. In other words, bank equity holders can only obtain liquidity by selling their shares to third parties via secondary markets. They cannot force a bank to repurchase their stocks nor to go into liquidation in order to pay them their residual share.

Daniel Tarullo identifies at least three main reasons why bank capital is regulated. He asserts that: '[p]olicymakers and commentators often begin a discussion of bank capital adequacy requirements by citing their role in providing a buffer against bank losses,

[294] Chapter 3 (sec 4) describes liquidation protection and the asset partitioning framework.

protecting creditors in the event a bank nonetheless fails, and creating a disincentive to excessive risk taking or shirking by bank owners and managers'.[295] Contemporary views boil down the need for capital to two main reasons: (1) as a check on moral hazard and risk taking, and (2) providing loss absorbency.

Capital adequacy has become a leading type of microprudential regulation designed in order to promote financial stability. It is generally assumed that some form of capital regulation is desirable because of banks' ownership and capital structures. The rest of the chapter assumes that banks' prudential regulation is socially desirable.

Banks are highly levered firms.[296] This is because banks have a greater proportion of borrowed funds than the amount of their own funds. Insured and uninsured deposits make up a significant part of banks' liabilities. Depositors, other creditors – and potentially, the deposit insurer – are all bank fixed claimants. For corporate banks, shareholders typically benefit from limited liability. Limited liability protects shareholders from losses in excess of their shareholding. The combination of limited liability, excessive leverage, the short term compensation of managers and deposit protection insurance could incentivize banks' managers to take on excessive risks in order to maximize shareholders' return on equity (ROE).[297] In other words, this combination can create a moral hazard problem.

For non-joint stock banks, the previously described effect varies slightly. Co-operative and mutual banks are owned by their depositors-members.[298] While non-profit banks have depositors, but no owners. In co-operative and mutual banks there is a conflation

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[295] Daniel Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Peterson Institute for International Economics 2008) 16.
[296] Pagano (n 291) 41.
[297] See Alexander (n 291).
[298] Across the EU some co-operative banks can also be organized as limited liability companies or joint stock companies owned by a co-operative parent institution. See European Association of Co-operative Banks (EACB), 'EACB Key priorities on the Capital Requirements Regulation (CRR) as regards Capital, Leverage Ratio and Liquidity; and on Capital Requirements Directive IV (CRD IV) regarding corporate governance' (February 2012) <http://www.globalcube.net/clients/eacb/content/medias/publications/position_papers/banking_legislation/120224_EACB_Key_priorities_CRR-CRD_IV__FINAL.pdf> accessed 6 December 2016.

between owners and depositors. For the depositors-owners of these types of non-joint stock banks, deposit protection insurance exerts similar effects to those that limited liability brings to bear to shareholders in corporate banks. This means that it limits potential losses and creates disincentives for depositors-members to monitor banks' managers and activities. In other words, it can also generate a moral hazard problem.

When banks are insufficiently capitalized, it means that they have low levels of own funds compared to their borrowed funds. As explained before, this can incentivize excessive risk taking at the expense of creditors and other types of fixed claimants. This is because leverage can potentially magnify both the upside and the downside of risk-taking.

2.2. How Much Capital are Banks Expected to Have?

Banks' regulatory capital under the Basel Accord is usually expressed as a percentage (eg 8%) of their risk weighted assets ('RWAs'). RWAs are different to the total assets that appear on banks' balance sheets. This is because RWAs represent only a fraction or percentage of a bank's total assets.

The rationale for using RWAs – instead of simply taking total assets from the balance sheet – is that every asset (ie loans, credit cards, mortgages, sovereign debt, buildings and premises) does not have the same risk profile.[299] Thus, depending of how risky their assets are, banks can adjust how much capital they need in order to absorb potential losses should they occur. Risk weighting is simply multiplying the value of the asset by a number between zero (0) and one (or 100%) – where a number closer to one implies a riskier asset.

Figure 5 depicts bank capital ratios to total assets – instead of RWAs – for several jurisdictions. The figure shows how for some countries, (except the US) the capital to

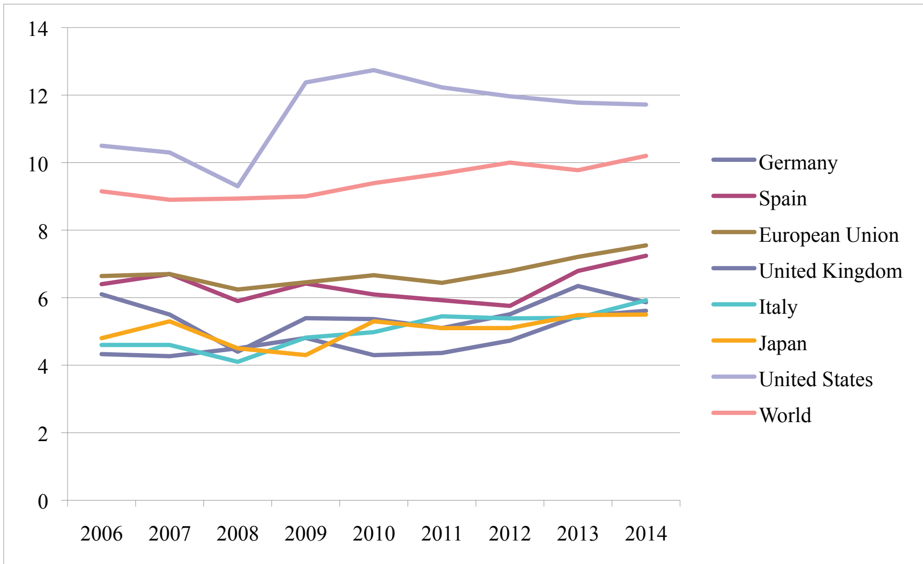
[299] For example, risk weighting allows accounting for the fact that cash would presumably have a lower risk profile than an investment in a public company's shares or than a mortgage.

total assets ratio is well below the 8% mark contained in the Basel Accords. Thus, measuring capital adequacy as a percentage of total assets instead of RWAs is a more stringent measure. More importantly, it also highlights that banks with capital ratios (capital to total assets) close to the 6% mark could have their equity wiped-out with a mere 6% reduction in the value of their assets.

Figure 5

Bank Capital to Total Assets Ratio[300] for Selected Countries

(Source: World Bank)



[300] For calculating this ratio the World Bank uses bank capital and reserves divided by total assets – and not as a percentage of risk-weighted assets (RWA). Capital and reserves include: 'funds contributed by owners, retained earnings, general and special reserves, provisions, and valuation adjustments. Capital includes tier 1 capital (paid-up shares and common stock), which is a common feature in all countries' banking systems, and total regulatory capital, which includes several specified types of subordinated debt instruments that need not be repaid if the funds are required to maintain minimum capital levels (these comprise tier 2 and tier 3 capital). Total assets include all nonfinancial and financial assets'. Source: World Bank.

2.3. Basel I and Basel II

It is widely agreed that: '[t]he international convergence of bank capital regulation started with the 1988 Basle[301] Accord on capital standards'.[302] One of the main drivers behind the adoption of the original Basel Accord was the claim of unfair competition by leading international banks across G-10[303] countries that were purportedly undercapitalized in comparison with some of their competitors.

The first Basel Accord was signed in July 1988, and was phased in by January 1993.[304] This Accord became widely known as Basel I. Basel I was promoted and signed by the G-10, and was intended to create a level playing field for the capital maintenance of internationally active banks.[305] Many countries worldwide eventually adopted Basel I, helping increase prudential requirements for banks across multiple jurisdictions.

Basel I required banks to have a target ratio of capital to RWAs set at 8%. Half of this requirement (50% or 4 percentage points) had to be in the form of core or 'Tier 1' capital (also called 'going concern capital'). The remaining half (50% or 4 percentage points) had to be in the form of 'Tier 2' capital (or 'gone concern capital'). Under Basel I, Tier 1 was comprised of: '(a) paid-up share capital/common stock; and (b) disclosed reserves'. While Tier 2 capital was comprised of: '(a) undisclosed reserves, (b) asset revaluation reserves, (c) general provisions/general loan-loss reserves, (d) hybrid (debt/equity) capital instruments, and (e) subordinated debt'.[306]

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[301] It is common for early documents from the BCBS and its predecessors to use the 'Basle' spelling. In contemporary documents and the media 'Basel' is widely used instead.
[302] Joao A C Santos, 'Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature' (2000) BIS Working Papers n 90 <http://www.bis.org/publ/work90.pdf> accessed 6 December 2016.
[303] At the time the BCBS was comprised of the Group of ten countries ('G10'): Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States, and also Luxembourg.
[304] Santos (n 302) 17.
[305] See Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' ('Basel I') (July 1988) para 3 <http://www.bis.org/publ/bcbs04a.htm> accessed 6 December 2016.
[306] Basel I App 1.

Moreover, under Basel I: 'on–balance sheet assets were assigned to one of four risk buckets (0%, 20%, 50% and 100%) and then weighted by the bucket's weight'.[307] This is how RWAs are calculated. So for example, an asset worth $100, with a risk weight of 100% requires 8% of capital (or $8). While an asset with a similar value ($100) but with a lower risk weight of 25%, requires only $2 of regulatory capital.

In spite of the many benefits brought by Basel I, in June 1999 the BCBS released its proposal for reforming the capital standards. One of the main critiques to Basel I was its '(…) lack of sensitivity to credit risk'.[308] Under Basel I risk weighing was done using fixed risk-buckets that depended on the *type* of asset rather than on the credit risk of the counterparty. For example, sovereign bonds from OECD countries had a 0% risk-weight – regardless of the issuer's credit risk. In turn, corporate bonds were always given a 100% risk-weight.

In an effort to provide greater credit risk sensitivity, the BCBS published a revised Basel Accord in 2004. The Basel Committee's revised proposal became widely known as 'Basel II'.[309] Basel II kept some of the same capital standards as Basel I, namely improving the standardized approach to risk weighing. However, for larger and more sophisticated banks, Basel II introduced the so-called *Internal Rating Based Approach* ('IRB'), which allowed banks to rely on their own in-house credit risk assessments. The IRB increased the dependence on 'highly developed risk assessment capabilities by the banks themselves'.[310]

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[307] Santos (n 302) 17. See also Basel I para 29.
[308] Irina Molostova, 'Introduction to The Internal Ratings Based Approach Under Basel II' (2008) 1 JIBFL 19.
[309] See Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards – A Revised Framework' ('Basel II') (Comprehensive Version, June 2006) <http://www.bis.org/publ/bcbs128.htm> accessed 6 December 2016.
[310] Tarullo (n 295) 16.

Basel II also introduced the so-called ‘three pillars’ comprised of: ‘(a) minimum capital standards, (b) a supervisory review process and (c) effective use of market discipline’.[311] In spite of these changes, the 2007-2008 crisis ensued and Basel II came under fire. Some countries, like the US never fully implemented Basel II.

3. WHAT DOES BASEL III BRING TO THE TABLE?

Basel III is the latest version of the Basel Accords. It is expected to be fully in force by January 2019. Some parts of the accord are not yet finished.[312] However, many countries have already adopted a large part of the reforms under the assumption that they are of crucial importance for strengthening and promoting financial stability.[313]

Basel III builds on Basel II's three pillars in order to strengthen banks' resilience.[314] Like the previous Basel Accords, Basel III relies on capital adequacy based on RWAs. However, Basel III introduces changes to the definition of total regulatory capital and also adds some tools in order to measure leverage and liquidity, and manage systemic risk. This section describes the new measures contained in Basel III with the objective of explaining how the revamped definition of a central component of these tools – called Common Equity Tier 1 capital (CET 1) – can pose challenges for non-corporate banks and financial regulators worldwide.

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[311] Basel II was also notably longer and more complex than the first Basel Accord. While Basel I stretched for about 30 pages and relied on basic arithmetic, Basel II (including its annexes) exceed 340 pages and involved more advanced mathematics. See Andrew Haldane, ‘The Dog and the Frisbee – Speech given at the Federal Reserve Bank of Kansas City's 36th economic policy symposium, “The Changing Policy Landscape”’ (31 August 2012) <http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf> accessed 6 December 2016.

[312] For example, the final version of the net stable funding ratio (‘NSFR’).

[313] See Basel Committee on Banking Supervision, ‘Basel III Monitoring Report’ (March 2016). <http://www.bis.org/bcbs/publ/d354.pdf > accessed 6 December 2016.

[314] Alexander (n 291).

3.1. More and Better Quality Capital

One of the major objectives of Basel III is to strengthen bank capital requirements. The goal of these rules is to increase the 'quality, quantity and the transparency' of banks' own funds in order to build capital cushions that increase loss-absorbency during difficult times.[315] In order to achieve the objective of *more* and *better* quality capital, the Basel Committee has reformed the preexisting capital standards, focusing on greater common equity requirements.

Basel III faces an important challenge. It has to provide the basis for a harmonized definition of what regulatory capital actually is. As Narissa Lyngen describes, in the past, some discretion was left to national regulators, which ultimately allowed banks: 'to fulfill Tier 1 capital requirements with instruments that in some cases seemed unlikely to provide financial cushioning in the case of a loss'. Adding that: '[t]his allowed banks to effectively overstate their capital positions, creating issues of enforcement of the Accord at the national level'.[316]

Moreover, studies have also shown inconsistencies in the way that banks used to calculate their RWAs.[317] The aforementioned inconsistencies, which have existed in the past, could also be relevant for the calculation of capital and liquidly standards for non-joint stock banks.

Under Basel III, the regulatory capital ratio is still set at 8% of RWAs. Capital is also comprised of Tier 1 and Tier 2 capital.[318] However, banks are now required to have 75%

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[315] Peter King and Heath Tarbert, 'Basel III: An Overview' (2011) 30 Banking & Financial Services Policy Report 3. See also Basel III, 2.

[316] Narissa Lyngen, 'Bassel III: Dynamics of State Implementation' (2012) 53 Harvard International Law Journal 519, 525.

[317] Vanessa Le Leslé and Sofiya Avramova, 'Revisiting Risk-Weighted Assets – Why Do RWAs Differ Across Countries and What Can Be Done About It?' (2012) IMF Working Papers WP/12/90 <https://www.imf.org/external/pubs/ft/wp/2012/wp1290.pdf> accessed 6 December 2016.

[318] The concept of 'Tier 3 capital' that was presented under Basel II has been abandoned. See Basel III para 9.

of their capital ratio in the form of Tier 1 capital (6 percentage points), and only 25% (or 2 percentage points) in the form of Tier 2 capital.[319] Moreover, the definition of Tier 1 capital has been slightly reformed and now includes two additional subcategories: (i) Common Equity Tier 1 capital (hereinafter, 'CET 1') and (ii) Additional Tier 1 capital ('AT1').

CET 1 is capital of the highest quality and loss absorbency. It is mainly comprised of common stock and retained earnings. Banks are required to have at least 4.5 percentage points of their total capital ratio in the form of CET 1. This means that 75% – or three fourths (3/4) – of a bank's Tier 1 capital (and over 56.25% of a bank's total capital ratio) needs to be in the form of CET 1.

Alongside CET 1, Additional Tier 1 capital (AT1) is the second component of Tier 1 capital. AT1 should be equivalent to 1.5 percentage points of a bank's total capital ratio. AT1 securities are subordinated to (eg rank junior or are paid later than) 'depositors, general creditors and subordinated debt of the bank'.[320] Tier 1 capital includes certain equity instruments, like preferred shares and share premiums that result from the sale of stocks at higher than par value.[321] AT1 can also include loss absorbing securities held by banks' parent entities and contingent capital securities (commonly referred to as 'CoCos').[322] CoCos are 'hybrid capital securities that absorb losses in accordance with their contractual terms when the capital of the issuing bank falls below a certain level'.[323]

According to S. Avdjiev et al. CoCos' loss absorbency comes from two of their main features: their trigger event and their loss absorbency mechanism.[324] CoCo-holders agree (*ex ante*) that regulators can offset their investment against losses in order to boost capital

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[319] Under Basel I and Basel II, banks were required to have half (50%) of their total capital in the form of Tier 1 and the other half (50%) in the form of Tier 2 capital.
[320] The general characteristics of AT1 securities are listed in Basel III para 55.
[321] Basel III sets out the characteristics that instruments need to have in order to qualify as AT1. See Basel III para 54-56.
[322] Stefan Avdjiev, Anastasia Kartasheva and Bilyana Bogdanova, 'Cocos: A Primer' (September 2013) BIS Quarterly Review 46.
[323] ibid.
[324] ibid.

levels whenever the latter are depleted or in the event that a pre-established trigger event occurs.[325] Moreover, CoCos can also boost capital levels by equity conversion or through write-downs.[326]

Tier 2 capital, also known as 'gone concern' capital[327], now constitutes up to 2 percentage points of the total capital ratio. Basel III establishes the criteria that Tier 2 capital securities must have[328]. These are typically subordinated debt instruments and other securities 'subordinated to depositors and general creditors of the bank'. Thus their creditor rank for loss-apportionment follows equity holders and investors in AT1 instruments.

The following stylized example can help illustrate the most recent changes in the composition of banks' capital. Before Basel III, for every $16 of total regulatory capital that a bank had, $8 needed to be in the form of Tier 1 capital and $8 in the form of Tier 2 capital. Under Basel III, for every $16 of total capital, Tier 1 capital now comprises $12, out of which $9 dollars need to be in the form of CET 1. In comparison, the amount of required CET 1 alone ($9) will now exceed the Tier 1 capital that was necessary under Basel I and Basel II ($8 in this simplified example). Figure 6 shows the total capital ratio under Basel III.

Moreover, Figure 6 can also help illustrate how losses are apportioned across different bank stakeholders. Tier 1 capital instruments are written down first (CET1 and then AT1). Once Tier 1 capital is written down, Tier 2 instruments are next in line to absorb losses, if needed.

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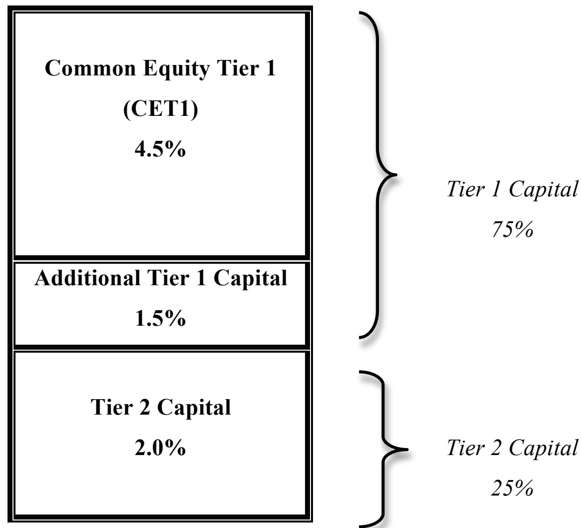
[325] ibid.
[326] Referring to CoCos, Christos Hadjiemmanuil considers that their: 'unilateral conversion in the event of distress can permit a rapid debt-to-equity recapitalisation of the issuing institution, avoiding the need for public funding'. C Hadjiemmanuil, 'Special Resolution Regimes for Banking Organizations: Objectives and Limitations' in Wolf-Georg Ringe and Peter M Huber (eds) *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation* (Hart Publishing 2014).
[327] See Basel III para 58.
[328] ibid.

Figure 6

8% Total Capital Ratio Under Basel III



Because of the importance that CET 1 plays with regards to total capital requirements, national regulators have the difficult task of defining it within the guidelines provided by the Basel Committee. The Basel Committee set out a list of 14 attributes that CET 1 needs to have (see Table 4). In the EU, Article 28 of the Capital Requirements Regulation ('CRR') sets out the conditions that capital instruments need to have in order to qualify as CET 1. This definition faces the additional challenge that across EU member countries a plethora of organizational forms exist – and not all of them issue common or ordinary shares.

Table 4

Criteria for Classification as Common Shares under Basel III

(Source: BCBS[329])

1.	Represents the most subordinated claim in liquidation of the bank.
2.	Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (ie has an unlimited and variable claim, not a fixed or capped claim).
3.	Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
4.	The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.
5.	Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).
6.	There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default.
7.	Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
8.	It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.
9.	The paid in amount is recognized as equity capital (eg not recognized as a liability) for determining balance sheet insolvency.

[329] Basel III 12-13.

10. The paid in amount is classified as equity under the relevant accounting standards.
11. It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument.
12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.
13. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized by the owners.
14. It is clearly and separately disclosed on the bank's balance sheet.

Defining CET 1 is of utmost importance for the implementation of Basel III. This is because other complementary measures and tools introduced in Basel III hinge upon the concept of CET 1. The next subsections describe these measures in order to showcase how the concept of CET 1 is central to most of them.

3.2. Capital Conservation Buffer

Basel III introduces a capital conservation buffer in order to ensure that banks have enough accumulated capital to endure economic downturns. The capital conservation buffer has been set at 2.5% of RWAs. The capital conservation buffer is comprised of CET 1, and it is established on top of the regulatory minimum capital requirement.[330] In the words of the BCBS, the capital conservation buffer: 'is designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred'.[331] Put differently, the capital conservation buffer seeks to guarantee that banks

[330] This means that it is in addition to the 8% capital ratio, which in turn must include 6% of RWAs in the form of Tier 1 capital – out of which 4.5 percentage points have to be in the form of CET 1. Consequently, adding the capital conservation buffer raises the capital ratio to 10.5% of RWAs – out of which 7% has to be in the form of CET 1.
[331] Basel III para 122.

have extra capital in addition to the minimum capital requirements, in order to maintain threshold conditions during economic downturns.

The rationale behind the capital conservation buffer is that banks should exhibit high quality capital in excess of the minimum requirements. If a bank's capital levels fall close to the minimum outside a period of financial distress, then it will be expected to rebuild its buffers in order to keep capital levels above and beyond the minimum requirements. This does not mean that regulators would intervene or sanction banks that exhibit a capital conservation buffer below the required levels. That is, the objective is not to create a new minimum capital requirement, but rather to restrict distributions to owners or managers whenever the buffer is too low and until it is fully replenished.[332]

There are several ways for banks to increase their capital conservation buffer. One way is to reduce dividend and bonuses payments and build the buffer through retained earnings. The Basel Committee describes what it calls a 'collective action problem' that can occur with regards to distributions. Banks could want to signal financial strength (or avoid signaling weaknesses) by distributing (or failing to distribute) earnings. However, the BCBS wants to avoid distributions to the owners and managers whenever capital buffers are depleted in order to allow achieving the required thresholds.[333] Assuming that earnings actually exist, increasing regulatory capital through retained earnings is a strategy that is available to both corporate and non-corporate banks.

Another alternative for some banks in order to achieve the required conservation buffer is to raise funds from the public.[334] Corporate banks can do this by offering new shares to existing shareholders (eg via a rights issue). In addition, joint-stock banks could also try

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[332] According to the Basel Committee '[i]tems considered to be distributions include dividends and share buybacks, discretionary payments on other Tier 1 capital instruments and discretionary bonus payments to staff'. See Basel III para 132(a).
[333] Basel III para 127. For a detailed discussion on building up bank capital through retained earnings see Admati and Hellwig (n 282) 169-175.
[334] Adjusting the denominator of the capital adequacy ratio can also enhance regulatory capital. This includes investing in assets with lower risk weights or reducing the amount of RWAs.

selling shares to new shareholders[335] or selling shares at a premium.[336] Banks that are not organized as joint stock companies would face some funding challenges on this front, as their capital is not always represented in shares that they can issue to the general public. This makes the concept of CET1 – which is of central significance to the implementation of the capital conservation buffer – a challenging standard for non-joint stock banks. It also underscores why the relationship between legal form and capital requirements is important.

Table 5

Individual Bank Minimum Capital Conservation Standards

(Source: Basel III)

Common Equity Tier 1 Ratio	Minimum Capital Conservation Ratios (expressed as a percentage of earnings)
4.5% - 5.125%	100%
>5.125% - 5.75%	80%
>5.75% - 6.375%	60%
>6.375% - 7.0%	40%
> 7.0%	0%

[335] According to Eilis Ferran and Look Chan Ho '[t]here are basically three ways for a company to finance its operations: share issues, debt, and retained profits'. See Eilis Ferran and Look Chan Ho, *Principles of Corporate Finance Law* (2nd edn, OUP 2014) 42.

[336] Alexander (n 291).

Table 5 depicts the minimum capital conservation levels that banks have to maintain according to their level of CET1 capital ratios. For example, it establishes that a bank with a CET1 ratio of 6.5% would have to conserve at least 40% of its earnings in a subsequent period (eg the bank can only distribute up to 60% of its earnings as dividend payments, share buybacks or discretionary bonus payments) in order to replenish its capital conservation buffer until CET1 plus the capital conservation buffer reach or exceed 7% of RWAs.[337] This amount is independent of any additional CET1 needed to meet the 6% Tier 1 and 8% Total Capital requirements.

The capital conservation buffer will become fully effective on 1st January 2019. The Basel Committee has designed a schedule for phasing in the capital conservation buffer between 1st January 2016 and year-end 2018. In 2016, the capital conservation buffer is set to begin at 0.625% of RWAs and will increase each subsequent year by an additional 0.625 percentage points, until its final level of 2.5% of RWAs is reached on 1 January 2019.[338] Table 6 depicts the required levels of the capital conservation buffer during the implementation period.

[337] Basel III para 130.
[338] Basel III para 133.

Table 6

Capital Conservation Buffer Implementation

(Source: Basel III)

DATE	**CAPITAL CONSERVATION BUFFER (In percentage points)**
1st January 2016	0.625%
1st January 2017	1.25%
1st January 2018	1.875%
1st January 2019	2.5%

3.3. Countercyclical Capital Buffer

Pro-cyclicality was a major issue experienced during the financial crisis. When there is an economic boom, markets and market participants tend to act accordingly: lending freely, making deals, requiring less collateral for loans, etc. However, during economic downturns, markets and market participants tend to dry-up. This pro-cyclical tendency is embedded in many aspects of modern finance. For example: collateral requirements (margin calls), mark-to-market accounting, leverage and the granting of credit. Paradoxically, capital seems to be most important whenever it is needed the most.

Trying to counteract pro-cyclicality has also become one of the objectives of Basel III. The Basel Committee has introduced a countercyclical capital buffer that aims to increase the 'sensitivity and coverage of the regulatory capital requirement'.[339] The countercyclical capital buffer complements the capital conservation buffer. The rationale is that when financial supervisors perceive that credit growth promotes or leads to systemic risk, they can require extra capital from banks in order to restrict lending. Once the systemic risk considerations cease to exist, then this requirement is no longer needed.

In order to illustrate countercyclical measures, Prof. Rosa M. Lastra refers to the story of Joseph found in the Bible and the Quran.[340] Joseph implemented countercyclical measures in Egypt in order to save extra provisions in times of prosperity that were then used in subsequent periods of scarcity and famine. During times of credit growth, banks will be required to have additional levels of capital in order to prevent the potential buildup of systemic risk. Once the concerns of systemic risk are no longer present, financial supervisors can calibrate and reduce this requirement, stimulating banks to lend more and aiming to avoid a credit contraction.[341]

[339] Basel III para 20.

[340] Rosa M. Lastra, *International Financial and Monetary Law* (2nd edn, Oxford University Press 2015).

[341] Financial commentator Frances Coppola alerts against the common misconception that the countercyclical capital buffer (CCB) is a: ' "reserve" built up in good times that can be drawn down in more challenging times'. She clarifies that the purpose of the CCB is to '(…) *dampen* credit booms and busts'. See Frances Coppola, 'Capital, Liquidity and the Countercyclical Buffer

This buffer is one of the novel macroprudential measures included in Basel III.[342] Macroprudential regulation has become topical in the aftermath of the financial crisis.[343] Traditionally, the Basel Capital rules were considered to be microprudential in their nature, concerned mostly with the safety and soundness of individual financial institutions. In turn, macroprudential tools – like the countercyclical capital buffer and the SIFI surcharge discussed later in this chapter – aim to foster financial stability and prevent the build-up of systemic risk.

The internationally agreed range of the discretionary countercyclical capital buffer has been set between zero and 2.5% of RWAs on top of the 8% baseline capital ratio. However, countries can also require greater levels if needed during periods of excessive credit expansion. The countercyclical capital buffer needs to be fulfilled with CET1, which is capital of the highest lost absorbency.[344] If banks fail to meet this requirement, their distributions will be restricted until they do so. As Figure 7 shows, with the addition of the discretionary countercyclical capital buffer, potential total capital requirements have increased under Basel III to up to 13% of capital over RWAs.[345]

Once again, because of their inability to issue and sell shares in order to build up their CET1, non-joint stock banks could be at a disadvantage *vis-à-vis* corporate banks with regards to the countercyclical capital buffer.

– in plain English' (*Coppola Comment,* 1 October 2015) <http://www.coppolacomment.com/2015/10/capital-liquidity-and-countercyclical.html> accessed 6 December 2016.

[342] Introductory remarks on the rise of macroprudential regulation are discussed in chapter 2.

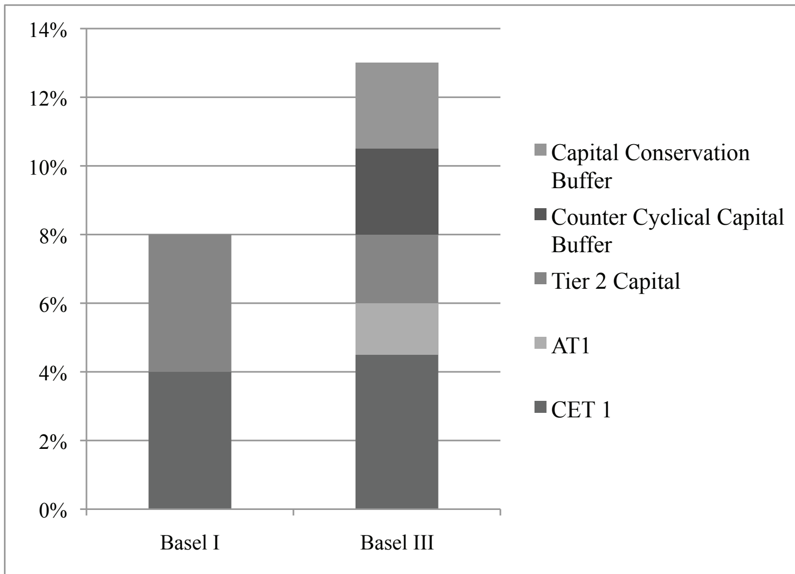
[343] For a general overview of the development of macroprudential regulation and supervision see Rosa Lastra, 'Sistemic Risk and Macroprudential Supervision' in Niamh Moloney, Eilis Ferran, Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP 2015). See also Gabriele Galati and Richhild Moessner, 'Macroprudential Policy – A Literature Review' (2011) BIS Working Papers n 337 <http://www.bis.org/publ/work337.pdf> accessed 6 December 2016; Samuel G Hanson, Anil K Kashyap, and Jeremy C Stein, 'A Macroprudential Approach to Financial Regulation' (2011) 25 Journal of Economic Perspectives 3.

[344] Basel III para 142.

[345] See also King and Tarbet (n 315).

Figure 7

Total Regulatory Capital to RWAs Under Basel I and Basel III



3.4. G-SIB Surcharge

Global systemically important banks[346] ('SIBs' or 'SIFIs') are of significant concern for standard setting bodies and supervisors. Since 2011, the Financial Stability Board (FSB) has worked under the mandate of the G20 on identifying global SIBs (G-SIBs') and determining how much extra capital they should have.

G-SIBs consist of open-ended list of around 30 large corporate banking groups considered 'too-big-to-fail' ('TBTF') – essentially because their failure could have an adverse impact of financial stability across different countries. The FSB publishes an updated list of G-SIBs on a yearly basis.

[346] Also called 'systemically important financial institutions' or 'large and complex financial institutions'.

One of the main strategies implemented for tackling TBTF is requiring G-SIBs to have a higher capital ratio than regular banks. This would purportedly lower the probability of failure or financial distress. The Basel Committee has worked alongside the FSB and G-SIB home country regulators in order to develop and implement a so-called 'G-SIB surcharge' of additional required capital.

The FSB has created five 'buckets' of additional loss absorbency. The G-SIB surcharge adds an additional capital buffer between 1.0% and 3.5% for banks identified under each bucket. Table 7 depicts the list of G-SIBs alongside with their respective risk bucket. By 2019, G-SIBs' total loss-absorbency capacity will be expected to amount to a capital ratio of up to 16% of RWAs. The FSB plans to gradually raise G-SIB TLAC to 18% by January 2022.

According to the Board of Governors of the Federal Reserve System the rationale behind the G-SIFI surcharge is twofold. Firstly, it creates incentives for G-SIFIs to reduce 'their systemic footprint'.[347] In other words, it is intended to provide a disincentive for moral hazard that stems from being 'too-big-to-fail'. Secondly, the surcharge may 'may offset any funding advantage that SIFIs have on account of being perceived as "too big to fail"'.[348] So it also serves as a 'Pigouvian' charge against any implicit subsidies and advantages that could result from being TBTF.

[347] Board of Governors of the Federal Reserve System, 'Calibrating the GSIB Surcharge' (20 July 2015) <http://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf > accessed 6 December 2016.
[348] ibid.

Table 7
2016 List of G-SIBs and Their Required Level of Additional Loss Absorbency
(Source: FSB[349])

G-SIBs	Bucket
(Empty)	5 (3,5%)
Citigroup JP Morgan Chase	4 (2,5%)
Bank of America BNP Paribas Deutsche Bank HSBC	3 (2,0%)
Barclays Credit Suisse Goldman Sachs Industrial and Commercial Bank of China Limited Mitsubishi UFJ FG Wells Fargo	2 (1,5%)
Agricultural Bank of China Bank of China Bank of New York Mellon China Construction Bank Group BPCE Groupe Crédit Agricole ING Bank Mizuho FG Morgan Stanley Nordea Royal Bank of Scotland Banco Santander Société Générale Standard Chartered State Street Sumiomu Mitsui FG UBS Unicredit Group	1 (1,0%)

[349] Financial Stability Board, '2016 list of global systemically important banks' (2016) <http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf> accessed 6 December 2016 - G-SIBs are allocated to buckets with regards to their loss absorbency requirements that will need to held. This is in addition to their Total Loss-Absorbing Capacity.

3.5. Leverage Ratio

So far, the measures contained in Basel III refer to more and better quality capital. In addition to the aforementioned buffers, Basel III also aims to tackle excessive leverage in the banking system.

The BCBS considers that '[o]ne of the underlying features of the crisis was the build up of excessive on- and off-balance sheet leverage in the banking system'.[350] During the crisis, banks were required to reduce their debt levels. Deleveraging would often exacerbate problems creating a destructive downward spiral with sliding asset prices and fire sales that accentuated losses and led to a severe credit crunch.

In order to tackle some of the leverage problems experienced during the crisis, the Basel Committee introduced a leverage ratio as part of Basel III. The leverage ratio's main objectives are to curb the negative effects of deleveraging processes and to create a 'simple, transparent and independent measure of risk'.[351]

The leverage ratio has been set at 3% of Tier 1 capital over a bank's average total exposure. The capital measure used for the ratio is the revamped definition of Tier 1 capital, which is mainly comprised of CET 1. In the denominator, the average total exposure includes on-balance sheet and off-balance sheet items, as well as derivatives.[352]

Contrary to the previous measures described so far, the liquidity ratio does not hinge upon the concept of RWAs. Moreover, it uses Tier 1 capital instead of the more stringent CET 1.

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[350] Basel III para 16.
[351] ibid.
[352] ibid para 154-160.

3.6. Liquidity Ratios

For any firm, liquidity can be as important as capital. Like any economic agent, a bank can be solvent and at the same time lack enough cash to make payments whenever they are due. Until the advent of Basel III no globalized liquidity standards existed. In order to strengthen liquidity management, Basel III introduces two new minimum liquidity standards.

The first measure, called the Liquidity Coverage Ratio (LCR) addresses short term funding needs with the objective of promoting 'short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high quality liquid resources to survive an acute stress scenario lasting for one month'.[353] The second measure, called the Net Stable Funding Ratio (NSFR) is (at the time of writing) currently still been developed for supporting banks' funding structure for one year and for supporting the maturity structure of assets and liabilities.

3.7. Summary

Basel III redefines the main components of banks' total regulatory capital. The revamped concept of Tier 1 capital – with CET 1 at its core – is essential to ensuring higher loss-absorbency. As explained, CET 1 also plays a major role for the application of the counter cyclical capital buffer, the capital conservation buffer, the G-SIFI surcharge and the leverage ratio.

However, CET 1 hinges on the assumption that all banks are corporations that can issue common shares. The BCBS acknowledges this assumption, addressing non-joint stock banks in a footnote to Basel III, which states that the:

[353] Basel III para 38.

> (CET 1) criteria also apply to non joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure. The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non joint stock companies in order to ensure consistent implementation.[354]

In turn, the next section discusses some policy implications, challenges and unintended consequences that could arise regarding the design of capital and liquidity rules and their linkage to bank legal forms.

4. UNINTENDED CONSEQUENCES

The precedent discussion on Basel III and CET 1 leads to answering the main question that this chapter purports to examine: do international bank capital and liquidity standards account for the fact that – in a real world setting – commercial banks are not always organized as corporations? More importantly, it raises concerns regarding whether standard setting bodies like the BCBS and the FSB, and domestic financial supervisors across countries, are taking such organizational differences into account when they design and implement the most recent set of capital rules.

[354] ibid fn 12.

4.1. Capital Standards and Bank Organizational Forms: Does One-Size-Fit-All?

The definition of CET 1 is central for the implementation of several core parts of Basel III. However, CET1 seems to have been primarily designed for banks organized as joint stock companies. This has the potential of creating implementation inconsistencies and uncertainty for banks that are not organized under the corporate form, including: mutual banks, co-operative banks, savings institutions, credit unions, etc.

Moreover, Basel III seems to allow leeway so that regulators across countries can design and implement different rules for non-joint stock banks. This could undermine the consistency of Basel III across countries. It is essential to prevent inconsistencies across countries regarding the application of CET 1 to non-joint stock banks.

The Basel Committee acknowledges in Basel III that '[t]he vast majority of internationally active banks are structured as joint stock companies (…)'.[355] However, the Basel Committee has also pointed out that Basel III's objectives are to: 'improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy'.[356] Consequently, in order to achieve this policy objective, corporate and non-corporate banks should be deemed of equal importance.

Domestic supervisors and regulators are faced with the task of implementing Basel III. In the EU, parts of the Basel III rules have been implemented through the Capital Requirements Regulation ('CRR') and the Directive on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms ('CRD IV').

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[355] Basel III para 53. For the purpose of Basel III, joint stock companies or corporations are defined as: '(…) companies that have issued common shares, irrespective of whether these shares are held privately or publically'.

[356] Basel Committee on Banking Supervision (BCBS), 'Basel III: A global regulatory framework for more resilient banks and banking systems' (December 2010) (rev June 2011) <http://www.bis.org/publ/bcbs189.htm> accessed 6 December 2016.

4.2. Capital Standards and Democratic Legitimacy

Failing to take non-joint stock banks into account when designing capital and liquidity rules can raise concerns regarding the legitimacy of such standards. As Prof. Kern Alexander points out: '[m]any of the organisations and other bodies that produce international financial regulatory standards are themselves "soft" in the sense that they are networks of informally constituted international bodies consisting of public regulatory officials, or representatives from the financial services industry'.[357] This is certainly the case with the BCBS – and to a certain extent, also the FSB. The fact that capital and liquidity rules are devised by international standard setting bodies with little connection to political constituencies raises important questions regarding the lack of democratic legitimacy and accountability.

Non-joint stock banks, their managers and stakeholders could challenge the Basel Committee's authority to determine how their regulatory capital is defined and measured. Moreover, there seems to be some discontent at the fact that intricacies of non-joint stock banks are often sidelined. Challenges to democratic legitimacy can also leave some room for regulators to attempt to maneuver exemptions or to apply different definitions of CET1 for their domestic non-joint stock banks. Ultimately, this can lead to the same problems and unaddressed loopholes that eroded the effectiveness of Basel I and Basel II.

5. CONCLUDING REMARKS

International capital and liquidity standards should be designed for all types of banks – including joint stock and non-joint stock banks. Some non-joint stock banks, like mutual associations and savings banks, do not issue common shares. This entails that some regulatory concepts, such as CET1, can pose some implementation challenges for their application to co-operatives, mutual societies and other forms of non-joint stock banks.

[357] See Kern Alexander, 'Rebuilding International Financial Regulation' (2011) Butterworth's Journal of International Banking and Financial Law.

It could be argued that the biggest and most important banks are mostly chartered under the corporate form. In fact, all existing G-SIBs are legally organized as groups of different corporations (holding companies, affiliates, subsidiaries and the consolidated legal personality of branches). However, this does not necessarily mean that capital and liquidity requirements should be bespoke standards made primarily for the measure of corporate banks.

Non-joint stock banks can also be of domestic and regional systemic importance.[358] As was discussed under chapter 3, customer owned banks and nonprofit banks often provide essential financial services to small and medium enterprises (SMEs) within certain geographical areas, and have also historically focused on social benefit and charitable activities. The IMF has acknowledged the risk of creating an uneven playing field between different types of banks, when referring to the particular case of the Spanish saving banks (*cajas de ahorros*), it stated that: '[n]ew international capital standards, which put greater emphasis on equity capital and tighten asset risk weighing, represented an additional challenge'[359] for the Spanish *cajas*. The same could be said about co-operatives and mutual banks as well.

Domestic and cross border systemic risk can buildup anywhere within a financial system. It is certainly not exclusively related to corporate banks. Non-corporate banks can also experience financial distress and bankruptcy, and when they do, their failure could imply some form of State intervention or taxpayer bailout.

As the Vice-President of the European Association of Co-operative Banks (EACB), Gerhard Hofmann, has been credited with saying that co-operative – and I add, other types of non-joint stock banks – are 'too important to be in the footnote when such

[358] Some co-operative banks can have domestic systemic importance. See Hans Groeneveld 'A Snapshot of European Co-operative Banking' (April 2016) 7 http://www.globalcube.net/clients/eacb/content/medias/publications/annual_reports/20160411_HG_EACB_FINAL_Snapshot.pdf accessed 6 December 2016.

[359] IMF 'The Reform of Spanish Savings Banks: Technical Note' (May 2012) para 13.

[capital and liquidity] regulations are drafted'.[360] In a recent report, Hans Groeneveld has stated that 'the effects of different organisational forms and/or business models on banking market structures remain relatively underexposed' in the publications of leading financial regulators and international standard setting bodies, like the IMF, the BIS and the ECB.[361]

An important linkage exists between legal form, the composition of regulatory capital (total loss-absorbing capacity) and bank resolution. As has been discussed so far, organizational forms determine how a bank's regulatory capital structure is legally characterized. Legal forms – and their varying levels of affirmative asset partitioning (entity shielding) – also determine the pecking order of owners' and creditors' claims on a bank's property.

Broadly speaking, banks' owners provide institutions with Tier 1 capital, while certain creditors and other investors provide its Tier 2 capital.[362] Whenever a bank experiences losses (eg because of bad loans or investments), Tier 1 capital providers (eg owners) suffer losses first. Thus owners always absorb losses before creditors and depositors.

It is important to note, as previously discussed in chapter 3, that some banks either have no owners (eg nonprofit banks like the Spanish saving banks) or are owned by their depositors (eg British building societies and credit unions). So a bank's pecking order becomes important when losses have to be apportioned across different stakeholders. In turn, the next chapter examines the relationship that exists between organizational forms and bank resolution.

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[360] See 'Leaders discuss new regulations at European Co-operative Banks Convention' (n 281).
[361] Groeneveld (n 358).
[362] This includes secured and unsecured bondholders, unsecured and secured depositors (including other banks), and the central bank.

Chapter Five

Can Differences in Legal Form and Creditor Rank Hinder Cross-Border Bank Resolution?

SUMMARY

Could differences in legal form and creditor priority undermine cross-border bank resolution procedures? This chapter raises questions regarding whether a better understanding of bank legal forms – and the economic consequences of asset partitioning – could also provide some insights for making cross-border bank resolution more effective. According to the asset-partitioning framework, entity shielding is the essential feature of organizational law. Entity shielding has two important economic consequences: creditor rank and liquidation protection. Creditor rank is predetermined by organizational form and insolvency laws and can be changed through legislation or contract. The chapter analyzes the implementation of bank resolution and bail-ins across the EU and finds variations in the order of certain types of bank creditors in member countries, which could undermine the set of European resolution rules. Moreover, the geographical partitioning of assets that results from entity shielding can further create coordination problems and challenges for the effectiveness of single and multiple-point of entry bank resolution processes.

KEYWORDS: Bank resolution, bank legal forms, entity shielding, creditor priority, internal asset partitioning, external asset partitioning, single point of entry (SPE), multiple point of entry resolution (MPE), BRRD.

'Put briefly, financial institutions do not internalise the spill-overs of their behaviour to the financial system as a whole and to the real economy'.[363]

Dirk Schoenmaker and Peter Wierts (2012)

1. INTRODUCTION

Both during and after the onslaught of the most recent financial crisis, States and financial supervisors have faced major challenges, including dealing with bank failure and financial distress while preventing disruptions to the overall financial system and the real economy.[364] The agenda for revamping global finance has been dominated by objectives such as mitigating moral hazard, reducing the external cost of bank failures and putting an end to odious taxpayer funded bailout packages.[365]

One particular concern that financial standard setting bodies and regulators have discussed is whether banks should be subject to regular insolvency rules (*lex generalis*) or if they require their own specific regimes (*lex specialis*).[366] The prevailing view is that banks are different to other firms and should be subject to special bank insolvency or orderly *resolution* regimes in order to deal with their financial distress[367] or potential

[363] Dirk Schoenmaker and Peter Wierts, 'Macroprudential Policy: The Need for a Coherent Policy Framework' (2011) DSF Policy Paper Series n 13, 4.
[364] Christos Hadjiemmanuil, 'Special Resolution Regimes for Banking Organizations: Objectives and Limitations' in Wolf-Georg Ringe and Peter M Huber (eds) *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation* (Hart Publishing 2014).
[365] Emilios Avgouleas and Charles Goodhart, 'Critical Reflections on Bank Bail-ins' (2015) 1 Journal of Financial Regulation 2-29.
[366] See Eva Hüpkes, 'Insolvency – Why a Special Regime for Banks' (2003) IMF 3 Current Developments in Monetary and Financial Law. See also ER Morrison, 'Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?' (2010) 82 Temple Law Review 449.
[367] Financial distress is defined here as 'a bank that is facing difficulties in continuing its usual activities because of lack of funding or lack of capital'. See Mathias Dewatripont and Xavier Freixas, 'Bank Resolution: Lessons from the Crisis' in M Dewatripont and X Freixas (eds), *The Crisis Aftermath: New Regulatory Paradigms* (London, Centre for Economic Policy Research,

failure and to stop bailouts.[368] However, legal and coordination challenges exist across jurisdictions that threaten to hinder the effectiveness of cross-border bank resolution.

Bank resolution procedures can be defined as 'any public intervention that is intended to restore the bank's normal business conditions or to liquidate it, thus restoring normal conditions for all other banks'.[369] Several jurisdictions, including the United States[370] (US), the Netherlands[371], Germany[372] and the United Kingdom[373] (UK), have

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2012) 106 available online <http://voxeu.org/sites/default/files/file/Crisis_Aftermath.pdf> accessed 6 December 2016.

[368] John Armour considers that: 'a strong case exists for the application of special procedures to mitigate the transmission of financial shocks'. While referring to resolution, Armour has stated that the 'critical assumption' of the 'specialness of banks, which provides the justification for their prudential regulation, also dominates their post-failure treatment and determines its objectives'. See John Armour, 'Making Bank Resolution Credible' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (OUP 2015) 428. See also Hadjiemmanuil (n 364).

[369] Dewatripont and Freixas (n 367) 106.

[370] Both John Armour and Christos Hadjiemmanuil agree that the US pioneered in the development of special bank insolvency rules. According to Hadjiemmanuil, the US approach to bank resolution dates back to the savings and loan crisis of the 1980s, which led to the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (the 'FDICIA'). The US regime predates the 2007-08 financial crisis, thus J Armour refers to it as a 'first generation' resolution mechanism (as opposed to post-crisis or 'second generation' reforms). Moreover, the Dodd Frank Act 2010 further implemented strategies for dealing with the resolution of systemically important banks. See Hadjiemmanuil (n 364); Armour (n 368).

[371] Intervention Act (Interventiewet) Act of 24 May 2012 to amend the Act on Financial Supervision and the Bankruptcy Act as well as a number of other Acts in connection with the introduction of supplementary powers to intervene in financial institutions in financial trouble (Act on Special Measures for Financial Institutions) (Wet van 24 mei 2012 tot wijziging van de Wet op het financieel toezicht en de Faillissementswet, alsmede enige andere wetten in verband met de introductie van aanvullende bevoegdheden tot interventie bij financiële ondernemingen in problemen) (Wet bijzondere maatregelen financiële ondernemingen), Stb. 2012, 241. Cited from Matthias Haentjens and Lynette Janssen, 'New National Solutions for Bank Failures: Game-changing in the UK, Germany and the Netherlands?' (2015) 1 Journal of Financial Regulation 294.

[372] Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz) vom 9. Dezember 2010, BGBl. 2010, I, 1900.

[373] The UK's SRR was established through the Banking Act 2009. The Financial Services (Banking Reform) Act 2013 added bail-in as a resolution tool in the UK. Moreover, the following instruments have also been implemented: The Bank Recovery and Resolution Order 2014; The Bank Recovery and Resolution (No 2) Order 2014; The Banks and Buildings Societies (Depositor Preference and Priorities) Order 2014; The Building Societies (Bail-in) Order 2014; The Banking Act 2009 (Restriction of Special Bail-in Provision, etc) Order 2014; The Banking Act 2009

implemented specialized bank resolution regimes (or 'SRRs').[374] SRRs can include a combination of both pre-established judicial insolvency proceedings – as well as administrative legal rules used to deal with insolvent or distressed banks.

In the European Union (EU), member States have had to reform their national practices in accordance to the Banking Recovery and Resolution Directive[375] (hereinafter, 'BRRD') and the Single Resolution Mechanism Regulation[376] (SRM) that applies to the Eurozone Countries – and constitutes a pillar of the 'Banking Union'. Several international financial standard setting bodies[377], including the Financial Stability Board (FSB)[378], the Basel Committee (BCBS)[379] and the International Monetary Fund (IMF)

(Mandatory Compensation Arrangements Following Bail-in) Regulations 2014. See HM Treasury, 'Transposition of the Bank Recovery and Resolution Directive: A Response to the Consultation' (March 2015) para 1.3. <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417789/transposition_of_BRRD_consultation_response.pdf> accessed 6 December 2016.

[374] See Gustaf Sjöberg, 'Banking Special Resolution Regimes as a Governance Tool' in Wolf-Georg Ringe and Peter M Huber (eds) *Legal Challenges in the Global Financial Crisis: Bail-outs, the Euro and Regulation* (Hart Publishing 2014).

[375] 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, OJ L 173/190. EU Member States had to make the BRRD operational by 1st January 2015.

[376] 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, OJ L 225; and Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund of 14 May 2014 (8457/ 14).

[377] For a general overview of international initiatives see Matthias Haentjens, 'Bank Recovery and Resolution: An Overview of International Initiatives' (2014) 3 International Insolvency Law Review 255.

[378] Financial Stability Board (FSB) 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2011) <http://www.fsb.org/wp-content/uploads/r_111104cc.pdf?page_moved=1> accessed 6 December 2016.

[379] Basel Committee on Banking Supervision, 'Report and Recommendations of the Cross-Border Bank Resolution Group (March 2010).

and the World Bank[380] have also promoted and recommended in their publications that countries establish orderly bank resolution procedures.

The need for special bank insolvency rules seems paradoxical, considering that in some languages the word 'bankruptcy' itself has its etymological roots in the Italian phrase 'banca rotta' – which literary refers to the ancient practice of breaking moneychangers' tables or benches (*banca*) once they stopped honoring their payments.[381] Before the widespread advent of SRRs, bank insolvency was typically dealt either by applying ordinary commercial reorganization and winding up procedures[382], or through *ad hoc* (public and private) measures used by bank regulators (eg convoy rescues[383], mergers and acquisitions, bailout packages, nationalization, emergency liquidity assistance, etc).[384]

This chapter argues that differences in bank legal forms should be taken into consideration both for the design of SRRs as well as during bank resolution procedures. The chapter argues that legal form can be relevant because of three important factors: (A) legal forms establish different ownership structures (eg which stakeholders own a bank); (B) ownership structure determines a bank's capital structure or loss absorbing capacity (discussed under chapter 4); and (C) the entity shielding that results from organizational form determines banks' absolute creditor priority and liquidation protection.

Ownership and capital structures vary across corporate and non-corporate banks. Moreover, creditor priority also changes – and can further diverge across jurisdictions. The latter can create coordination problems and potential legal uncertainty for the cross-border resolution of some banks in the EU. Moreover, if not taken into account, it could

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[380] International Monetary Fund (IMF) and the World Bank, 'An Overview of the Legal, Institutional and Regulatory Framework for Bank Insolvency' (17 April 2009).
[381] Matthias Haentjens and Pierre de Gioia-Carabellese, *European Banking and Financial Law* (Taylor and Francis 2015) ch 7.1. In Spanish, *bancarrota* or even *quiebra* (literally meaning 'fracture' or 'breakage'), *banqueroute* (French), Bankrott (German), etc.
[382] ibid ch 7.1.
[383] Takeo Hoshi, 'Financial Regulation: Lessons from the Recent Financial Crises' (2011) 49 (1) Journal of Economic Literature 120. See also Takeo Hoshi, 'The Convoy System for Insolvent Banks: How it Worked and Why it Failed in the 1990s' (2002) 14(2) Japan and the World Economy 155.
[384] See Hadjiemmanuil (n 364).

also hinder the effectiveness of resolution strategies and bring forth litigation should resolution authorities and courts attempt to change bank creditor priority.

Bank resolution tools include: resolution funds, investor bail-ins, asset transfers – and they are typically used in combination with other crisis management tools, like deposit protection insurance schemes and lender of last resort functions.[385] Moreover, domestic insolvency laws, which configure the creditor loss-bearing order, also tend to differ across national lines. Regulators and supervisors can also decide to change (improve or worsen) the position of certain bank creditors through special legislation, as has recently happened in several European countries.[386]

The combination of the aforementioned factors calls for several questions. Should legal form be taken into consideration when dealing with bank resolution? Does resolution play out differently across bank legal forms? And more importantly, could 'entity shielding' (creditor rank and liquidation protection) work against different types of resolution strategies, hindering their proposed objectives and reducing their effectiveness?

This chapter explores if and how the way that banks are legally organized and their different incentive structures interacts with some of the aforementioned resolution tools and strategies. Special focus is given to the interplay between the entity shielding that results from legal forms and organizational law, and bank resolution regimes and techniques – like investor bail-in and asset transfers to bridge banks. The chapter extends and applies the asset-partitioning framework (introduced and described in chapter 3) to the context of resolution rules, legal forms and loss apportionment across bank creditors. The applied framework is used to help explain the potential perils of having divergent creditor ranks across jurisdiction and could also help mind organizational features in order to make resolution processes more effective. The discussion focuses on cross-border resolution in the EU in order to better illustrate some of the tensions between legal

[385] See generally Rosa M Lastra, *International Financial and Monetary Law* (2 edn OUP 2015) ch 4.
[386] See s 4.3 below.

form and resolution. However, some of the ideas can be generalized to other jurisdictions as well.

The rest of the chapter is divided into four additional sections. Section 2 revisits the economic rationale for orderly bank resolution and briefly explains why banks require special insolvency rules and how these rules differ from regular insolvency procedures. Section 3 restates the asset-partitioning framework, and introduces recent extensions regarding distinctions between 'internal' and 'external' partitions, and the economic consequences for banking groups comprised of different legal entities. Section 4 discusses the linkage between legal forms and bank resolution. In particular, it identifies how national insolvency rules and legal forms interact with the loss apportionment system promoted by some resolution tools, like bank bail-in. Moreover, it describes the interface between legal form and the single point of entry ('SPE') and the multiple point of entry ('MPE') resolution techniques. Section 5 concludes.

2. DO BANKS NEED SPECIAL INSOLVENCY RULES?

Is bank insolvency very different from the bankruptcy of other firms? If so, how? This section discusses the economic rationale commonly identified as justifying the existence of bank SRRs. The first subsection focuses on the sources of market failure that underpin the need for SRRs. The second subsection describes some of the differences between SSRs and ordinary insolvency procedures.

2.1. The Economic Rationale for Bank Resolution

Financial crises generated by bank failures have been associated to several economic problems. The sources of market failure that are commonly cited include: negative externalities, moral hazard and the preservation of financial stability and critical functions (public goods problems). In turn, these economic problems are discussed.

2.1.1. The External Costs of Bank Failures

Financial crises and bank failures are often socially costly.[387] Trying to salvage – or conversely – keeping a *zombie* bank alive, is also costly. Banks, their owners, managers and creditors are often portrayed as reaping the private benefits of their activities while externalizing the costs of bank failure to taxpayers and society. Moreover, the insolvency of credit institutions can often spillover to other financial entities and to the real economy, creating financial instability, threatening critical functions, stifling economic growth and distressing public finances.[388] Financial contagion can spread and transmit these external costs across different institutions and countries.

According to one estimate by researchers at the Federal Reserve Bank of Dallas, the US experienced an output loss somewhere between '$6 trillion to $14 trillion' during the 2007-2009 period.[389] According to the IMF's calculations, the countries that were worst affected by the downturn lost between 4-6% of their GDP.[390] On average, countries committed up to 25% of their GDPs on the provision of governmental guarantees, pledges and other forms of State aid.[391] This estimate does not account for the costs to other jurisdictions.

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[387] Charles Goodhart argues that bailouts need not always be costly to taxpayers, pointing as an example the case of the US financial rescues through the Troubled Asset Relief Program (TARP) – which actually were profitable for taxpayers. According to the US Treasury: "*TARP's bank programs earned significant positive returns for taxpayers. As of September 30, 2015, Treasury has recovered $275.0 billion through repayments and other income – $29.9 billion more than the $245.1 billion originally invested*". Available online <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/Pages/default.aspx> accessed 6 December 2016.

[388] Armour (n 368).

[389] David Luttrell, Tyler Atkinson and Harvey Rosenblum, 'Assessing the Costs and Consequences of the 2007-09 Financial Crisis and its Aftermath' (September 2013) 8 (7) Dallas Fed Economic Letters 1 <https://www.dallasfed.org/assets/documents/research/eclett/2013/el1307.pdf> accessed 6 December 2016.

[390] International Monetary Fund (IMF), 'A Fair and Substantial Contribution by the Financial Sector' (June 2010) Final Report for the G-20, 4.

[391] ibid 4. According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 are close to €1 trillion or 8% of the EU GDP. Between October 2008 and December 2012, the European Commission 'approved €591.9 billion or 4.6% of EU 2012 GDP in state aid measures in the form of recapitalisation and asset relief measures'. See European

Accordingly, the potential harm arising from bank insolvency or distress has been considered as an important factor that justifies the need for SRRs.

2.1.2. Bank Failure: Moral Hazard and 'Too-big-to-fail'

Moral hazard and the 'too-big-to' set of problems are other underpinning factors that have justified the need for SRRs. As Gustaf Sjöberg has stated, 'bailing out the owners and creditors of banks creates perverted incentives that increase the risk level in the financial system. To preserve financial stability and at the same time uphold (or create) market discipline (that is, to avoid moral hazard) is therefore of paramount importance'.[392]

In the context of bank failure, moral hazard arises whenever owners, managers and creditors allow banks to take excessive risks pursuant to the perception that – in case that they run into financial difficulties – they will be bailed-out or will have some sort of preferential treatment by the government.[393] In other words, banks and their constituents misbehave because they anticipate that they will be rescued or subject to *ad hoc* rules, either because they are considered too big, too interconnected or too systemically important to fail. Thus bank bailouts and regulatory forbearance are closely related to the moral hazard problem.[394]

The 'judgment proof-problem', as described by Prof. Steven Shavell, is another manifestation of moral hazard that can affect banks and their stakeholders. The judgment proof problem consists of: 'the possibility that injurers may not be able to pay in full for

Commission, 'Memo: EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions' <http://europa.eu/rapid/press-release_MEMO-14-297_en.htm> accessed 6 December 2016.

[392] Sjöberg (n 374).

[393] See Gary Gorton, *Misunderstanding Financial Crises: Why We Don't See Them Coming* (OUP 2012).

[394] Lastra (n 385).

the harm they cause'.[395] The judgment-proof problem implies that failing banks – as financial 'polluters[396]' or 'injurers' – do not always have enough assets plus insurance to cover the full extent of the damages that their insolvency or financial distress can generate. Being 'judgment-proof' is a special case of moral hazard, slightly different from – but still related to – the 'too-big-to' set of problems (eg 'too-big-to fail', 'too-big-to-save', etc.). A bank might have insufficient own funds to pay for the externalities or damages that its failure produces. It need not be a 'big bank', simply one with insufficient own funds to fully absorb its losses once they materialize.

Combined with other tools, such as capital, liquidity and leverage standards, the existence of orderly resolution proceedings with the ability of apportioning losses to different bank stakeholders can help better align incentives and curb moral hazard.

2.1.3. Financial Stability and Preserving Critical Functions

Other important goals of SRRs are promoting financial stability and preserving critical bank functions – such as the correct functioning of payment systems and access to savings. These are generally considered to be global public goods.[397]

The interbank system is also a conduit for the transmission of monetary policy.[398] During a banking crisis, essential functions might be impaired. This means that depositors might be left without access to their deposits, payments might me delayed or suspended – causing additional disruptions to the economy. Thus SRRs can complement depositor

[395] Steven Shavell, 'The Judgment Proof Problem' (1986) International Review of Law and Economics, 45. See also Steven Shavell, 'Minimum Asset Requirements and Compulsory Liability Insurance as Solutions to the Judgment-Proof Problem' (2005) 36 (1) RAND Journal of Economics 63.
[396] Avgouleas and Goodhart (n 365).
[397] See Hüpkes (n 366). See also Joel P Trachtman, 'The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation' (2010) 13 Journal of International Economic Law 719, 721; Martin Wolf, 'The World's Hunger for Public Goods' *Financial Times* (London, 24 January 2012) <http://www.ft.com/intl/cms/s/0/517e31c8-45bd-11e1-93f1-00144feabdc0.html> accessed 6 December 2016.
[398] Geoffrey Davies and Marc Dobler, 'Bank Resolution and Safeguarding the Creditors Left Behind' (2011) Bank of England Quarterly Bulletin 213 <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb110302.pdf>

protection insurance schemes in preserving financial stability, preventing bank runs and protecting depositors from losing their deposits.

2.2. Differences Between Special Resolution Regimes and Regular Insolvency Rules

SRRs are said to have several objectives that are different to the goals of regular insolvency rules. One social objective often cited by leading financial regulators and policymakers is to minimize the total cost of bank failure and mitigate negative externalities and spillover effects that can leave taxpayers and other stakeholders to foot the bill.[399] Other objectives also include enhanced protection for depositors and ensuring the operational continuity and continuity of access[400] to core banking services (like deposits, clearing, settlement and processing of payments, etc.) during times of financial distress.[401]

According to Gustaf Sjöberg, bank resolution serves two specific purposes: first, establishing a legal framework and tools for dealing with bank failure; and secondly, promoting market discipline through deterrence in order to mitigate moral hazard and prevent bank crises altogether.[402] On the other hand, Rosa Lastra considers that '[b]ank resolution regimes aim to preserve the stability of financial and payments systems while in some countries also minimizing the social costs of failure to taxpayers'.[403]

[399] See eg FSB 'Key Attributes' (n 378) 1, which state that their implementation: 'should allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions'; See also BCBS, 'Report and Recommendations of the Cross-border Bank Resolution Group' (n 379) 16.
[400] According to the UK's Prudential Regulatory Authority (PRA), operational continuity refers to 'the arrangements that need to be made to ensure continuity of the critical shared services needed to facilitate a firm's recovery actions, resolution, or post-resolution restructuring'. The PRA states that this is 'different from the concept of continuity of access' which in turn implies 'continuity from the customers' (in particular, depositors') point of view (…)'. See DP1/14, 6
[401] See for example, BOE and PRA DP1/14.
[402] Sjöberg (n 374).
[403] Lastra (n 385).

These objectives are different to the objectives for regular insolvency rules, which generally aim to achieve 'fair and predictable treatment of creditors and maximization of assets of the debtor in the interests of creditors'.[404] The European Commission has considered that:

> In normal insolvency procedures, the primary objective is to maximise the value of assets of the failed firm in the interest of creditors. However, these may take many years, in particular for complex institutions leading to uncertainty with a knock on effect on confidence. In contrast, the primary objective of bank resolution is to respond in a rapid and decisive manner to a bank in financial distress to maintain financial stability and minimise losses for society, in particular in relation to taxpayers, while ensuring similar results to those of normal insolvency proceedings in terms of allocation of losses to shareholders and creditors.[405]

Thus, as the BRRD states whenever liquidation under 'under normal insolvency proceedings might jeopardise financial stability, interrupt the provision of critical functions, and affect the protection of depositors (…) it is highly likely that there would be a public interest in placing the institution under resolution and applying resolution tools rather than resorting to normal insolvency proceedings'.[406]

3. ASSET PARTITIONING AND BANK RESOLUTION

As discussed in chapter 3, bank entity shielding is a consequence of having a stand-alone legal personality under organizational laws. Together with limited liability (also called 'owner shielding' or 'defensive asset partitioning'), entity shielding forms the 'asset

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[404] ibid.

[405] European Commission, 'Memo: EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions' <http://europa.eu/rapid/press-release_MEMO-14-297_en.htm> accessed 6 December 2016.

[406] BRRD recital 45.

partitioning' framework.[407] Bank entity shielding implies: '(…) the demarcation of a pool of [a bank's] assets that are distinct from the assets owned, singly or jointly, by the [bank's] owners'.[408]

Two consequences stem from banks' entity shielding: creditor priority and liquidation protection.[409] As will further be explained in the subsequent section, these two consequences are relevant to resolution and crisis management in general, because they matter for how losses are apportioned across different types of bank creditors – both at the group and the entity levels. In turn, the asset-partitioning framework is further described and expanded.

3.1. Creditor Rank and Liquidation Protection

The creditor priority that results from a bank's 'entity shielding' means that legal entities within a banking group are entitled to their own assets and have their distinct priority of creditors with varying hierarchies. In principle, the assets of each bank are preferentially 'pledged' for that bank's creditors – shielding such loss absorbing assets from the claims of the creditors of other group entities (including parent and *sibling* entities) as well as from the claims of the creditors of their owners, directors and managers.

On the other hand, bank 'liquidation protection' implies that if a bank's owners (ie investors, a holding or parent company, etc) or other group entities become insolvent, the owner's personal creditors (or the personal creditors of other group entities) cannot force

[407] The framework is presented in Henry Hansmann, and R Kraakman, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387; Henry Hansmann and Reinier Kraakman, 'Organizational Law as Asset Partitioning' (2000) 44 European Economic Review 807; Henry Hansmann, R Kraakman and Richard Squire, 'Law and the Rise of the Firm' (2006) 119 Harvard Law Review 1333.

[408] Paraphrasing Reinier Kraakman et al., *The Anatomy of Corporate Law: a Comparative and Functional Approach* (2nd edn, OUP 2009) 6.

[409] Hansmann and Kraakman, 'The Essential Role of Organizational Law' (n 407).

liquidation of the bank and its assets in order to satisfy their claims once the owner's assets have been exhausted.[410]

Both liquidation protection and creditor priority are relevant for cross-border resolution, as will be further explained in the next section. However, recent extensions to the asset partitioning framework merit further explanation, as they are useful for broadening the framework to analyze SRRs.

3.2. Internal and External Asset Partitioning

It is often neglected that – both domestic and international – commercial banks are organized using different type of legal forms and complex group structures that operate on a cross-border basis. Each entity within a group can have its own accounting records and they often transact with each other or provide intra-group guarantees to third parties.[411] Moreover, each entity can be organized using a menu of organizational forms. As discussed so far in this thesis, it is common for banks and their groups to be legally setup as corporations, mutual societies, nonprofit associations, co-operatives, and other legal forms for arranging economic activity.

The structure of many cross-border banks entails that asset partitioning can be replicated across other several legal entities within the group. Henry Hansmann and Richard Squire have recently proposed a distinction between *internal* and *external* partitions.[412] Under this extension to the framework, *external* partitions refer to 'the legal barrier dividing a corporation from its ultimate owners: its human and institutional equity holders'.[413] On the other hand, internal partitions are legal barriers 'within a corporate group' (eg

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[410] ibid.
[411] See Dafna Avraham, Patricia Selvaggi, and James Vickery, 'A Structural View of U.S. Bank Holding Companies' (2012) FRBNY Economic Policy Review. In the words of M Haentjens and P de Gioia-Carabellese: 'a bank often is a complex organisation with myriad levels of operation'. Haentjens and de Gioia-Carabellese (n 381) 81.
[412] Henry Hansmann and Richard Squire, 'External and Internal Asset Partitioning: Corporations and Their Subsidiaries' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (forthcoming OUP 2017).
[413] ibid.

between a parent corporation plus any corporations it wholly owns, directly or indirectly).[414] The aforementioned authors argue that this distinction is useful for identifying the economic consequences that entity shielding can have for different creditors – and also for analyzing the catalogue of de-partitioning remedies available to them.

A stylized example can help explain the distinction between external and internal partitions. Assuming that British Bank Holding Co. is a publicly traded bank holding company with three wholly owned subsidiaries – each one located in: Britain, Germany and Greece. *External* partition separates the assets of the British Bank Holding Co. from the assets of its shareholders (for the sake of argument, assume that they are a mix between pension funds, investment funds and individuals). On the other hand, internal partitions separate the assets of the British Bank Holding Co. from the assets of each independently instituted subsidiary.

The aforementioned elements allow setting up the framework for describing how organizational form interacts with bank resolution strategies, discussed in the subsequent section.

4. THE NEXUS BETWEEN BANK RESOLUTION AND LEGAL FORM

When a 'bank' enters into financial distress or fails, it is in fact a legal entity – or even parts of a network or a complex cluster of different legal entities – that need to be resolved. As Richard Herring and Jacopo Carmassi have pointed out: '(…) the complexity of the corporate structures that most international financial conglomerates

[414] ibid.

have developed is itself a significant source of systemic risk. In the event of bankruptcy, hundreds of legal entities would need to be resolved'.[415]

Organizational complexity could exacerbate moral hazard and undermine market discipline[416] if banks and their stakeholders were somehow shielding their liability through convoluted legal cobwebs. Furthermore, complexity and the agglomeration of legal entities can also generate unintended consequences across borders, since some of these entities can operate in different jurisdictions. Each entity within a banking group can have its creditors who have an overall claim over their assets and it is not uncommon for entities to provide intra-group guarantees *vis-à-vis* different creditors.[417]

Bank organizational forms have their own incentive structures, attributes and characteristics. Two of their most salient characteristics – ownership structure and legal personality ('entity shielding') – have economic consequences that have to do with residual risk (loss) bearing hierarchies and how losses are apportioned between different bank constituencies that can be located across jurisdictions.[418] Thus, legal form is bound to be important during banks' lives, but also during their deaths.

4.1. Can Entity Shielding Facilitate Bank Resolution?

One way that legal forms and entity shielding can interact in favor of orderly bank resolution is by creating different asset pools.[419] Every legal entity in a banking group is entitled to its own property rights that it can use to conduct its activities. According to the asset partitioning framework, '[t]he symmetrical partition [limited liability and entity

[415] Richard Herring and Jacopo Carmassi, 'The Corporate Structure of International Financial Conglomerates – Complexity and its Implications for Safety and Soundness' in Allen N Berger, Philip Molyneux and John O S Wilson (eds), *Oxford Handbook of Banking* (OUP 2010) 197.
[416] ibid.
[417] Hansmann and Squire (n 412).
[418] Hansmann Kraakman (n 407).
[419] Hansmann and Squire (n 412).

shielding] between the company and its owners – [block] creditors in both directions – divides assets and liabilities into workable bundles'.[420]

This feature can explain why many recent leading structural banking reforms have opted for the separation of certain banking activities into different legal entities. The United Kingdom's 'ring-fencing' rules and the EU's Liikanen reforms are notable examples of this recent trend.[421] The UK's Prudential Regulatory Authority (PRA) has even expressly indicated that ring-fencing deposit taking institutions through independent local subsidiaries aims to enhance 'the resolvability of both groups and individual entities'.[422] Thus, entity shielding seems to generate some benefits in favor of resolvability by making banks bankruptcy remote.

4.2. Creditor Priority Rights

Absolute creditor priority has been called 'bankruptcy's most important and famous rule'.[423] It establishes that the loss-bearing order agreed to outside of insolvency will be honored during bankruptcy. In other words, it means that losses will not be shifted from one group of creditors to another. Absolute creditor priority provides legal certainty to creditors, allowing them to price the risk that they take whenever extending credit based on the distribution rank during insolvency proceedings. In spite of creditor rank being pre-established by regular insolvency law and contract, a great deal of rent-seeking and 'priority-jumping' can take place during bankruptcy.[424]

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[420] ibid.

[421] Legal separation or ring-fencing is a common feature of the EU's banking structural reforms, the UK's ring-fencing rules, as well as the application of the Dodd-Frank Act's 'Final Volcker Rule' to foreign banking organizations (FBOs). Chapter 6 focuses on banking structural reforms.

[422] Consultation Paper CP19/14 ss 1.17-1.22 <http://www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp1914.aspx> accessed 6 December 2016.

[423] Mark Roe and Frederick Tung, 'Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain' (2013) 99 Virginia Law Review 1236.

[424] Roe and Tung (n 423) 1238.

As discussed before, absolute creditor rank is also preserved during bank resolution. However, rent-seeking and creditor rank can also occur. Resolution authorities and financial regulators may feel inclined to favor their local depositors and creditors (eg voters) over foreign depositors and creditors.

Creating bank subsidiaries is another way to re-arrange creditor rank in a particular jurisdiction. Whenever a bank sets up a legally incorporated subsidiary – it shields that entity's assets from other group creditors. Thus, creating legal entities has an effect on creditor rank and how assets are distributed in order to guarantee the claims of different creditors.

4.3. National Insolvency Regimes and Creditor Rank

Another important legal challenge is the linkage between the pan-European resolution rules, national insolvency laws and variations to bank creditor priority. Like organizational laws, insolvency regimes across EU Member States remain a domestic matter.[425] Moreover, the BRRD leaves some leeway for countries to change the treatment or the priority rights of certain bank creditors during resolution through legislation. Germany and Italy provide two recent examples of how domestic legislation can rearrange bank creditor rank.

Germany prepared a legislative proposal in order to align its regime for the resolution of credit institutions with the BRRD and the SRM. The then German 'draft law' contained provisions for the statutory subordination (during resolution) of certain unsecured debt instruments issued by banks. Such debt securities would be subordinated under the law (eg rank junior) to interbank deposits, corporate deposits, money market instruments and certain derivatives and derivative like instruments.[426] What this meant in practical terms was a change in the loss-bearing pecking order with the objective of facilitating bail-in

[425] Haentjens and Janssen (n 371).
[426] Opinion of the European Central Bank of 2 September 2016 on Bank Resolution (CON/2015/31).

during the course of a bank resolution. Thus the holders of the statutorily subordinated securities would bear losses before other aforementioned groups of bank creditors.

The German Federal Ministry of Finance requested an opinion from the European Central Bank (ECB) on the German draft law. On 2 September 2015, the ECB issued its opinion stating that the German proposal was expected to 'facilitate resolution and the implementation of the FSB's forthcoming TLAC proposals'.[427] In its opinion, the ECB added that: 'statutory creditor hierarchy in bank insolvency proceedings is expected to enhance the implementation of the bail-in tool in resolution'.[428]

As a result, losses in resolution would be allocated to holders of the cited subordinated debt instruments, 'who would be bailed-in ahead of other senior unsecured creditors, thus fostering effective resolution action and reducing the need to have recourse to the resolution fund (…)'.[429] In other words, the position of the holders of the subordinated securities was changed – for worse. This could potentially raise banks' funding costs and dissuade investors from purchasing the subordinated instruments.[430]

Italy provides another example of how creditor rank can be altered through national legislation. When implementing the BRRD, Italy made unsecured depositors '(deposits not covered by article 108 BRRD) senior to other unsecured debt of the bank'.[431] This means that other (uninsured) depositors are to be paid in full before paying other types of unsecured bank creditors. Thus, from the perspective of these uninsured depositors, their creditor rank was improved – at the expense of lower ranking creditors, who were made worse off.

[427] ibid.
[428] ibid.
[429] ibid.
[430] Cleary Gottlieb, 'Beyond Bail-in – German and Italian Proposals Affecting Bondholder Rights' (21 September 2015) Alert Memorandum <http://textlab.io/doc/1505228/german-and-italian-proposals-affecting-bondholder-rights> accessed on 6 December 2016.
[431] ibid. See also BRRD art 108.

These examples support the view that in spite of having a set of common resolution rules, creditor rank can still be rearranged through domestic legislation, contract (eg issuing subordinated debt) or as a matter of organizational laws. This results from the BRRD's reliance on 'normal insolvency procedures' as supplementary rules to SRRs. Divergent approaches imply that the same type of bank creditor could rank differently (eg not *pari passu*) *vis-à-vis* banks' asset partitions across member states. As Matthias Haentjens and Lynette Janssen have predicted the 'common European rules will fail to eliminate some significant differences between national bank insolvency regimes'.[432]

These differences in the treatment of creditors' property rights can create challenges for resolving banks across national borders. As John Armour considers, the international scope of banking operations represents a challenge for coordinating solutions, because:

> Property laws cannot be waived extraterritorially. Consequently, unless every jurisdiction in which the banking organization operates has signed up to an equivalent resolution procedure and there is general agreement about how the costs of the process are to be shared, there is no guarantee that a coordinated outcome can, in fact, be achieved.[433]

Consequently, the asset partitioning created by entity shielding could also generate coordination problems for resolving cross-border banks under the multiple point of entry resolution technique. In turn, these challenges are discussed.

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[432] Haentjens and Janssen (n 371) 294, 297. Said authors add that 'these differences will materialize most acutely when a large bank fails that has operations throughout the EU, especially if—as would be likely—those operations are located both in the UK and the Eurozone (where resolution measures are coordinated under SRM)'.
[433] Armour 'Making Bank Resolution Credible' (n 368).

4.4. Single and Multiple Point of Entry Resolution

There are two main approaches to resolving a cross-border banking group. These are called single point of entry (SPE) and multiple point of entry resolution (MPE).[434] SPE or 'top-down' resolution strategies 'involve a single resolution authority applying its powers to the top of a financial group'.[435] In other words, it entails that one jurisdiction – typically a bank's home country – takes care of the entire resolution process, regardless of where the assets and subsidiary entities are located.

On the other hand, MPE resolution strategies involve 'the application of resolution powers by two or more resolution authorities to multiple parts of the group (ideally simultaneously), including strategies in which a group is broken up into two or more separate parts'.[436] MPE is the approach taken in Europe. One of the main critiques to MPE raised by Jeffrey N. Gordon and Wolf-Georg Ringe is that 'it would empower several regulators in various jurisdictions and thus create coordination problems, frictions, and a race to grab assets for the purpose of protecting national creditors'.[437] These potential challenges and coordination problems can result from entity shielding (affirmative asset partitioning). Consequently, entity shielding also has its costs.

Figure 8 presents a simplified example in order to explain how creditor rank and liquidation protection play out *vis-à-vis* SPE and MPE resolution strategies. Assuming that 'British Bank Holding Company' wholly owns and operates three incorporated banking subsidiaries across different countries: 'British Bank Plc', 'Greek Bank' and

[434] Financial Stability Board (FSB), 'Guidance for Recovery and Resolution Planning: Making the Key Attributes Requirements Operational (November 2012) <http://www.fsb.org/wp-content/uploads/r_121102.pdf?page_moved=1> accessed 6 December 2016.

[435] Federal Deposit Insurance Corporation (FDIC) and Bank of England (BOE), 'Resolving Globally Active, Systemically Important, Financial Institutions (10 December 2012) available online <http://www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf> last accessed 6 December 2016.

[436] FSB 'Guidance for Recovery and Resolution Planning' (n 434) 15.

[437] Jeffrey Gordon and W Georg Ringe, 'Bank Resolution in Europe: the Unfinished Agenda of Structural Reform' in Danny Busch & Guido Ferrarini (eds), *The European Banking Union* (OUP 2015).

'German Bank Limited'. Furthermore, assuming that both the British and the Greek subsidiaries become insolvent.

Under a SPE resolution strategy, the British resolution authority (home country) would lead the resolution process at the holding company level. Thus, the Greek and German resolution authorities would not play a primary role in the process. Because of entity shielding, assets in the German bank are unavailable to satisfy potential shortfalls that could exist for repaying the creditors of the British and Greek banks. The British resolution authority could bail-in (or capitalize) any securities held by the parent company in order to recapitalize one of the subsidiaries. Moreover, creditors of both subsidiaries could try to ask a court to pierce through the corporate veil (eliminate limited liability) – but that would only allow them to bring claims against the British Bank Holding Company. Liquidation protection precludes the British resolution authority or the courts from forcing the liquidation of the German bank in order to cover shortfalls in other group entities.

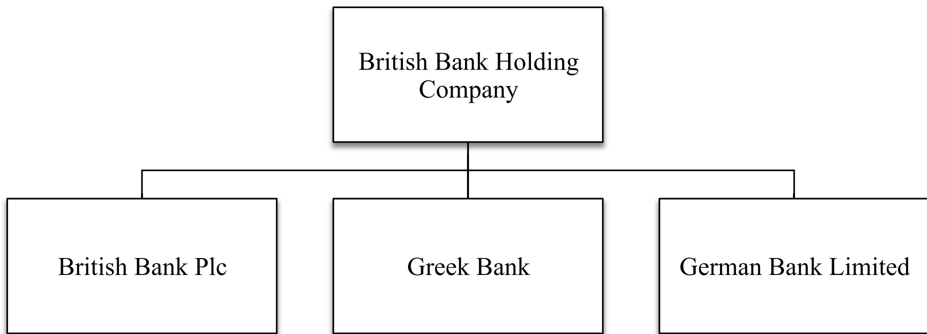
Under MPE resolution, the same scenario would play-out differently. Just like before, entity shielding creates asset partitions in each jurisdiction. Some asset pools could have higher loss absorbing capacity and liquidity (surpluses) than others (shortfalls). Thus, coordination is necessary in order to prevent any of the resolution authorities from grabbing more assets or liquidity than they strictly need in order to resolve a failed subsidiary within their jurisdiction.[438] This situation can be exacerbated considering that often cross-border resolution proceedings can be inward looking – paying little or no attention to the actions of other resolution authorities.[439]

[438] ibid.

[439] See Avgouleas and Goodhart (n 365).

Figure 8

Entity Shielding and SPE and MPE Resolution Strategies



4.5. Bank Bail-in

Since the last financial crisis bank bail-in and contingent capital have emerged as resolution tools. It seems paradoxical that statutory bail-in is being treated as a novelty, when letting losses fall were the fall – according to the pre-established loss-bearing order enshrined in the law – has always been a common feature of corporate restructuring and insolvency regimes. In the opinion of E. Avgouleas and C. Goodhart, part of the moral hazard problem affecting banks stemmed from the fact that '(…) in the past banks' subordinated debt did not provide any cover when bank liquidation was not an option, which meant that subordinated creditors were bailed out alongside senior creditors by

taxpayers'.[440] Consequently, bank creditors were often bailed-out leading to 'creditor inertia' and inadequate monitoring.[441]

Bank bail-in refers to rules allocating losses to existing investors as an alternative to spreading losses amongst taxpayers. In an economic sense, bail-ins aim to internalize the negative spillovers of bank failure. However, it is not always the case that enough 'bail-inable' funds are readily available to cover all the losses resulting from bank distress or failure. Consequently, bank bail-in is no panacea. When not enough investor funds are available publicly funded bailout packages could ensue. So it can be said that alternatively, bail-ins aim to reduce or minimize the amount of public money needed to bailout a failing or failed bank.

Bail-in can work differently in corporate and non-corporate banks. Different classes of shareholders own corporate banks. As discussed in previous chapters, shareholders are residual owners (or residual risk bearers) and they provide banks with their highest lost absorbing capital – called Common Equity Tier 1 (CET1) capital. This means that shareholders bear the full brunt of losses when they occur.

Corporate bank bail-in implies writing down equity and other instruments that form part of banks' going and gone concern regulatory capital. CET 1 capital is written down first, before additional Tier 1 (AT1) capital. Only when the latter are fully exhausted, can regulators trigger the conversion of CoCos or reduce other Tier 2 capital instruments, like subordinate bonds, in the hands of creditors.

Many non-corporate banks lack shareholders – thus there are often no shares to write down. Non-corporate banks' CET1 capital can be comprised of deposits, retained earnings and entities' own funds that have been built-up through past earnings. In the case of co-operative and mutual banks, there is a conflation between owners and depositors. Therefore, some owners will be (at least partially insured) and will benefit

[440] Avgouleas and Goodhart (n 365) 4.
[441] ibid.

from the protection of their property rights, underwritten by deposit insurers. These bank owners get to 'leap-frog from the back, to the front of the line', shielding themselves from losses during bail-in. Moreover, the position of other uninsured depositors has also been enhanced in order for their credit to rank at least *pari passu* to other bank unsecured creditors.

The aforementioned description depicts how bail-in and resolution tools can play out differently when it comes to corporate and non-corporate banks. Thus differences in the incentive structures that result from ownership and organizational form cannot be disregarded, because they can lead to different outcomes and can generate unintended consequences.

5. CONCLUSIONS

This chapter has considered the linkage between bank legal form, creditor rank, deposit protection insurance schemes and resolution regimes (SRRs). The main point that this chapter presents is that SRRs should take into account the differences in legal forms and creditor priority that exist across jurisdictions. Banks are not always shareholder-owned corporations. Non-corporate banks can be owned by insured depositors – or in other cases, can lack owners.

The entity shielding that results from bank legal forms creates and establishes patterns of creditors rights regarding a bank's assets. Creditor rank varies across organizational forms, because of differences in ownership structure. Consequently, loss apportionment in a corporate bank is bound to be different to how losses are absorbed by the stakeholders of non-corporate banks.

The preceding analysis does not assume that legal form can make banks entirely failsafe. But it could – in the words of Thomas Huertas – provide some insights towards making

banks less likely and 'safer to fail'.[442] Or at least the analysis can help identify how certain discrepancies in legal form and domestic insolvency laws could generate challenges for cross-border resolutions and other crisis management tools, like deposit protection insurance and lender of last resort.

The way that banks are legally organized is bound to be important during their lives – but also during their death. A better understanding of the ownership structure of legal forms and the intricacies of entity shielding could serve as bulwarks against bank failure.

[442] Thomas F Huertas, *How Resolution Will Revolutionise Banking* (Palgrave Macmillan 2014).

Chapter Six

Bank Organizational Forms and Structural Reforms – Ring-Fencing and Asset Partitioning in the United Kingdom[443]

SUMMARY

A plethora of policy recommendations have been discussed as a response to the global Financial Crisis that reached its nadir in 2007-2008. The ring-fencing of deposit-taking functions in the United Kingdom (UK) is one of the structural reforms enacted through legislation in order to guarantee the continuous provision of core bank services and allow for the orderly resolution of retail banks. Similar bank structural reforms have either been adopted or are being proposed in the European Union (EU), the United States of America, Germany and France. However, it is still uncertain exactly how British ring-fenced bodies (RFBs) will be legally organized in the future. This chapter explores some of the legal and economic aspects that underpin the implementation of commercial bank ring-fencing in Britain. The chapter argues that through the prism of Corporate Law and Economics, ring-fencing retail banking services through so-called 'subsidiarization' and 'electrification' can be construed as forms of asset partitioning. These measures aim to protect bank stakeholders and ultimately taxpayers against disruptions in the provision of core financial services as well as from having to incur the costs of bank failures. They could, however, also have unintended consequences, which can further be exacerbated by the effects of the UK's impending exit from the EU.

Keywords: Commercial Banking, Bank Ring-fencing, Ring-fenced Bodies, Vickers Report, Asset Partitioning.

[443] This chapter is largely based on a working paper titled 'Bank Ring-Fencing and Asset Partitioning – Some Implications for the Legal Structure of Ring-Fenced Bodies in the United Kingdom'. The chapter has benefited from the comments and critiques of two anonymous referees from an academic journal. The title is a reference to H Hansmann and R Kraakman's seminal article on organizational law as asset partitioning. An abridged and preliminary version of some of its ideas was originally presented in Klaus Heine and Enmanuel Cedeno-Brea, 'The Legal Structure of Ring-Fenced Bodies in the United Kingdom: A Response to Consultation Paper CP19/14 on the Implementation of Ring-fencing: on Legal Structure, Governance and the continuity of Services and Facilities', for the Prudential Regulatory Authority's (PRA) Public Consultation CP19/14 (January 2015).

‘Everyone wants to ring-fence something, but they can’t agree on what’.[444]

Perry Mehrling

1. INTRODUCTION

A number of regulatory reforms for banking have been proposed, discussed or adopted as a response to the global Financial Crisis that hit its critical point in 2007-08. The ring-fencing of commercial banks[445] is one of the *structural reforms*[446] aimed at changing the way that banks and banking groups are legally organized and conduct their business.[447] Ring-fencing purports to reapportion certain banking activities into different legal entities.

In the United Kingdom (UK), the ring-fencing of retail banking core activities became law in December 2013, when the Financial Services (Banking Reform) Act 2013 that amended the Financial Services and Markets Act 2000 (FSMA 2000) received Royal Assent. The British ring-fencing model legally segregates certain ‘core banking activities’ perceived as being essential to the economy – such as deposit taking and lending to households and to small and medium enterprises – from other activities and assets considered as being riskier (or less essential), such as dealing in certain kinds of

[444] Perry Mehrling, ‘Ring-fencing Explained’ (*The Money View*, 3 October 2012) <http://www.perrymehrling.com/wp-content/uploads/2015/07/Money-View-Archive.pdf> accessed 6 December 2016.

[445] This refers to entities within a banking group that typically receive retail deposits from the general public in order to on-lend the funds to third parties. Commercial banks are also referred to as ‘clearing banks’ in the UK, as ‘credit institutions’ under EU Law and as ‘depositary institutions’ in the USA.

[446] Sir John Vickers has considered structural reform as a subset of overall banking reform, which includes other broad elements like capital and liquidity regulation, corporate governance, remuneration and taxation, recovery and resolution, etc. See John Vickers, ‘Some Economics of Banking Reform’ (2012) Economics Series Working Papers 632. See also Rosa M Lastra, *International Financial and Monetary Law* (2nd edn, OUP 2015) 142-146.

[447] In the past, ring-fencing has been proposed or implemented as a tool for several economic sectors, such as public utilities, insurance and investment banking. However, this chapter primarily focuses on the ring-fencing of commercial banks as currently being implemented in the UK. As a result, unless otherwise specified, all allusions to ‘ring-fencing’ refer to the ring-fencing of banks and banking groups in the UK.

securities (hereinafter referred to as 'excluded activities').[448] The banks subject to ring-fencing will have to partition their local retail activities through an adequately capitalized – and legally separate – ring-fenced body ('RFB').

The UK's ring-fencing model resulted from the main policy recommendations that were proposed in 2011 by the Independent Commission on Banking, chaired by Sir John Vickers (hereinafter, the 'ICB' or the 'Vickers Commission'). The Vickers Commission had issued its final report (the 'Vickers Report') calling for a: 'retail ring-fence (…) to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such provision can be maintained in the event of the bank's failure without government solvency support'.[449] Ring-fencing purports to create a safe domain for core banking activities and services, by insulating these from the other activities perceived to stockpile systemic risk.

The deadline for implementing ring-fencing in Britain is 1st January 2019.[450] Ring-fencing applies to the UK subsidiaries of corporate banks and banking groups that hold deposits in excess of GBP 25 billion. The separation of core activities from excluded activities would be achieved through a combination of 'subsidiarization' and 'electrification'. In this context, 'subsidiarization' implies compulsory rules requiring banks to setup their business using a local subsidiary incorporated in the UK (as opposed to relying on branches).

On the other hand, the concept of 'electrification' remains legally unclear. According to the UK's Parliamentary Commission on Banking Standards (PCBS), 'electrification' was

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[448] Some authors, like Thomas Huertas and Douglas Elliott, challenge the assumption that traditional commercial banking is less risky than investment banking. See Douglas J Elliott, 'Ten Arguments Against Breaking Up the Big Banks' in Andreas Dombret and Patrick S Kenadjian (eds), *Too Big to Fail III: Structural Reform Proposals – Should We Break up the Banks?* (De Gruyter 2015) 119. See also Thomas Huertas, *How Resolution Will Revolutionise Banking* (Palgrave Macmillan 2014) 44.
[449] Independent Commission on Banking, 'Final Report' (London, 12 September 2011) 233.
[450] Crown dependencies are excluded.

intended as a deterrent 'creating a very significant disincentive for banks to depart from the spirit of the ring-fence'.[451] The PCBS warned that electrification would empower financial regulators to pursue complete structural separation if banks attempted bypassing, gaming or circumventing the ring-fencing measures.[452] Subsequently, while ring-fencing has been dubbed 'Glass-Steagall light', 'electrification' is the threat of full-blown 'Glass-Steagall' type segregation.

Discussions on varying levels of functional separation of banking activities are neither novel nor have they been limited to the UK. The complete functional separation of commercial and investment banking was the salient feature of the Banking (Glass-Steagall) Act of 1933 in the United States of America (USA).[453] Moreover, in the aftermath of the 2007-2008 global Financial Crisis, similar – albeit partial – functional segregation policies have either been adopted or are currently being discussed for implementation in the European Union (EU) and other financial regulatory trend-setting jurisdictions such as the USA, Germany and France.

In the EU, the European Commission established its own High-Level Expert Group as a response to the Vickers Report and the UK's structural reforms. The team of experts was referred to as the 'Liikanen Group', because Mr. Erkki Liikanen, the Governor of the Finish Central Bank, chaired it. In October 2012, the Liikanen Group presented its final report ('Liikanen Report') on structural reforms for the EU banking sector, which amongst other recommendations, concluded the need to require the: 'legal separation of certain particularly risky financial activities from deposit-taking banks within the banking

[451] See House of Lords/ House of Commons Parliamentary Commission on Banking Standards, First Report of Session 2012-2013, HL Paper 98/ HC 848 (21 December 2012) paras 153-158. The report also presents Sir John Vickers' interpretation of 'electrification', who stated that: 'If the industry turned out to be unreformable, and I am not so pessimistic as to think that, of course it is possible that total separation would turn out in due course to be the better step to take by creating full structural separation as a viable alternative'.
[452] ibid.
[453] See Sections 16, 20, 21, and 32 of the Banking (Glass-Steagall) Act of 1933 48 Stat. 162 (1933). Ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.). Section 16 was codified as 12 U.S.C. § 24 (Seventh). Section 20 was codified as 12 U.S.C. §377. Section 21 was codified as 12 U.S.C. §378(a)(1). Section 32 was codified as 12 U.S.C. § 78.

group'.[454] Although the Liikanen Report did not explicitly refer to this solution as 'ring-fencing' – it was in its essence, exactly that.

Acting on the recommendations of the Liikanen Report, on 29 January 2014 the European Commission adopted a proposal for a Regulation on Structural Measures Improving the Resilience of EU Credit Institutions (the 'Commission's proposed Regulation').[455] The Commission's proposed Regulation on structural banking reform aims to prohibit credit institutions and other systemically important financial institutions ('SIFIs') from engaging in proprietary trading[456] as well as legally separating other trading activities from the entity engaged in deposit-taking activities which are protected under depositor guarantee schemes. Thus, while the UK's ring-fencing model aims to protect 'deposits from traders' losses'[457], the EU Commission's proposal purports to build the fence around the trading activities, so that negative externalities do not spillover to affect deposits.

In June 2015, the EU Council 'agreed its negotiating stance' on the Commission's proposed Regulation. In order to grandfather-in existing structural national regimes, the Council's text includes two alternatives for implementing ring-fencing either 'through

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[454] High-level Expert Group on reforming the structure of the EU banking sector ('Liikanen Group'), 'Final Report' ('Liikanen Report') (October 2012) iv <http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf> accessed 6 December 2016.

[455] Commission Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, COM (2014) 043 (Jan. 29, 2014) <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0043&from=EN> accessed 6 December 2016.

[456] Proprietary trading occurs when banks and financial institutions purchase or sale financial instruments, like derivates or units in investment funds, for their own account, rather than for the benefit of their clients. Financial institutions engage in proprietary trading in order to manage or hedge their own liquidity or financial needs – but also as a way to make additional profits. According to Stacy Goto Grant: 'Regulators, however, are most concerned with what is colloquially referred to as "proprietary trading", which involves speculative trading for the firm's own account where trading is based on short-term price fluctuations in the financial markets as opposed to changes in the underlying value of the securities being traded'. See Stacy Goto Grant, 'International Financial Regulation through the G20: the Proprietary Trading Case Study' (2013) 45 Geo. J. Int'l L. 1217, 1221. See also United Kingdom Parliamentary Commission On Banking Standards, 'Third Report' (2012-2013) H.L. 138, 10 (U.IL).

[457] The Economist, *Debts, Deficits and Dilemmas: A Crash Course on the Financial Crisis and its Aftermath* (Profile Books 2014) 64.

national legislation requiring core retail activities to be ring-fenced, or through measures imposed by competent authorities in accordance with the regulation'.[458]

The Liikanen Report also triggered significant structural reforms in Germany and France.[459] Although not exactly identical, the French and German laws adopted the subisidiarization strategy with a different twist on the British model – and more in line with the Commission's proposal. Instead of ring-fencing the deposit-taking unit, both legislations tackled structural segregation by building a fence or firewall around the legal entity conducting the trading activities.[460] Thus, agreeing on the 'ring-fence' but legally segregating the trading unit instead of the deposit-taking entity. Moreover, while in the UK ring-fencing applies to deposit taking institutions with deposits over GBP 25 billion, the German and French structural measures are akin to the Commission's proposed Regulation, insofar that they only apply to SIFIs.[461]

In the USA, the 'Volcker rule' provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ('Dodd-Frank Act') set out to legally restrict proprietary trading from commercial banking. This means that banks face restrictions when dealing in securities for their own account, but can still intermediate on behalf of their clients. The Dodd-Frank Act also limits the ownership stake that commercial banks can take in pooled investment vehicles, such as private equity funds and hedge funds.[462]

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[458] See Council of the European Union Press Release, 474/15 (19 June 2015) <http://www.consilium.europa.eu/en/press/press-releases/2015/06/19-restructuring-risky-banks-council-agrees-negotiating-stances/> accessed on 6 December 2016.

[459] In France: LOI n° 2013-672 du 26 Juillet 2013 de séparation et de régulation des activités bancaires, J.O. n° 173 du 27 Juillet 2013, p.12530. Available online: <http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000027754539> accessed 6 December 2016. In Germany : Gesetz zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen v. 7.8.2013, BGBI. 2013. For a comprehensive comparative analysis of the structural banking reforms across the UK, the US, the EU, France and Germany, see Mathias Lehmann, 'Volcker Rule, Ring-Fencing or Separation of Bank Activities – Comparison of Structural Reform Acts Around the World' (2016) 17 Journal of Banking Regulation 176.

[460] Lehmann (n 459).

[461] ibid.

[462] See § 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111–203, which establishes prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds.

In spite of this relatively recent reform, other similar measures in force in the USA can be traced back to the Glass-Steagall Act of 1933.[463]

Moreover, the Dodd-Frank Act also includes two additional banking structural measures: the 'Swaps Push Out Rule' and the 'Foreign Banking Organization Rule'.[464] The 'Swaps Push Out Rule' precludes granting US federal assistance to swap dealers or participants registered with the Commodity Futures Trading Commission (CFTC) or with the Securities Exchange Commission (SEC). Swaps are derivatives and the rationale driving the rule is to cut any potential subsidy or governmental funding for these activities considered as being of a riskier nature.

On the other hand, the 'Foreign Banking Organization Rule' entails that foreign banks with 'US non-branch assets of $50 billion or more will be required to hold their US subsidiaries through a US intermediate holding company (IHC), which is subject to capital, capital planning, liquidity and stress testing requirements similar to those applicable to US bank holding companies (BHCs)'.[465]

The fact that some of the leading financial standards-setting jurisdictions have taken important steps towards designing and implementing structural banking reforms underlines the perceived importance of the relation between banks' legal structures and financial stability in the aftermath of the 2007-08 crisis.[466] However, the Volcker and Liikanen models, and the UK, French and German legislations have been criticized as

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[463] Winthrop N Brown, 'With this Ring, I thee Fence: How Europe's Ringfencing Proposal Compares with U.S. Ringfencing Measures' (2014) 45 Georgetown Journal of International Law 1029, 1032.

[464] See Financial Stability Board, 'Structural Banking Reforms: Cross-border Consistencies and Global Financial Stability Implications – Report to G20 Leaders for the November 2014 Summit', (27 October 2014) <http://www.financialstabilityboard.org/wp-content/uploads/r_141027.pdf> accessed 6 December 2016.

[465] ibid.

[466] ibid.

being 'highly contentious'[467], 'duplicative'[468], patchy; as well as 'disjointed', 'uncoordinated' and sometimes 'pointing towards different directions'.[469]

Notwithstanding the on-going implementation of ring-fencing type policies around the world, some important questions remain regarding: (i) a comprehensive definition of what bank ring-fencing exactly is; (ii) how ring-fenced bodies (RFB) will be legally structured in the UK; and (iii) what could be some of ring-fencing's unintended consequences.

This chapter applies the 'asset partitioning' theoretical framework developed by organizational law and economics in order to examine bank ring-fencing policies in the UK. Although this is certainly not the only framework that can be used, it has been chosen because it proves to be useful to better understand UK-type ring-fencing and the consequences that it has on different bank stakeholders. The chapter evaluates the need for special statutory provisions regarding bank ring-fencing in lieu of the legal structures already available for organizing banking activities, through the laws on business organization (ie Corporate Law, Trusts Law, Contract Law). Moreover, some of ring-fencing's unintended consequences are discussed.

The chapter is structured into four additional sections. Section 2 adopts a positive approach in order to examine the economic rationale that underpins the need for establishing RFBs. It summarizes part of the literature regarding bank ring-fencing with the objective of better understanding UK-style ring-fencing. Moreover, the economic problems that could justify ring-fencing regulation are discussed. Section 3 raises some questions regarding some aspects of bank ring-fencing as currently being implemented in the UK. The section discusses the so-called 'sibling structure' recommended by the

[467] House of Lords' European Union Committee, 'The Post-crisis EU Financial Regulatory Framework: Do the Pieces Fit?' (2 February 2015) 89-90.
[468] ibid.
[469] Rosa M Lastra, 'Memorandum submitted as written evidence to the House of Lords' European Union Committee' Written evidence (FRF0018) (6 October 2014) <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/eu-sub-a-economic-and-financial-affairs-committee/review-of-the-eu-financial-regulatory-framework/written/13542.html> accessed 6 December 2016.

Prudential Regulatory Authority ('PRA'). Section 4 analyzes whether ring-fencing could have harmful unintended consequences for certain RFB stakeholders, like depositors and financial supervisors. Section 5 concludes.

2. SOME ECONOMIC ASPECTS OF BANK RING-FENCING

What exactly do scholars and policymakers mean when they refer to 'ring-fencing'? This section applies a positive economic analysis to bank ring-fencing and RFBs. The first subsection reviews part of the existing literature on bank ring-fencing with the aim of presenting a definition of what it means. The second subsection discusses the sources of market failure that have led to the proposal of bank ring-fencing as a structural solution for making banks safer. A third subsection applies the 'asset partitioning' framework of to RFBs.

2.1. What is Bank Ring-Fencing?

In spite of the rise of bank 'ring-fencing', and to a certain extent, of 'subsidiarization'[470], as catchphrases after the onslaught of the 2007-08 Financial Crisis, both concepts are said to be 'inconsistently and often ill defined'.[471] In an attempt to provide a functional definition of ring-fencing, Steven L. Schwarcz considers it as a 'financial regulatory concept' that 'can best be understood as legally deconstructing a firm in order to more optimally reallocate and reduce risk'.[472] According to this perspective, risk-allocation occurs: 'by separating risky assets from the firm; by preventing the firm itself from engaging in risky activities or investing in risky assets; or by protecting the firm from affiliate and bankruptcy risks'.[473] Said definition is rooted on a risk-based approach and

[470] Alison Lui, 'Retail Ring-fencing of Banks and its Implications' (2012) 13 Journal of Banking Regulation 336, 338.
[471] Steven L Schwarcz, 'Ring-Fencing' (2013) 87 Southern California Law Review 69.
[472] ibid. See also Steven L Schwarcz, 'Banking and Financial Regulation' in Francesco Parisi (ed), *The Oxford Handbook of Law and Economics* (OUP 2015).
[473] Schwarcz, 'Ring-Fencing' (n 471) 72-82.

primarily focuses on ring-fencing from the perspective of the RFB and the banking firm as nexus of contracts.[474]

Another meaning, found in the literature in the years preceding the heightened use of 'ring-fencing' as a catchphrase (before the ICB's Report), describes it as: 'different restrictions on intra-group cross-border transfers imposed by the host/home country regulators'.[475] This conception mainly referred to limitations imposed by either host or home country regulators on the transfer of assets (or capital) from one entity within a banking group to another, located in a different jurisdiction. The justification for this view of ring-fencing was that during the last Financial Crisis, some regulators restricted banks from transferring assets/capital between entities within a group because of the perception that such transfers could potentially jeopardize the safety and soundness of their locally supervised financial institutions.

In a similar tenor, K. D'Hulster and I. Okter-Robe present a conception of ring-fencing more related to what they refer to as regulatory 'territorial approaches' or 'geographical ring-fencing'.[476] According to said authors: '(T)his type of ring-fencing is imposed unilaterally by prudential supervisors with the objective of protecting the domestic assets of a bank so they can be seized and liquidated under local law in case of failure of the whole, or other entities of, the banking group'.[477] By doing this, these authors posit that: 'the interests of domestic stakeholders such as taxpayers, depositors, shareholders, creditors and deposit insurers, are better protected in times of stress as the effects of cross-border contagion would be limited'.[478] This type of ring-fencing is typically applied by host state supervisors looking to minimize and contain the local impact of bank

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[474] ibid 82.

[475] Eugenio Cerutti, Anna Ilyana et al., 'Bankers Without Borders? Implications of Ring-Fencing for European Cross-Border Banks' in Peter Backé, Ernest Gnan and Philipp Hartmann (eds), *Contagion and Spillovers: New Insights from the Crisis* (Larcier 2010), 167. Available online: <https://www.suerf.org/docx/s_765d5fb115a9f6a3e0b23b80a5b2e4c4_2807_suerf.pdf> accessed 6 December 2016.

[476] See Katia D'Hulster and Inci Okter-Robe, 'Ring-fencing Cross-Border Banks: An Effective Supervisory Response?' (2015) 16 Journal of Banking Regulation 169.

[477] ibid.

[478] ibid.

failure. In the academic literature, it is also referred to by the use of terms that often carry a negative connotation, such as: 'fragmentation', 'protectionism[479]', 'balkanization' and 'home bias'.[480]

The definition of the type of ring-fencing that is being implemented in the UK, which is proposed by this study, builds on the referenced conceptualizations by characterizing it as a compulsory form of asset partitioning combined with the geographical and functional reapportionment of activities across different legal entities. Thus, it underlines UK-type ring-fencing's two main characteristics: (1) geographical asset partitioning; (2) achieved through subsidiarization.[481]

This approach is consistent with the *risk-allocation,* functional and the geographical dimensions of ring-fencing ubiquitous in the literature. The contribution of this definition is rooted on the patterns of property rights created by organizational law. This means that the law creates and/or rearranges existing patterns of property (and loss bearing) rights. However, before delving into the intricacies of this proposed definition, it is useful to review the economic rationale behind the implementation of ring-fencing.

2.2. The Economic Rationale for Ring-fencing Banks

Several models for structural banking reform have been proposed and adopted around the world as a response to the 2007-08 Financial Crisis.[482] It is important to note that

[479] See Roland Beck et al., 'The Side Effects of National Financial Sector Policies: Framing the Debate on Financial Protectionism' (2015) ECB Occasional Paper n 166.

[480] K. D'Hulster has developed a measure to rank so-called 'territorial bias' in prudential banking regulation and supervision in 22 European Union (EU) and non-EU countries with financial systems predominantly owned by foreign banks. See Katia D'Hulster, 'Ring-Fencing Cross-Border Banks: How is it Done and How Important is it?' (2014). Available at SSRN: <http://ssrn.com/abstract=2384905> or <http://dx.doi.org/10.2139/ssrn.2384905> accessed 6 December 2016.

[481] Rosa Lastra considers that: 'Functional separability (via ring-fencing) and geographical separability (via adequate rules on cross border resolution (…) should ensure a safer banking system'. Lastra, *International Financial and Monetary Law* (n 446) 143.

[482] See generally Financial Stability Board, 'Structural Banking Reforms' (n 464).

structural reforms are not envisaged as a standalone panacea for revamping global banking, but are rather designed for their use in conjunction with other tools within the framework of a wider and multi-pronged set of reforms.

As is the case with the rationale for financial regulation, the economic basis behind bank structural reforms has been justified on the correction of market failures. Some of the economic problems that bank structural reforms aim to tackle include: (i) negative externalities and spill-over effects; (ii) the public good nature of financial stability and global payments systems; (iii) the moral hazard that affects large, complex financial institutions; and (iv) the threats of bank runs and the time inconsistencies exhibited by regulators (and politicians).

2.2.1. Negative Externalities and Spill-over Effects

As stated by D. Llewellyn, banks generate negative externalities when 'the social costs of [their activities] (…) exceed private costs and such potential social costs are not incorporated in the decision making of the firm'.[483] This entails that banks often take risks and make business decisions without necessarily taking into account the negative (or positive) unintended consequences that their actions could have on the financial system, the real economy, public finances and society as whole.

Charles Goodhart and Rosa Lastra have pointed out that: '[t]he cross-border expansion of banks (via mergers and acquisitions, joint ventures or the establishment of branches and subsidiaries) and the effective supervision of institutions operating in various jurisdictions present numerous challenges for financial regulators and supervisors'.[484] Financial instability and systemic risk in one jurisdiction can spread to other countries

[483] David Llewellyn, 'The Economic Rationale for Financial Regulation' (1999) FSA Occasional Paper 1, 13.
[484] Charles Goodhart and Rosa M Lastra, 'Border Problems' (2010) 13 Journal of International Economic Law.

through the channels of contagion or transmission conduits.[485] The cross-border potential of these negative externalities can give rise to publicly funded bailouts and transfers from taxpayers in one jurisdiction to financial institutions – and their stakeholders – located elsewhere. Bank failure in one country can also have negative economic consequences across borders.

Bank failures can imply direct and indirect social costs. The costs imposed by such failures can affect more than just a bank's direct stakeholders. They can – and often do – spill-over to other financial institutions, public finances and also to the real economy, affecting financial and macroeconomic stability. According to the International Monetary Fund's (IMF) estimates, the countries that were worst affected by the 2007-08 downturn lost between 4-6% of their Gross Domestic Products (GDP).[486] On average, some countries committed up to 25% of their GDPs on the provision of governmental guarantees, pledges and other forms of state aid.[487]

In the case of global banks and SIFIs, the negative consequences of their failure or distress can spread across borders, disturbing financial stability and the international payments system. The often-cited phrase attributed to Sir Mervyn King that 'global banks are global in life but national in death'[488] does little justice to the fact that bank failure or *death* can have a detrimental cross-border impact.[489] Consequently, the externalities produced by global banks can also make them – to a certain extent – global in their death.

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[485] Rosa M Lastra enumerates four of these transmission mechanisms, which include: '(1) the inter-bank, inter-institution, inter-instrument channel; (2) the payment systems channel; (3) the information channel; and (4) the psychological channel'. The psychological channel is further discussed with regards to bank runs under s 2.2.4 below. Rosa M Lastra, 'Systemic Risk, SIFIs and Financial Stability' (2011) 6 Capital Markets Law Journal 197, 202.
[486] International Monetary Fund (IMF), 'A Fair and Substantial Contribution by the Financial Sector' (June 2010) Final Report for the G-20, 4.
[487] ibid.
[488] Financial Services Authority (FSA), 'A Regulatory Response to the Financial Crisis' (March 2009) Discussion paper 09/2, 55 <http://fic.wharton.upenn.edu/fic/Policy%20page/dp09_02.pdf> accessed 6 December 2016.
[489] Even though the quotation is largely construed as a critique to the fact that most bank resolution regimes at the time remained national in their nature.

In addition to containing the spread of systemic risk and contagion across borders as well as reducing the costs of governmental intervention, ring-fencing also purports to limit the negative spill-over effects between: (i) certain banking activities with different risk profiles; and (ii) contagion risks across entities within a financial group or conglomerate.

In the first sense, ring-fencing purports to segregate assets as well as certain activities according to their risk profile by reallocating them into different legal entities. According to UK policymakers, the rationale behind this segregation is that certain core banking activities – considered as being essential to the economy – are comingled with other activities and assets (excluded activities). Governmental guarantees, like deposit protection insurance schemes and lender of last resort functions, are seen as providing an implicit subsidy to excluded activities. This can reduce the cost of failure for banks and some of their constituencies, and can encourage them to 'undertake more risk than they otherwise would, which increases the likelihood of bank failure'.[490] By unbundling and segregating activities into different legal entities, ring-fencing would purportedly eliminate the implicit subsidy extended to the set of riskier activities, while still protecting the so-called core activities and services of the banking system.

Moreover, by adopting ring-fencing, regulators and policymakers aim to reduce the probability that intra-group contagion could affect local payments, 'core services' and taxpayers' fiscal exposure – while at the same time, attempting to mitigate the negative externalities of failure through their internalization within a segregated legal entity. The segregation of activities into different legal entities aims to put a backstop on potential losses emanating from certain activities or business lines within a banking group (eg a trading unit), from spreading to a local deposit-taking entity in the UK.

The rationale behind the aforementioned separation is to allow legal entities within a banking group (located in the UK or elsewhere) that are conducting riskier activities to fail or be resolved, without having to recur to the safety net provided by implicit

[490] Richard S Grossman, 'Double Liability and Bank Risk Taking' (2001) 33 Journal of Money, Credit and Banking 143.

governmental guarantees in the UK – or in the worst-case scenario – to a publicly funded bailout using British taxpayers' monies. Schwarcz calls this making a firm 'bankruptcy remote'.[491] In the words of the PRA: '[t]his is intended to protect retail banking from risks unrelated to the provision of that service and ensure that banking groups which get into trouble can be resolved in an orderly manner, thereby avoiding taxpayer liability and ensuring the continuous provision of necessary retail banking services'.[492] In this sense, the PRA has identified ring-fencing's objectives as 'ensuring the continuity of core [retail] services' by: (i) promoting resilience through the limitation of spill-over shocks between entities within a group; and (ii) enhancing the resolvability of both groups and individual entities.[493]

2.2.2. Moral Hazard and Large, Complex Systemically Important Banks

Ending the 'too-big-to-fail' (TBTF) and moral hazard problems that underpin large, complex financial institutions and Global SIFIs (G-SIFIs) is one of the main concerns in the ongoing agenda for revamping global finance.[494] G-SIFIs and large banking groups are characterized by their size, complexity, their levels of interconnectedness, lack of substitutability and their global outreach.[495] The sheer number of separate legal entities and the convoluted structures that some banks have can serve as a proxy to illustrate just how complex banks have become. For instance, the four largest US Bank Holding Companies each have more than 2,000 subsidiaries – two of them have more than 3,000 subsidiaries.[496] This increased legal complexity is not limited to US banks. Table 1 presents information regarding the total numbers of companies and recorded

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[491] Schwarcz, 'Ringfencing' (n 471) 5.
[492] Consultation Paper CP19/14 s 1.7.
[493] ibid ss 1.17-1.22.
[494] See Chairman of the Financial Stability Board, Letter to G20 Finance Ministers and Central Bank Governors, 'Financial Reforms – Finishing the Post-Crisis Agenda and Moving Forward' (4 February 2015) <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf> accessed 6 December 2016.
[495] See Financial Stability Board (FSB), 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (October 2014) <http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf> accessed 6 December 2016.
[496] Dafna Avraham, Patricia Selvaggi, and James Vickery, 'A Structural View of U.S. Bank Holding Companies' (July 2012) FRBNY Economic Policy Review 1.

subsidiaries[497] for some selected global banking groups, listed according to their total assets.

Table 8
Number of Companies and Subsidiaries for Selected Financial Institutions
(Source: Bankscope Database)

BANK NAME	TOTAL ASSETS IN MIL USD	NO. OF COMPANIES IN CORPORATE GROUP	NO. OF RECORDED SUBSIDIARIES
HSBC Holdings Plc	2,634,139	1,988	2,463
JPMorgan Chase & Co	2,573,126	2,023	5,275
BNP Paribas	2,522,470	2,096	2,800
Deutsche Bank AG	2,222,314	2,014	5,408
Barclays Plc	2,161,178	1,647	2,949
Crédit Agricole S.A.	2,119,532	1,163	636
Bank of America	2,104,534	2,350	4,218
JP Morgan Chase Bank, NA	2,074,952	2,023	537
Citigroup Inc	1,842,530	1,230	1,108
Wells Fargo & Company	1,687,155	2,574	4,093
Société Générale	1,588,163	951	995
Lloyds Banking Group Plc	1,394,977	1,630	56
UBS AG	1,074,164	479	4,379
BPCE SA	988,072	1,559	1,897
Credit Suisse Group AG	931,569	424	3,497
Goldman Sachs Group, Inc	856,240	1,051	3,889
Morgan Stanley	832,702	1,265	4,270
Commerzbank AG	758,049	1,048	1,381
UniCredit Bank AG	399,970	1,952	451
Bank of New York Mellon	385,303	493	5,920

[497] Defined as ownership of more than 50.01%.

The 'too-big-to' set of problems can entail perceptions that some institutions are either: too-big-to-save (TBTS), too-interconnected-to-fail, too-complex-to-resolve or too-big-to-prosecute. TBTF institutions thrive on the moral hazard generated by governmental subsidies and guarantees, which can prompt them to engage in excessive risk taking because of the perception that governments will bail them out in the event of their failure or financial distress.[498] Although it is very difficult to measure, in the UK some empirical studies estimate the implicit subsidy to major banks to oscillate from around £6 billion to over £100 billion.[499] What is more, the utter size of some of these TBTF institutions and the fiscal restrictions that their host/home countries can face entails that any potential governmental bailout could lack credibility or be outright unaffordable for some states. A grim reality may be that TBTF megabanks have only become bigger after the onslaught of the 2007-08 economic meltdown.[500]

Ring-fencing also purports to reduce information asymmetries between banks and other stakeholders, such as creditors, depositors and supervisors, with respect to the opacity of certain activities and assets deemed to be riskier – or simply too difficult – to adequately monitor or supervise.[501] The purported outcome would be that depositors are less likely to run on a RFB should other related group entities become financially distressed or insolvent. By 'separating the wheat from the chaff', British bank regulators and supervisors expect to rest assured in order to better focus on their oversight endeavors.

[498] Franklin Allen et al., 'Moral Hazard and Government Guarantees in the Banking Industry' (2015) 1 Journal of Financial Regulation 1.
[499] See Joseph Noss and Rhiannon Sowerbutts, 'The Implicit Subsidy of Banks' (2012) Bank of England Financial Stability Paper n 15. See also Bank of England, 'Financial Stability Report' (December 2010).
[500] James Barth et al., 'Just How Big Is the Too Big to Fail Problem?' (2012) Journal of Banking Regulation 265.
[501] For example, derivatives and some off-balance sheet operations. See Anat Admati, 'Financial Regulation Reform: Politics, Implementation and Alternatives' (2013) 18 N.C. Banking Inst. Special Edition 72.

2.2.3. The Payments System and Financial Stability as Global Public Goods

The 2007-08 global economic crisis exposed many of the frailties of the international monetary and financial system. Financial market integration and cross border interconnection have accentuated the need to preserve so-called 'global public goods', such as the worldwide payments systems, global economic growth and financial stability.[502] Interestingly enough, the mirror concepts of financial and payment system instability can be construed as global 'public bads'. As economic theory points out, public goods are non-rival and non-excludable in their consumption. This means that consumption of the payments systems and financial stability belong to every nation, their 'benefits are available to all States, and one State's consumption does not reduce their availability to others'.[503]

The public good problem surrounding financial stability is also connected to the aforementioned problems of negative and positive externalities. If one country invests a lot in financial stability and supervision, others states may still benefit from those efforts without having to contribute at all. Moreover, any country – regardless of whether it invests or not in financial stability – can still import financial instability stemming from another jurisdiction.

The transnational nature of these global public goods comes from the fact that their enjoyment and upholding is no longer confined within national borders.[504] However, similar to other public good problems, their existence can generate underinvestment, collective action and free-riding problems.[505] This is the rationale for having States and international bodies –like the Financial Stability Board (FSB) – undertaking the goals of

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[502] Joel P Trachtman, 'The International Law of Financial Crisis: Spillovers, Subsidiarity, Fragmentation and Cooperation' (2010) 13 Journal of International Economic Law 719, 721. See also Martin Wolf, 'The World's Hunger for Public Goods' *Financial Times* (London, 24 January 2012) < http://www.ft.com/intl/cms/s/0/517e31c8-45bd-11e1-93f1-00144feabdc0.html> accessed 6 December 2016.
[503] Trachtman (n 502) 721.
[504] Dirk Schoenmaker, 'A New Financial Stability Framework for Europe' (2008) 13 The Financial Regulator.
[505] See Lastra, *International Financial and Monetary Law* (n 446) 129.

preserving some of these global public goods by making sure that investing resources for achieving financial stability is the concern of every jurisdiction.

Ring-fencing has been presented as a potential solution for attaining the provision of public goods, like financial stability and core services continuity, locally in any jurisdiction. However, if other countries do not implement similar ring-fencing measures, the efforts could be undermined, as the import/export of negative externalities, such as systemic risk, across jurisdictions is not necessarily curtailed. Consequently, unless different countries adopt coordinated rules, contagion cannot be mitigated on a cross-border level.[506]

2.2.4. Time Inconsistency and Bank Runs

Bank supervisors, investors and customers do not always behave in a consistent manner. Foremost, banking regulators and supervisors – and to a certain extent, also politicians – often vow to put an end to the moral hazard produced by TBTF financial institutions. They do so by promising not to bail out financial institutions with public money should they enter into economic distress or come closer to failure because of undercapitalization or managerial malfeasance. However, during critical moments of financial distress, governments and independent monetary authorities can renege on their pledge and bailout financial institutions with taxpayers' funds in order to prevent the wider economic (and political) costs of failure.

Ring-fencing could purportedly ameliorate this time inconsistency problem, in the sense that the legal separation serves as a signal that differentiates between core and excluded activities. Should a RFB require a bailout, taxpayers and other stakeholders could rest assured that only core services – and not other excluded activities or assets – are rescued.

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[506] One could argue that ring-fencing resembles a form of vaccination: it can only help protect the local jurisdiction implementing it. However, it does not necessarily stop the spread of contagion elsewhere. Moreover, the different approaches employed so far seem to be different concoctions that could have varying consequences and effects. Consequently, unlike vaccines, if all countries scramble to ring-fence different entities the resulting fragmentation could make all jurisdictions worse off.

This could support existing governmental guarantees aimed at curtailing bank runs.[507] The segregation could also make it clear to the public whenever an entity that is not a core institution or RFB is salvaged. This could ultimately impose a political constraint on regulators while serving as an *odyssean* pre-commitment mechanism for them to 'tie themselves to the mast' in order to withstand the proclivity to bail-out entities that are not RFBs.

While the purported benefits of ring-fencing for tackling the time inconsistency problem and bank runs might hold true for the case of British depositors, it might not be the case across borders. For example, the heterogeneity of different policies adopted throughout EU states, such as Germany and France, could undermine the signaling benefits to European consumers that structural policies seek to achieve. Moreover, they can also hinder the objective of having a strong Banking Union.[508] In France and Germany, ring-fenced bodies are trading units – instead of deposit-taking entities like in the UK. This means that different activities are segregated in these countries. Sending contradicting signals can create confusion regarding which entities are segregated or protected in each jurisdiction across the EU Single Market. Consequently, the benefits that ring-fencing could provide against potential bank runs could be compromised.[509]

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[507] The seminal article by Douglas Diamond and Philip Dybvig states that: '[d]uring a bank run, depositors rush to withdraw their deposits because they expect the bank to fail'. In turn, this panic can become a self-fulfilling prophecy because of fractional-reserve banking. This entails that 'the sudden withdrawals can force the bank to liquidate many of its assets at a loss and to fail'. See Douglas Diamond and Philip Dybvig, 'Bank Runs, Deposit Protection Insurance and Liquidity' (1983) 91 Journal of Political Economy 401-419, 401.

[508] The Banking Union is the name of the Eurozone's latest regulatory framework reform with common rules for banks in all 28 Member States. The Single Rulebook, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are the cornerstones of the reform. See also n 176. At the time of writing, a majority of UK voters had decided on a referendum celebrated on 23 June 2016 in favor of the UK leaving the EU. However, it is still uncertain how the UK's exit from the EU will be implemented.

[509] In order to tackle some of the information asymmetries between depositor/consumers and non-ringfenced bodies ('NRFBs') the UK's Financial Conduct Authority (FCA) has published a consultation paper (CP15/23) titled 'Ring-fencing: Disclosures to consumers by non-ring-fenced bodies' (July 2015) <www.fca.org.uk/your-fca/documents/consultation-papers/cp15-23> accessed 6 December 2016. NRFBs are defined as: '(…) a deposit-taker that is not an RFB, or a deposit-taker that has been exempted from ring-fencing. For example, a deposit-taker that is not an RFB but is part of a corporate group that contains a RFB'.

Finally, ring-fencing could be ineffective to prevent bank runs when governmental guarantees are either not credible, limited, or are simply unfeasible. This would be the case of states that cannot afford to salvage failing too-big-to-save (TBTS) financial institutions. Time inconsistency could also undermine the effectiveness of the so-called 'electrification' of the fence, which threatens to completely breakup banks should they try to circumvent the firewall measures.

2.2.5. Summing-up

As discussed in this subsection, bank ring-fencing in the UK has been proposed as a structural solution – which employed in conjunction with other measures – could be used to tackle some of the cited economic problems experienced during the 2007-08 financial crisis. However, segregating particular activities into different entities also draws out some additional economic concerns.

Ring-fencing also raises some legal questions. Foremost, there is a choice on the legal form used to actually establish the ring-fenced subsidiary. There are patterns of property rights (loss bearing) that are modified whenever different legal entities – such as subsidiaries – are created. In addition, there is a concern that UK ring-fencing rules might be inconsistent with the EU's principle of freedom of establishment. Moreover, the Corporate Law and Economics literature points out to asset partitioning as one of the most relevant attributes of certain legal organizational forms. In turn, the following subsection discusses whether ring-fencing is a form of asset partitioning, as well as some of the consequences that result from such an interpretation.

2.3. Bank Ring-fencing as a Form of Asset Partitioning

When further examined through the prism of Corporate Law and Economics, the ring-fencing of core banking activities though subsidiarization that is currently being implemented in the UK evokes the theory of organizational law as asset partitioning

presented by Hansmann, Kraakman et al.[510] This is because the creation of a RFB as a subsidiary within a group structure potentially entails that: (i) the legal personalities of the holding entity, its RFB, and other group entities would be different; and (ii) that some degrees of limited liability could also be in place in order to protect the parent entity, its owners and other group entities from the obligations and liabilities of the RFB.[511] Thus, subsidiarization rearranges or modifies the existing patterns of bank creditors' (loss bearing) rights.

The academic literature identifies two types of asset partitioning, namely (a) limited liability (known as 'defensive asset partitioning' or 'owner shielding') and (b) 'affirmative asset partitioning' (also known as 'entity shielding').[512] Both entity shielding and owner shielding are two sides of the same coin. Limited liability protects an entity's owners from the claims of the entity's creditors. 'Entity shielding' protects a firm's property from its owners and from the owners' creditors. Different organizational forms can have varying levels or degrees of these two forms of asset partitioning (oscillating from weak to complete).[513] In turn, the features of both forms of asset partitioning are discussed with greater detail.

2.3.1. Defensive Asset Partitioning: The Limited Liability of RFBs

The establishment of ring-fenced banks as subsidiaries within banking groups could entail the possibility that RFBs be endowed with limited liability. Limited liability is a salient feature of some organizational forms, such as (public and private) business corporations (joint stock companies) and limited liability companies (LLCs). In essence, these are the type of entities that ring-fencing rules will apply to in the UK – since there

[510] See generally Henry Hansmann, and R Kraakman, 'The Essential Role of Organizational Law' (2000) 110 Yale Law Journal 387; Henry Hansmann and Reinier Kraakman, 'Organizational Law as Asset Partitioning' (2000) 44 European Economic Review 807; Henry Hansmann, R Kraakman and Richard Squire, 'Law and the Rise of the Firm' (2006) 119 Harvard Law Review 1333.
[511] The degree of limited liability (ie strong/weak) will be contingent upon the type of legal structure used in order to incorporate the RFB (ie if it is a corporation, a trust, etc.).
[512] See Henry Hansmann, and R Kraakman, 'The Essential Role of Organizational Law' (n 510).
[513] ibid.

is a carve-out provision that excludes co-operative banks, credit unions and building societies.

From an economic perspective, limited liability creates an asset partition that works to protect the property of the owners of a legal entity against claims brought by the entity's creditors. Limited liability puts a floor under the losses that a firm's owner can experience during a downturn.[514] Limitedly liable owners can externalize their downside risks to other stakeholders – specially, involuntary ones.[515] If RFBs are structured using an organizational form with limited liability – which is likely to be the case – then the depositors and other creditors of the RFB do not, in principle, have a legal claim against the beneficial owners of the entity (eg against its holding organization) nor against other legal entities within a banking group's structure. This means that while regulators could have the faculty to bail-in equity holders and some types of bank creditors (including depositors), they would not necessarily have the prerogative to compel these stakeholders to inject additional funds into a RFB, should it become insolvent. In order to be able to execute claims against the direct owners of a RFB endowed with limited liability, regulators would need to pierce through one or several corporate veils of protection.

When limited liability is coupled with freely transferable shares, investors can diversify their portfolios.[516] Limited liability can purportedly lower a RFB's cost of capital and allow it to raise funds. According to the literature, limited liability should have a greater effect on an entity's involuntary creditors (ie tort victims) because voluntary creditors can 'incorporate the risk of non-payment into the contract price'.[517] This could be the case for certain bank creditors that have enough clout to enable them to negotiate with RFBs on a level playing field. However, in their dealings with RFBs, most retail depositors (as a

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[514] It could be argued that de facto limited liability exists with regards to the ownership interests of the owners of a mutual association.
[515] Frank Easterbrook and Daniel Fischel, 'Limited Liability and the Corporation' (1985) 52 University of Chicago Law Review 89.
[516] ibid.
[517] ibid.

class of unsecured bank creditors[518]) presumably contract with banks by adhering to boilerplate terms, conditions, and market commissions, fees and interest rates.

2.3.2. Affirmative Asset Partitioning: The Legal Personality of RFBs

Having an independent legal personality means that a RFB (ie a corporation, a limited liability company, etc.) is a subject of law entitled to exercise rights and undertake obligations. Subsidiaries are typically standalone bodies corporate, which means that they have an independent legal personality as well as their own capital and limited liability. Bank branches, on the other hand, do not necessarily have a separate legal personality of their own and enjoy limited liability on a consolidated basis (eg they share the limited liability of their parent entities).[519]

From an economic perspective, having an independent legal personality means that an organization can own property and undertake its own obligations (enter into contracts). In the case of a RFB, it also means that the property that it owns is different to the property owned by its holding company and its ultimate beneficial owners. As a corollary to this, the assets of a RFB are – in principle – unavailable to its direct or ultimate beneficial owners, to the creditors of its parent organization or to the creditors of its ultimate beneficial owners. This is referred to as 'liquidation protection' in the literature.[520] This entails that, to a certain degree, the property of the RFB is shielded from appropriation by: (i) the parent organization, (ii) the parent organization's ultimate beneficial owners; (iii) other legal entities within the group structure; and (iv) the creditors of (i), (ii) and (iii).

[518] Depositors will be amongst the voluntary, unsecured creditors of a RFB. Moreover, RFBs will have additional secured, unsecured, voluntary and involuntary creditors. Deposit insurers – and ultimately, taxpayers – could also potentially become involuntary and unsecured creditors of a RFB in the case that it is rescued with public funds.

[519] See Giovanni Dell'Ariccia and Robert Marquez, 'Risk and the corporate structure of banks' (2010) 65 Journal of Finance 1075.

[520] See Hansmann et al. 'Law and the Rise of the Firm' (n 510).

In turn, the assets of a RFB are segregated for the benefit of its own creditors, including its depositors – and ultimately, local taxpayers – should the threat of a bailout loom. This means that subsidiarization effectively modifies patterns of creditors' (or loss-bearing) rights. Moreover, having an independent legal personality also means that the corporate governance structure of a RFB can – and should be different – to the governance of its parent organization and related group entities.[521]

2.3.3. Why is Asset Partitioning Relevant for RFBs?

The fundamental difference between entity shielding (legal personality) and owner shielding (limited liability) is that: 'entity shielding protects the assets of the firm from the creditors of the firm's owners, while limited liability protects the assets of the firm's owners from the claims of the firm's creditors'.[522] For the particular case of RFBs in the UK, this means that entity shielding reshuffles creditors' rights over part of a banking group's consolidated balance sheet. Entity shielding (eg having an independent legal personality) would protect the RFB's property from the claims of the creditors of its owners (ie creditors of the holding organization) as well as from the claims of the creditors of other group entities.

Conversely, the ownership shielding provided by limited liability would protect the assets of the holding organization (the owners of a RFB) and the property of other group entities from the claims of a RFB's creditors. Thus, owner shielding is the mirror concept of entity shielding. Both forms of asset partitioning serve to establish the ring-fence. In this sense, asset partitioning works as a form of 'double-glazing'.[523] Because banking groups are characterized by multiple standalone subsidiaries, asset partitioning can be replicated throughout a group's structure.

[521] The PRA's proposed draft Rulebook for RFBs established detailed rules regarding the composition of a RFBs board in relation to directors serving or holding appointments in other entities of a RFB's group. See Bank of England & Prudential Regulation Authority (PRA), 'The implementation of ring-fencing: consultation on legal structure, governance and the continuity of services and facilities', Consultation Paper CP19/14, October 2014, Appendix 4.
[522] Reinier Kraakman et al., *The Anatomy of Corporate Law: a Comparative and Functional Approach* (2nd edn, OUP 2009) 10.
[523] I am grateful to Tobias Hlobil for this illustration.

Figure 9

Subsidiarization as Asset Partitioning

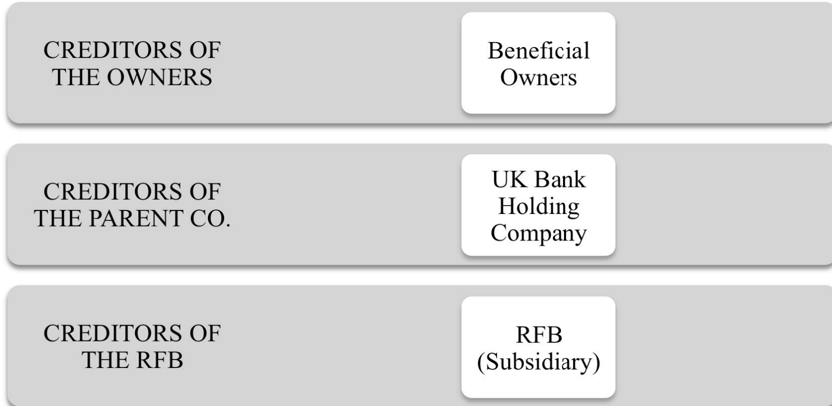

Figure 9 tries to depict how ring-fencing through asset partitioning works. A RFB subsidiary setup using an organizational form endowed with limited liability (eg a corporation) precludes the creditors of a RFB from pursuing the assets of its parent company – and also shields the property of its ultimate beneficial owners. Limited liability works as a shield that protects the parent entity, its investors (and also other entities within a banking group), from the claims of the RFB's creditors. Such creditors could potentially include a deposit insurer and taxpayers. Consequently, in the event that a RFB fails, its creditors cannot expect the RFB's parent company (nor the beneficial owners of the parent company or other group entities located abroad) to inject capital or provide liquidity to the failing subsidiary in order to prevent its failure.

This means that limited liability protects the holding company's property (and the property of other group entities) from the creditors of the RFB. However, certain types of RFB creditors – namely depositors – can further benefit from the deposit protection granted in the UK, thus reducing the extent of their potential losses.

Figure 9 also helps illustrate the entity shielding created by establishing RFBs through subsidiarization. RFBs would be endowed with a separate and independent legal personality from that of their parent companies (and their ultimate beneficial owners). As a result, the capital and assets (property rights) of a RFB would be protected from the claims of its parent company's creditors. Unless a RFB is liquidated, the creditors of its owners do not have access to the RFB's assets in order to satisfy their claims against the entity's owners. Entity shielding reinforces the idea that ring-fencing through subsidiarization purports to protect deposits and core retail functions locally by rearranging existing patterns of creditors' rights through the RFB.

The economic consequences of ring-fencing as asset partitioning are important for RFBs because such regulatory provisions essentially modify the patterns of creditors' – or in reverse order, loss-bearing – rights established in the law. In other words, ring-fencing changes creditor hierarchy. This means that it can favor or prioritize some creditors (bondholders, depositors, other banks, the central bank and ultimately domestic taxpayers) at the expense of others (creditors located abroad). Thus, ring-fencing reapportions parts of a bank's consolidated balance sheet. To a certain extent, deposit protection insurance schemes also achieve this creditor reshuffle through legal subrogation by deposit insurers.

In addition, strong entity shielding and strong owner shielding could be construed as having their own costs and benefits *vis-à-vis* ring-fencing's policy objectives. In particular, ring-fencing's objectives as declared by the PRA, include assuring the continuity of services by enhancing both the resolvability and the resilience of RFBs.

The explanation for the aforementioned idea is that on the one hand, a strong form of entity shielding for the ring-fenced subsidiaries would reduce the implicit contingent public sector guarantees for the country implementing ring-fencing, in the case that any RFB requires a public bailout. The enhanced guarantee results from the geographical segregation and the *pledge* of a RFB's assets for the benefit of local creditors. Entity shielding also facilitates opportunities for implementing states and regulators to

expropriate capital locally if needed.[524] Ring-fencing can also enhance resolvability by making RFBs 'bankruptcy remote'. These benefits underline the geographical dimension of asset partitioning through subsidiarization. Consequently, entity shielding seems to be aligned with some of ring-fencing's stated objectives.

On the other hand, a strong or complete form of limited liability (owner shielding) would entail that a RFB's owners could be affected by moral hazard and reduced incentives for adequately monitoring the ring-fenced entity (this is discussed in greater detail under Section 4 below). What is more, it could mean that in the event that a RFB is undercapitalized, enters into financial distress or becomes insolvent, regulators/governments cannot legally coerce a bank holding organization (or the RFB's ultimate beneficial owners or other 'sibling' entities) to inject fresh funds into the subsidiary with the aim to prevent it from failing. While the firewall created by entity shielding has the benefit of protecting assets and capital from going outside of the fence, the costs of limited liability can make it more difficult to bring in new capital when needed.

This 'double-glazing' feature is central to the concept of ring-fencing and the benefits resulting from asset partitioning. Entity and owner shielding can certainly have counteracting effects. Thus, asset partitioning can work as a double-edged sword. The problem is exacerbated when considering that asset partitioning is replicated in all subsidiaries throughout a banking group's structure. Particularly, in the presence of many different legal entities operating across borders.

In order to be able to reduce the aforementioned counteracting effects, financial regulators can calibrate the desired levels of asset partitioning. In this sense, both limited liability (owner shielding) and entity shielding can be decreased or augmented depending on the desired policy outcomes.

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[524] See Dell'Ariccia and Marquez (n 519).

Entity shielding can be increased by restricting intra-group flow of funds (capital, liquidity, profits, leverage) between entities in a banking group. For example, dividends and other forms of compensation payouts can be restricted. Moreover, regulators can impose strict capital, liquidity and leverage requirements across ring-fenced local subsidiaries. Conversely, these measures can also be relaxed, weakening the level of entity shielding.

There are a variety of tools for adjusting limited liability levels. Measures that can reduce limited liability can range from bail-in measures and corporate veil piercing, to special extended liability regimes. Some of these current and historical measures are briefly discussed in turn.

Thomas Huertas defines bank bail-in as writing-down or converting liabilities into equity.[525] But bank bail-in measures can encounter several limitations.[526] Primarily, bail-in applies *vis-à-vis* existing liabilities and residual claimants. This means that liabilities, liquidity and loss absorbing capital have to be enough to keep an entity going during times of financial distress and in order to avoid a publicly funded bailout.

Corporate veil piercing can also encounter some practical problems. Bank ownership can be widely dispersed, making it prohibitively expensive or simply unfeasible for deposit insurers or regulators to claim additional funds. Moreover, investors can also be insolvent. This is referred to as the judgment proof problem in the Law and Economics literature.[527] An additional potential mechanism that regulators could consider is

[525] Thomas F Huertas, *Safe to Fail: How Resolution Will Revolutionise Banking* (Palgrave Macmillan 2014) 92.
[526] ibid 93. According to Huertas in order for bail-in 'to work effectively within the time frame relevant for preservation of continuity, a number of conditions have to hold: (i) the resolution authority has to have the statutory authority to implement bail-in immediately; (ii) bail-in has to respect creditor hierarchy; (iii) bail-in of investor instruments should be sufficient to recapitalise the bank; (iv) bail-in of investor instruments should not trigger cross-default clauses'.
[527] Parties are judgment proof when they are 'unable to pay fully the amount for which they have been found legally liable' by a court of law. See Steven Shavell, 'The Judgment Proof Problem' (1986) 6 International Review of Law and Economics 45. See also Steven Shavell, 'Minimum Asset Requirements and Compulsory Liability Insurance as Solutions to the Judgment-proof Problem' (2005) 36 RAND Journal of Economics 63.

corporate veil piercing combined with something called 'reverse piercing of the corporate veil'.[528] This is essentially 'piercing entity shielding', and is often seen from the perspective of an entities' owners. Veil piercing and 'reverse veil piercing' are mirror concepts of each other, in the same way that entity shielding and owner shielding are mirror concepts of each other.

How would this potential solution work? While current liability calibration measures allow regulators to bail-in a RFB's holding company in the event of the failure or distress of the RFB, reverse veil piercing would also grant regulators the authority to seek additional assets and capital from other group entities (eg an investment bank or another affiliate entity located abroad), as a way to mitigate potential capital shortfalls, residual losses or 'judgment proof' problems affecting a RFB and its direct holding company. This can imply, for example, appropriating assets or restricting dividend policies in other group entities in order to recapitalize a RFB in distress or reimburse funds paid out by deposit insurers. This solution would be a mixture of strong entity shielding for the RFB, combined with weak owner shielding and weak entity shielding for the RFB's parent company and for other group affiliate entities. It is essentially breaking through layers of double-glazing, throughout a banking group's organizational structure.

The aforementioned proposal implies relaxing limited liability to a certain extent. Similar solutions for banking regulation have existed in the past. One notable example was the 'double limited liability' that existed in US from the late nineteenth to the early twentieth century.[529] Under this extended-liability regime, bank owners could stand to lose up to double their original investment. This meant that bank shareholders could not only lose the amount that they invested, but in the event of bank failure, they were also personally liable for an additional amount up to the par value of their original shareholding. Bank

[528] Michael J Gaertner, 'Reverse Piercing the Corporate Veil: Should Corporation Owners Have It Both Ways? (1989) 30 Wm. & Mary L. Rev. 667, <http://scholarship.law.wm.edu/wmlr/vol30/iss3/6> accessed 6 December 2016.

[529] See Grossman (n 490). See also Jonathan Macey and G Miller, 'Double Liability of Bank Shareholders: History and Implications' 27 Wake Forest Law Review 31. For a recent discussion of so-called 'de-partitioning remedies' see H Hansmann and R Squire, 'External and Internal Asset Partitioning: Corporations and Their Subsidiaries' in Jeffrey N Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (forthcoming OUP 2017).

extended liability regimes were eventually replaced by deposit guarantee schemes. Although extended liability regimes might be futile for global banks with dispersed ownership, they could provide some insights for designing policies aimed at tackling the economic problems that bank limited liability generates.

Another policy that could serve to buttress ring-fencing in the UK is requiring RFB holding companies to act as a 'source of strength' to their ring-fenced subsidiaries. In the US, the 'source of strength' of bank holding companies is interpreted to mean: '[t]he ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution'.[530] This would entail that in addition to the adoption of the 'sibling structure' both RFBs and their holding companies should be adequately capitalized, subjected to liquidity and leverage ratios, and that regulators could use the assets of parent companies – and other group entities – in order to bail-in ring-fenced subsidiaries.[531]

To sum up, while ring-fencing could be an effective measure for preventing capital flights between distressed or fragile entities within a banking group, it could also undermine resolvability by making it more difficult to bail-in or require a RFB's holding company to inject fresh capital to an undercapitalized or failing subsidiary.[532] As a result, these considerations regarding asset partitioning can be useful for calibrating the effectiveness of ring-fencing through subsidiarization as will be further explained under Section 3.

[530] As originally established in § 225.28 of the US Bank Holding Company Act of 1957 and Regulation Y.

[531] This is currently not the case for certain banking holding companies. For example, HSBC Holdings plc's 2014 Annual Accounts state that while: 'HSBC Holdings, the holding company of the Group, is the primary source of equity capital for its subsidiaries and provides non-equity capital to them when necessary' it 'does not provide core funding to any banking subsidiary, nor is it a lender of last resort and does not carry out any banking business in its own right'. See 'HSBC Holdings plc Annual Reports and Accounts 2014' <http://www.annualreports.com/Company/hsbc-holdings-plc> accessed 6 December 2016.

[532] It could be argued that reputational risk aversion could provide incentives for a banking group (wishing to continue conducting business as a going concern) to capitalize a failing RFB without necessarily having the legal obligation to do so. This argument has been made by Lui (n 470) 341.

2.3.4. Why Did Bank Ring-Fencing Require Special Legislation?

Much like the contributions of Corporate Law and Trusts Law, the ring-fencing of commercial banks seeks to establish patterns of creditors' – and other stakeholders' – property rights (loss bearing) that would either be impossible or prohibitively expensive to create via contract. The asset partitioning created by ring-fencing would benefit certain classes of domestic bank creditors and stakeholders: namely, depositors, deposit insurers – and most importantly – taxpayers. While depositors are typically existing and voluntary bank creditors, the taxpayers that effectively end up providing funds to salvage banks in distress are only potential – and often involuntary, bank creditors. Thus, ring-fencing reapportions and pledges the assets of the RFB for the benefit of local taxpayers – but also benefits the continuous functioning of bank core activities and the payments system in general.

In addition, ring-fencing could meet its regulatory objectives by minimizing the negative externalities produced by bank failure at the lowest transaction cost amongst competing organizational structures. This means that ring-fencing should ideally be the cheapest cost-avoiding organizational structure for segregating core bank activities from excluded activities. This functional segregation also entails that taxpayers are not underwriting riskier activities and assets via deposit protection insurance schemes and other forms of governmental guarantees.

One of the benefits that ring-fencing would purportedly provide is the reduction of the monitoring costs for bank creditors and other stakeholders – namely, depositors, supervisors and taxpayers – regarding the risk appetite of banks. Ring-fencing segregates core functions from other excluded activities. The rationale is that the monitoring costs of depositors and supervisors would be reduced since their main oversight would shift to the RFB. This is expected to make supervision less murky and failure less costly – but mostly for financial supervisors and countries implementing the measures. Consequently, ring-fencing could raise supervisory and failure costs for regulators located abroad.

Moreover, ring-fencing could also lower the cost of credit for the RFB, in a different manner to the way that limited liability does. This would work in a similar way to the enhanced creditworthiness that securitization and covered-bond structures provide.[533] By segregating assets and activities into a separate pool with a different pattern of creditors' rights, financial conglomerates may benefit from distinct credit ratings across units. A lower perceived risk profile for RFBs could entail cheaper funding *vis-à-vis* other legal entities within a banking group.[534]

In sum, regulatory ring-fencing could be the most cost-effective organizational solution for pledging assets for the benefit of depositors and other bank stakeholders in the event of insolvency, as well as for minimizing and containing the external costs of bank failure. Ring-fencing through subsidiarization as a form of asset partitioning has been statutorily designed to protect depositors – a special category of bank creditors – and also other stakeholders such as deposit insurers and taxpayers, from having to incur the insolvency costs of failing financial institutions.

It can be argued that – like limited liability – ring-fencing could also be established contractually by RFBs, on a case-by-case basis. However, contractually agreed ring-fencing would not be effective *vis-à-vis* involuntary creditors (eg taxpayers). Moreover, it would not imply an obligation for banks to voluntarily adopt the ring-fence. The creditors of the RFB could also negotiate and agree a special status for their claims.

As a result, effective ring-fencing with universal effects (*erga omnes*) is best established through special legislation. Moreover, establishing ring-fencing via legislation as the default regime reduces the mounting transaction costs that would result from having to include ring-fencing clauses in all of a RFB's contractual dealings with third parties. In

[533] Claire Hill, 'Securitization: A Low-Cost Sweetener for Lemons' (1996) 74 Washington University Law Quarterly 4.

[534] Of course, this is an empirical issue that ultimately will depend on the quality of the partitioned assets. See also John Armour et al., *Principles of Financial Regulation* (OUP 2016) 516-17.

addition to the legal and commercial uncertainty and costs that would result from having contractual ring-fencing provisions struck down by a court of law. Consequently, it seems efficient to create ring-fencing through special legislation instead of by means of contract.

3. SOME LEGAL ASPECTS OF RING-FENCING IN THE UK

The UK's ring-fencing reforms were complemented by the Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014 No. 2080 and the Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 No. 1960 (the 'Orders'). The Orders establish that as a default rule, RFBs are precluded from the activity of dealing in investments acting as principals, unless authorized (also known as proprietary trading).

The FSMA 2000 (as amended by the Financial Markets-Banking Reform- Act 2013) does not provide a definition for 'ring-fencing'. The legislation focuses mainly on RFBs, which are defined as any: 'UK institution which carries on one or more core activities (…)'.[535] By 'UK institution' the Act means a 'body corporate incorporated in the United Kingdom', with the exception of mutual societies[536] and UK institutions of a class excluded by order of the Treasury.[537] While 'core activities' refer to the 'the regulated activity of accepting deposits (whether carried on in the United Kingdom or elsewhere)'.[538] Moreover, 'core services' are defined as:

(a) Facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits;
(b) Facilities for withdrawing money or making payments from such an account;

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[535] Financial Services (Banking Reform) Act 2013 s 142A.
[536] Consultation Paper CP19/14 s 6.34 states that mutual societies include 'building societies, friendly societies, industrial provident societies and EEA mutual societies'. See also FSMA s 142(A).
[537] ibid paras (2) and (7).
[538] ibid s 142B.

(c) Overdraft facilities in connection with such an account.[539]

In October 2014, the UK's Prudential Regulatory Authority (PRA) published its Consultation Paper CP19/14 titled: 'The Implementation of Ring-Fencing: Consultation on Legal Structure, Governance and the Continuity Of Services and Facilities' (hereinafter, 'Consultation Paper' or 'CP19/14').[540] In May 2015, presented its 'Policy Statement PS10/15 on the implementation of ring-fencing: legal structure, governance and the continuity of services and facilities' (henceforth, the 'Policy Statement PS10/15') providing feedback on CP19/14 and restating the rules and supervisory statements related to bank ring-fencing.[541] The PRA's Policy Statement PS10/15 sets out the PRA's expected outcomes regarding bank ring-fencing policy in the UK. The key aspects of the ring-fencing policies presented in the document relate to: (i) the legal structure of banking groups, (ii) their governance; and (iii) the continuity of services and facilities.

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[539] ibid s 142C.

[540] According to the PRA, CP19/14 was 'one of four papers published on 6 October 2014 as part of its wider resolution and resilience agenda' for banks in the UK. The other papers published on the same date are: PRA Consultation Paper CP20/14, 'Depositor Protection', October 2014; PRA Consultation Paper CP21/14, 'Policyholder protection', October 2014; and PRA Discussion Paper DP1/14, 'Ensuring operational continuity in resolution', October 2014. All the aforementioned documents are available online at: <http://www.bankofengland.co.uk/pra/Pages/publications/cp/default.aspx> accessed 6 December 2016. A response to Consultation CP19/14 was presented using some of the ideas developed in this paper. See Klaus Heine and Enmanuel Cedeno-Brea, 'The Legal Structure of Ring-Fenced Bodies in the United Kingdom - A Response to Consultation Paper CP19/14 on the Implementation of Ring-fencing: on Legal Structure, Governance and the continuity of Services and Facilities' (2015) <http://hdl.handle.net/1765/77569> accessed 6 December 2016.

[541] Moreover, the PRA has also published Consultation Paper CP33/15 (September 2015), which described the PRA's proposed approach to ring-fencing transfer schemes, as well as Consultation Paper CP37/15 on 'The implementation of ring-fencing: prudential requirements, intragroup arrangements and use of financial market infrastructures' (October 2015). The PRA has stated that it intends to 'publish final versions of the rules and supervisory statements consulted on in the first and second ring-fencing consultations during the first half of 2016'. See Policy Statement PS10/15 para 16. The UK's Financial Conduct Authority (FCA) has also published a consultation paper (CP15/23) titled 'Ring-fencing: Disclosures to consumers by non-ring-fenced bodies' (July 2015) <www.fca.org.uk/your-fca/documents/consultation-papers/cp15-23> accessed 6 December 2016.

3.1. How Does the PRA Expect RFBs to be Legally Structured?

The Financial Services (Banking Reform) Act 2013 and its complementary Orders do not prescribe any compulsory formulas for legally structuring RFBs. The PRA's Consultation Paper, which states its proposed ring-fencing policy, does not stipulate specific rules either. Instead, the PRA set out its 'expectations for the legal ownership of RFBs and the entities which RFBs can own'.[542] The PRA does not delve into the granularities of different legal structures that could be used for ring-fencing deposits. This means that the PRA does not expressly dictate what legal form RFBs should adopt. In this sense, organizational laws provide an array of different legal forms that are readily available for the structuring of ring-fenced subsidiaries within a banking group. Existing organizational forms include: limited liability companies, public limited companies, general and limited liability partnerships, mutual structures and trusts and special purpose securitization vehicles.

Instead, the PRA states that: 'RFBs and entities that can conduct excluded or prohibited activities are expected to be structured as separate clusters of subsidiaries beneath a UK holding company'.[543] In the CP19/14, this is referred to as the adoption of a 'sibling structure' (see Figure 10).[544]

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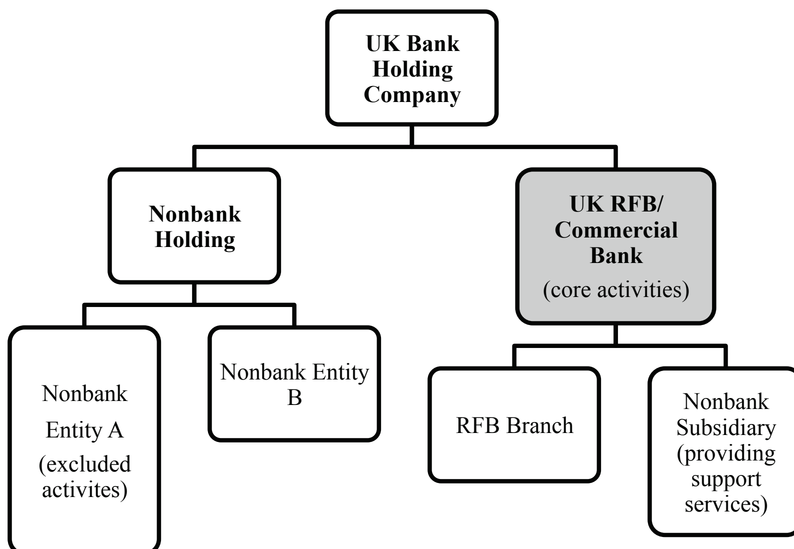
[542] Consultation Paper CP19/14 s 2.1 <http://www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp1914.aspx> accessed 6 December 2016.

[543] ibid s 2.6.

[544] Sir John Vickers has called this a convergence towards 'structured universal banking', also currently underway in the US. See John Vickers, 'Banking reform in Britain and Europe' (2013) Paper presented at the Rethinking Macro Policy II: First Steps and Early Lessons Conference Hosted by the International Monetary Fund, Washington, DC, 8.

Figure 10

Stylized 'Sibling Structure' of a Banking Group Containing a RFB



The adoption of a sibling structure according to the PRA's expectation entails that RFBs should not take ownership interests in entities conducting excluded activities (ie engaged in proprietary trading). Enabling this could possibly defeat the purpose of ring-fencing core activities by allowing banks to circumvent regulations by transferring prohibited activities to a controlled subsidiary (as depicted in Figure 11.).[545] The threat of complete segregation ('electrification') also aims to deter potential deviations from the strict firewall. Moreover, the PRA expects that RFBs should not be the subsidiary of an entity that conducts prohibited or excluded activities (see Figure 12).[546] The adoption of the sibling structure is also consistent with Article 13(3) of the Commission's proposed

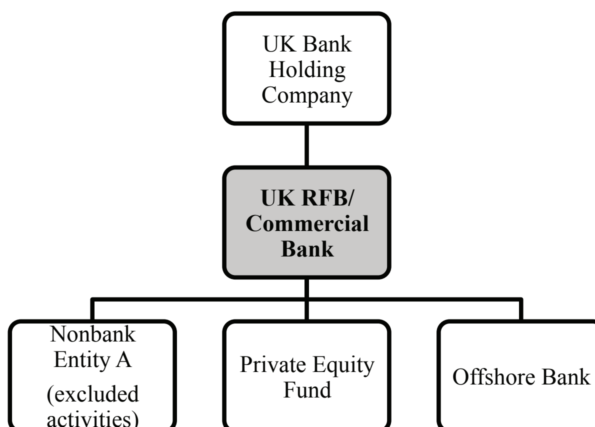
[545] Consultation Paper CP19/14 paras 2.7-2.9. In the French and German laws, proprietary trading and investments in hedge funds and other risky pooled vehicles – rather than deposits – are segregated into subsidiaries. Such ring-fenced entities cannot perform so-called core activities like deposit-taking. cf Lehmann (n 459) 9.

[546] According to the PRA, the rationale for this is that 'operating as a subsidiary of such an entity [conducting excluded activities] could threaten an RFB's ability to make independent decisions. For example, it may face pressure from the parent to take actions not in its interests'. See Consultation Paper CP19/14 paras 2.7-2.9.

structural Regulation, which require that 'the [banking] group must be organized into homogeneous functional subgroups constituted on the one side by core credit institutions and on the other trading entities'.[547]

Figure 11

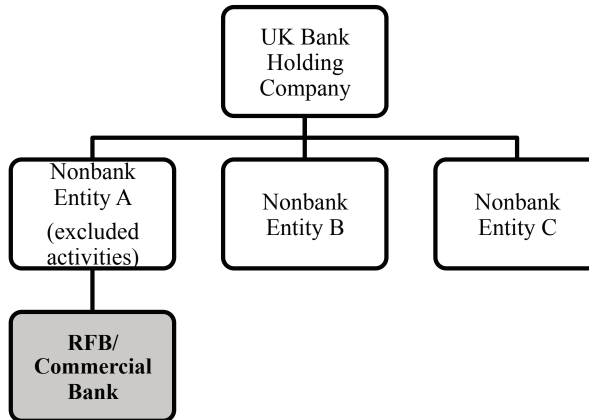
Discouraged Structure I: RFB with Ownership Interests in a Nonbank Financial Institution Conducting Prohibited Activities



[547] art 13(3) of the EU proposed Regulation states that: 'The EU parent shall ensure that a group containing core credit institutions and trading entities shall be structured so that on a sub-consolidated basis two distinct sub-groups are created, only one of which contains core credit institutions'. COM (2014) 043 (29 January 2014).

Figure 12

Discouraged Structure II: RFB as a Subsidiary of a Nonbank Financial Institution Conducting Prohibited Activities



The Consultation Paper suggests that the PRA does not intend to prescribe that banks and banking groups adopt a particular legal structure. This approach allows for some leeway regarding the legal arrangements that each banking group would undertake for setting-up their RFB in the UK. Banking groups would have to make a choice regarding the optimal legal form that their ring-fenced subsidiary will take.

Moreover, it cannot be assumed that RFBs will necessarily adopt the corporate form. While the corporate form is the dominant structure in commercial banking worldwide – it is certainly not the *only* organizational form available for structuring RFBs within a banking group. As discussed before, there is a gamut of organizational forms that can be used for setting up RFBs. This means that while 'a bank incorporated in France may look very different from one incorporated in Germany'[548] or one incorporated in the UK, RFBs in Britain are also likely to be organized differently. However, it is likely that most RFBs will be setup using the corporate form given that the ring-fencing measures only apply to corporate banks.

[548] Lehmann (n 459) 10.

3.2. Is Ring-Fencing Consistent with EU Law?

One particular concern raised against the UK's ring-fencing model is that it could run counter to the principle of freedom of establishment under EU Law and the existing passporting provisions within the European Economic Area (EEA).[549] The rationale behind this concern is that the British ring-fencing model forces certain banks to reorganize their retail business through the incorporation of a UK subsidiary. This eliminates the possibility of organizing banks as branches and imposes organizational form through the establishment of domestic subsidiaries. At the time of writing, the UK was still a member of the EU – in spite of the fact that a majority of British voters favored the UK leaving the EU through a referendum celebrated on 23 June 2016.

The principle of freedom of establishment is set out in article 49 (ex Article 43 TEC) of the Treaty on the Functioning of the European Union (TFEU). Said Article declares that:

> Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
>
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the

[549] Lui (n 470) 341-342. For a comprehensive discussion on freedom of establishment *vis-à-vis* bank branches and subsidiaries see also Almudena de la Mata Muñoz, 'The Future of Cross-Border Banking after the Crisis: Facing the Challenges through Regulation and Supervision' (2010) 11 European Business Organization Law Review 575.

> second paragraph of Article 54[550], under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

Freedom of establishment is one of the fundamental principles that underpin the EU single market. The principle is directly applicable legislation in EU member States. As A. De la Mata explains, in the context of banking freedom of establishment means that banks: 'established according to the legislation of one Member State and whose company premises, central administration or main centre of activity is within the EU, have the right to operate in other EU Member States through a branch, subsidiary or agency'. [551] Several decisions of the European Court of Justice (ECJ) restate the scope of this principle.[552]

The potential discrepancies between freedom of establishment and the ring-fencing policies adopted in the UK, Germany and France, prompted the European Commission to include a special carve out in its proposed structural Regulation in order to accommodate and grandfather-in existing structural models into conformity with projected EU rules. Article 21 of the Commission's proposal Regulation included 'provisions to allow credit institutions subject to national primary legislation at least equivalent to the EU proposal to derogate from the structural separation requirement'.[553] While this might serve as a justification to argue that national ring-fencing provisions are not inconsistent with the TFEU, the existing national arrangements remain patchy and diverse in their approach.

[550] TFEU art 54 defines companies or firms as: 'companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making'.

[551] De la Mata (n 549) 590.

[552] See Case C-307/97 Compagnie de Saint-Gobain v. Finanzamt Aachen Innenstadt, para.35; Case C-141/99 Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Belgische Staat, para 20; and Case C-471/04 Finanzamt Offenbach am Main-Land v. Keller Holding GmbH, para 29.

[553] House of Lords' European Union Committee (n 467) 89. See also art 21 of the Commission's Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions. Said provision is said to allow: 'for a possible derogation from the separation requirements in Chapter III [of the proposal Regulation] for credit institutions being covered by national legislation having an equivalent effect as the provisions of Chapter III of the proposal' Commission's Proposal s 3.3.4.10.

Moreover, the European Court of Justice can still be asked to adjudge on the legality of ring-fencing provisions.

The resulting panorama could fulfill the EU Commission's dismal concerns that: '[w]ithout a Union-wide approach banks will be forced to adapt their structure and operation along national boundaries, thereby making them even more complex and increasing fragmentation'[554] as well as undermining the objectives of the Banking Union. Moreover, in the aftermath of the UK's so-called 'Brexit' referendum and its impending exit from the EU, the resulting landscape can be even more complex than originally expected.

4. POLICY ANALYSIS: SOME UNINTENDED CONSEQUENCES OF RING-FENCING POLICIES

Could bank ring-fencing exacerbate – rather than reduce – some of the economic problems that it intends to tackle? This section uses economic analysis to describe and evaluate the potential unintended consequences that ring-fencing could generate. The existing model for RFB could complicate, rather than simplify, supervision. Moreover, ring-fencing as currently being adopted could exacerbate moral hazard for certain bank stakeholders, as well as increase coordination problems between host/home country regulators and supervisors across borders.

4.1. Increased Complexity of Banks' Legal Structures

Segregating bank activities into several legal entities can add a layer of complexity to supervisory tasks.[555] Global banking groups already exhibit convoluted and multilayered

[554] Commission's Proposal for a Regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions, 4-5.
[555] Lehmann (n 459) 4.

organizational and legal structures. Several different bank subsidiaries are often incorporated and operate across borders.[556]

Adding additional entities into the mix could augment – rather than reduce – supervisory hurdles and information asymmetries. This argument challenges the idea presented in the Vickers Report that: 'removing the complexity of some wholesale/investment banking would make it easier for ring-fenced banks to be managed, monitored and supervised'.[557] According to the ICB's view, the simplification process would also purportedly enhance resolvability. However, by increasing the number of supervisees through subsidiarization, supervisory oversight could be diffused, becoming ineffective when and where it matters the most. Alas, outside of the fence. Consequently, opportunities for malfeasance, excessive risk-taking and human error could proliferate.

4.2. Capital and Liquidity Problems

The Financial Stability Board has stated that: '[s]ome jurisdictions have concerns that structural banking reforms may potentially "trap" liquidity or capital in domestic silos, complicating the crisis management of globally active banks'.[558]As has been described, ring-fencing can have an impact on the capital and liquidity buffers held by banking groups. Prohibitions or restrictions to intra-group transfers can include limiting dividend distributions or having compulsory profit allocations. In particular, it can affect banks' subsidiaries operating in different countries. Leonardo Gambacorta and Adrian van Rixtel have argued that: 'ring-fencing and subsidiarization may constrain the allocation of capital and liquidity within a globally operating banking group'[559] adding that: '[t]hese restrictions would add to the supervisory responses in several countries that aim to

[556] The chart included as an appendix to this thesis aims to illustrate this complexity by depicting the stylized organizational structure of HSBC Holdings plc.
[557] Vickers Report 46.
[558] Financial Stability Board 'Structural Banking Reforms' (n 464) 13.
[559] Leonardo Gambacorta and Adrian van Rixtel, 'Structural Bank Regulation Initiatives: Approaches and Implications' (2103) BIS Working Papers n 412.

increase the self-sufficiency of foreign subsidiaries by tightening local liquidity and/or capital requirements'.[560]

Ring-fencing could create some distortions whenever stress tests are performed assuming that capital and liquidity located abroad can be used on a consolidated basis. Eugenio Cerutti and Christian Schimieder argue that an unconsolidated view taking into account different ring-fencing levels can provide a better picture for understanding the risks faced by international banks.[561] During times of crisis, depending on the ring-fencing levels, some units could suffer capital and liquidity shortfalls while others might have surpluses or at least enough to cover threshold conditions. The referenced authors argue that: '(…) not only is the size of a banking group's capital buffers relevant but also that the geographical location of those buffers within the banking group matter'.[562] Consequently, ring-fencing could have the undesirable effect of increasing banks' capital needs.

4.3. Moral Hazard for Certain Bank Stakeholders

The type of ring-fencing being implemented in the UK is aimed at protecting domestic depositors from losing access to their deposits and payments services in the event of bank insolvency or distress, while guaranteeing the continuity of operations of RFBs. Depositors in Britain – and in many other jurisdictions – are protected by deposit protection insurance schemes.[563] As discussed before, it is often argued in the economic literature that deposit protection insurance can be a source of moral hazard for depositors, since it can reduce their incentives to monitor banks' activities.[564] It is an inevitable question whether ring-fencing – as form of asset partitioning – combined with deposit

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[560] ibid.

[561] See Eugenio Cerutti and Christian Schmieder, 'Ring fencing and Consolidated Banks' Stress Tests' (2014) 11 Journal of Financial Stability 1.

[562] Eugenio Cerutti and Christian Schmieder, 'Ringfencing and Consolidated Bank Stress Tests' (*Vox*, 13 April 2013) available online: <http://www.voxeu.org/article/ringfencing-and-consolidated-bank-stress-tests> accessed 6 December 2016.

[563] The Financial Services Compensation Scheme (FSCS) is the statutory compensation program for depositors in the UK established in the FSMA 2000.

[564] See Franklin Allen et al. (n 498) 1–21.

protection is duplicative. What's more, it could also exacerbate moral hazard by reducing the efforts of different bank stakeholders, such as investors, depositors and financial supervisors.

4.3.1. Could Ring-fencing generate Moral Hazard for Investors and Depositors?

Because bank equity holders benefit from limited liability (owner shielding), and have a limited downside-risk, they might have reduced incentives to monitor a bank's activities. Consequently, banks' investors could have reduced incentives to effectively monitor RFBs. Moreover, the increased levels of depositor protection via ring-fencing could also generate moral hazard, thus further reducing the incentives to oversee bank activities observantly. Consequently, a trade-off could exist between increased moral hazard for the unsecured creditors of RFBs – in particular – depositors, and the monitoring and funding costs reductions that ring-fencing could provide, as previously discussed.

4.3.2. Could Ring-fencing generate Moral Hazard and Coordination Problems for Bank Supervisors?

As Prof. Viral Acharya has stated, ring-fencing measures are 'no panacea'.[565] They could also pose some challenges to bank regulators and supervisors. Some of the inconveniences that ring-fencing can generate for supervisors and regulators include: moral hazard, overconfidence, negative interstate externalities and heightened coordination problems.

Ring-fencing coupled with deposit protection insurance schemes can potentially generate moral hazard and biases for bank regulators. Regulators and supervisors could become overconfident by trusting that – thanks to a combination of ring-fencing and deposit protection insurance schemes – depositors are less likely to lose their money and taxpayers would not need to bailout RFBs in the event of failure. In other words, the

[565] Viral Acharya 'Ring-Fencing is good, But no Panacea' (Vox, 25 October 2011) <http://www.voxeu.org/article/ring-fencing-good-no-panacea> accessed 6 December 2016.

danger that the existing safeguards provided by the revamped financial safety net and crisis management framework could de-incentivize financial regulators from adequately supervising activities and services that fall outside of banks' 'safe' domain. This could lead to a decrease in the socially desirable oversight levels. Ring-fencing could also give supervisors an illusion of having greater control over RFBs, motivating them to concentrate more efforts in the oversight of ring-fenced entities, while losing sight of other entities within a banking group that operate outside of the fence.

As learned from the Lehman Brothers collapse in 2008, the failure or distress of systemically important nonbank financial institutions (NBFI) can also be a source for financial contagion leading to public sector bailouts.[566] Excluded activities can find their way into the domain of less regulated NBFI's. Systemic risks can also build-up in the less regulated shadow banking sector.[567] The Bank of England has recognized this by stating that: '[f]urther work is needed to evaluate the post-crisis reform agenda in a systemic context, taking due account of the emergence of new stability risks, including from the non-bank sector'.[568] Separating the 'wheat from the chaff' does not mean that the 'chaff' will necessarily take care of itself. Consequently, moral hazard, supervisory overconfidence or excessive attention to RFBs (while neglecting other nonbank entities) can also lead to undesirable results and unintended consequences.

The moral hazard problem affecting regulators and supervisors can also be linked to cross border coordination and burden sharing problems between supervisors in different jurisdictions.[569] In particular, coordination problems can arise when the country that

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[566] R Lastra, *International Financial and Monetary Stability* (n 446) 129.

[567] The Financial Stability Board (FSB) defines shadow banking as 'credit intermediation involving entities and activities (fully or partially) outside the regular banking system'. Financial Stability Board (FSB), 'Shadow Banking: Strengthening Oversight and Regulation Recommendations of the Financial Stability Board' (27 October 2011). See also Lehmann (n 459) 3.

[568] Bank of England, 'One Bank Research Agenda: Discussion Paper' (February 2015) 10.

[569] See Charles Goodhart and Rosa Lastra, 'Border Problems' (2010) 13 Journal of International Economic Law 705, 714. On burden sharing see Charles Goodhart and Dirk Schoenmaker, 'Fiscal Burden Sharing in Cross-Border Banking Crises' (2009) 5 International Journal of Central Banking 141; Iman van Lelyveld and Marco Spaltro, 'Coordinating Bank Failure Costs and

adopts deposit ring-fencing is the home country of important financial groups that conduct activities abroad. Katharina Pistor has characterized this problem as the 'Host's Dilemma'.[570] The problem occurs because the 'division of labour between home and host country regulators strongly favours Home over Host'.[571] If both home and host countries lack unity of interests with regards to the adequate supervision of a cross-border banking group, than supervisory blind spots and coordination problems can arise. Such problems can be directly linked to harmful spillover effects and the provision of global 'public bads', such as financial instability – largely affecting 'host countries [exposed] to risks emanating from activities of these foreign financial groups'.[572]

Ring-fencing can also produce negative externalities across borders. Building on the definition of interstate externalities presented by Richard Revesz in the context of pollution, a similar problem occurs with regards to ring-fencing because the country that ring-fences its banks reshuffles creditors' rights in order to favor local creditors and taxpayers – but doing so at the expense of creditors abroad.[573] At the same time, the jurisdiction that imposes the ring-fence obtains the 'jobs and fiscal benefits of the economic activity that generates the externality, without suffering the full costs of the activity'.[574]

Financial Stability' (2011) DNB Working Paper b 306; Dirk. Schoenmaker, 'Burden Sharing: From Theory To Practice' (2010) Revue D'economie Financière.

[570] Katharina Pistor, 'Host's Dilemma Rethinking EU Banking Regulation in Light of the Global Crisis' in *Festschrift for Klaus J. Hopt's 70th birthday on 24 August 2010: Corporations, Market and Responsibility*, 2339-2365.

[571] ibid 2340. According to Pistor, this allocation results from the 'Principles for the Supervision of Banks' Foreign Establishments' (May 1983) (also know as the 'Basel Concordat').

[572] ibid.

[573] Roland Beck et al. argue that: 'however, implemented unilaterally ex post as a crisis resolution tool, some [geographical ring-fencing measures] measures may have negative side effects on financial integration. In these situations, there may be conflicts between national and global financial stability, especially when national authorities have an incentive to ring-fence a failing banking group's assets to support domestic creditors at the expense of their foreign counterparts'. Roland Beck et al., 'The Side Effects of National Financial Sector Policies: Framing the Debate on Financial Protectionism' (2015) ECB Occasional Paper n 166, 20.

[574] Richard L Revesz, 'Federalism and Interstate Environmental Externalities' (1996) 144 U. Pa. L. Rev. 2341, 2343.

The case of the UK – a global banking powerhouse – can further illustrate the 'Host's Dilemma' and the cross-border externality problem that underpin bank ring-fencing. The UK's banking system has the potential to export externalities abroad. The Financial Stability Board (FSB) currently lists four British institutions as Global Systemically Important Banks (G-SIBs). These national champions include: Barclays, HSBC, Royal Bank of Scotland and Standard Chartered.[575] Out of these, HSBC – the second largest bank in the world in terms of assets, and the largest in Europe – is listed as requiring an additional higher loss absorbing capital buffer equal to 2.0% of risk-weighted assets.[576] Moreover, it is expected that only around 9% of HSBC's consolidated risk weighted assets would fall inside the fence.[577] On the other hand, Standard Chartered Bank, another British champion abroad, might not be even greatly affected by the measures since it does not conduct retail activities in the UK. Because British G-SIBs have an international outreach, their financial distress or failure has the potential to spread financial instability across borders.

If home states like the UK, reduce the consolidated oversight of their banking groups in order to concentrate on supervising their local RFBs and to limit implicit governmental contingent liabilities, then host country supervisors to such large and complex organizations could experience heightened coordination problems, asymmetric information problems (supervisory blind spots) and potential negative externalities domestically. Moreover, host country regulators to British G-SIBs could feel inclined to engage in a race-to-the-top by adopting similar – or even counteracting[578] ring-fencing measures – in an attempt to protect their own local stakeholders and limit the import of

[575] Financial Stability Board (FSB), '2016 list of global systemically important banks (G-SIBs)' (21 November 2015) <http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf> accessed 6 December 2016.
[576] This higher loss absorbency requirement has to be met with 'Common Equity Tier 1 capital as defined by the Basel III framework'. 2.0% is the required level of additional common equity loss absorbency as a percentage of risk-weighted assets that will apply to HSBC, with phase-in starting from January 2016. See Basel Committee on Banking Supervision (BCBS), 'Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement' (July 2013) 12 <http://www.bis.org/publ/bcbs255.pdf> accessed 6 December 2016.
[577] Emma Dunkley and Caroline Binham, 'Banks Hail Concession on Ringfencing' *Financial Times* (London, 15 October 2015) <http://www.ft.com/intl/cms/s/0/c76faf72-734c-11e5-bdb1-e6e4767162cc.html#axzz3rXB9dqdO> accessed 6 December 2016.
[578] Roland Beck et al. (n 573) 24.

negative externalities from abroad. This duplicity raises compliance costs.[579] Moreover, it would also tantamount to a new 'dilemma of British banking'[580] – but this time around, not for depositors and taxpayers in the UK. But rather for host country regulators, depositors and deposit insurers abroad, that would have to deal with the systemic challenges posed by British banks operating in their jurisdiction.

In sum, the aforementioned problems can also be understood using Dirk Schoenmaker's 'financial trilemma' framework, which states that: 'financial stability, financial integration and national financial policies are incompatible'.[581]According to this view, policymakers can attain two goals, but not all three. Consequently, one of the aforementioned policy objectives has to give. When seen through this perspective, ring-fencing –and other structural banking reforms – seem to favor financial stability and national financial policies at the expense of greater financial integration.

5. CONCLUDING REMARKS

Bank ring-fencing is one of several structural reforms that have been proposed or implemented around the world as a response to the 2007-08 global Financial Crisis. In the UK, ring-fencing is being implemented in order to protect domestic depositors, make banks more resolvable and prevent the fiscal costs of future bank failures. The British ring-fencing model separates deposit-taking and payment services from trading activities deemed as being as having a riskier profile. The legal segregation will be structured by

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[579] Compliance costs would include private and social costs for both home and host countries. Social costs include those of adopting ring-fencing measures and the costs of maintaining deposit insurance schemes and lower growth (calculated to oscillate between £1bn and £3bn for the UK alone). Private costs include operational or implementation charges and annual fees for banks. For the UK's banking industry, the *per annum* fee has been calculated to amount to £4bn-£7bn according to the Vickers Commission. See Sharlene Goff, 'Just the Facts: the Vickers Report', *Financial Times* (London, 12 September 2011) <http://www.ft.com/intl/cms/s/0/7321c692-dd16-11e0-b4f2-00144feabdc0.html> accessed 6 December 2016.

[580] The 'dilemma of British banking' as coined by the former Chancellor of the Exchequer, George Osborne, asked how Britain could: 'remain a successful global centre of finance without asking taxpayers to bear unacceptable risks or putting the broader economy at risk'. The mandate of the Vickers Commission and the objective of its subsequent report were to solve this dilemma.

[581] Dirk Schoenmaker, 'The Financial Trilemma' (2011) 111 Economics Letters 57–59.

requiring banks to set up their RFBs as locally incorporated and independently capitalized subsidiaries. The PRA also expects RFBs to be organized as separate clusters within banking groups, following the so-called 'sibling structure'.

The British ring-fencing model is neither novel nor particularly unique. Similar – albeit not identical – structural reforms have existed at least since the 1933 Glass-Steagall Act in the USA. Moreover, in the onslaught of the Financial Crisis, other financial trend-setting jurisdictions have adopted similar structural measures. This includes the Volcker Rule in the USA, the Liikanen recommendations in the EU, and the French and German laws that reapportion SIFI trading units into separate legal entities.

Ring-fencing has become a catch-phrase in the aftermath of the 2007-08 economic malaise. However, commentators argue that it is often poorly defined. When examined through the prism of organizational law and economics, British type ring-fencing can be construed as a regulatory form of asset partitioning combined with the geographical and functional allocation of activities across different legal entities. This approach is consistent with both the risk-allocation, the functional and the geographical definitions of ring-fencing that are ubiquitous in the legal and the economic academic literature.

Ring-fencing through 'subsidiarization' combines the economic attributes of asset partitioning, namely: (1) limited liability (owner shielding); and (2) entity shielding. Both owner and entity shielding are two sides of the same coin. While entity shielding could work in favor of protecting local creditors (depositors, taxpayers) in the event of insolvency, limited liability places a floor on the downside risks that banks' investors face. Moreover, limited liability can generate moral hazard for investors. The moral hazard problem extends to depositors in the case of banks that benefit from deposit protection insurance. This entails that different bank stakeholders – such as shareholders and depositors – may experience reduced incentives for adequately monitoring banks' activities. Consequently, owner shielding and entity shielding could have counteracting effects *vis-à-vis* ring-fencing's proposed objectives.

Proponents of separating core retail banking activities from excluded activities and assets do not consider ring-fencing to be an all-powerful solution for ending moral hazard and the persistent too-big-to-fail (TBTF) problematic in contemporary banking. In particular, this study has presented arguments stating that ring-fencing could exacerbate economic problems for certain bank interest groups – including regulators and depositors. Particularly, the UK's ring-fencing measures can create a type of 'Host's Dilemma' for financial regulators in countries where British banks carry out their business.

It has also been discussed that the plethora of different – and often conflicting – structural approaches that are currently being implemented across jurisdictions could undermine the benefits intended for RFBs in the UK. Diverging measures in the EU can also undermine the Banking Union, increase compliance costs for member countries and credit institutions operating in the Single Market, and create supervisory blind spots that could stockpile – rather than mitigate – systemic risk.

Moreover, the existence of uncoordinated and divergent bank structural reforms (Vickers, Volcker rule and Liikanen type ring-fencing) could be problematic. During cross-border resolution asset partitioning could shield-off banks' foreign assets from both home and host country supervisors.

Financial institutions could be incentivized to go 'forum shopping', leading to regulatory arbitrage. Where and how high the fence should be remain highly contested. This discussion is reminiscent of the 'boundary problems' of financial regulation identified by Charles Goodhart and Rosa Lastra, who stated that: '(…) whenever a fence or boundary is established, there is an incentive for institutions to place themselves or part of their business inside or outside the boundary depending on what appears to be more advantageous or beneficial to them'.[582] It is both difficult to decide where draw the line and to prevent regulated entities from circumventing it to their advantage.

[582] Goodhart and Lastra 'Border Problems' (n 484). See also Lastra, *International Financial and Monetary Law* (n 446) 144.

A final critique that could be raised to the way that ring-fencing has been implemented in the UK is that it has not delved into the granularities of legal structures for establishing RFBs. The Vickers Commission (ICB) originally set out to determine which activities should fall within the fence, as well as how strong the separation should be. In the jargon of the Vickers Report, these questions relate to the 'location' and the 'height' of the fence. However, apart from the adoption of the so-called 'sibling structure', questions of legal structure – akin to the materials used to construct the fence – were not addressed in great detail in the implementing norms.[583] Consequently, the matter goes further than simply asking whether subsidiaries or branches are preferred for establishing cross-border banks. In this sense, structural reforms should go one step further and ask which are the desired legal organizational forms (eg corporation, mutual societies, mutual funds) for organizing banking activities.

[583] Although in its Final Report, the Vickers Commission did provide some general models for achieving the level of operation segregation that it recommended. cf Vickers Report (n 449) 67-68. See also Timothy Edmonds, 'The Independent Commission on Banking: The Vickers Report and the Parliamentary Commission on banking standards' (30 December 2014) House of Commons Library Standard Note, 9 <http://www.parliament.uk/business/publications/research/briefing-papers/SN06171/the-independent-commission-on-banking-the-vickers-report-the-parliamentary-commission-on-banking-standards> accessed 6 December 2016.

Chapter Seven

Conclusions – the Legal Organization of Banks Matters for Financial Regulation

‘They looked from a certain point of view, from a certain paradigm, and missed everything that was important’.

Gary Gorton[584]

1. CONCLUDING REMARKS

This dissertation set out to answer if and how the way that commercial banks are legally organized can provide some insights for revamping financial regulation after the onslaught of the 2007-2008 global financial crisis. The thesis argues that banks’ legal and organizational details are often neglected or overlooked whenever designing financial regulations, such as: capital, liquidity and leverage rules, deposit protection insurance schemes, bank resolution regimes or so-called bank structural reforms.

Commercial banks are legal entities. This means that across jurisdictions banks adopt specific legal structures. Moreover, it is commonplace for banks – especially international banks – to be comprised of groups of many different legal entities. Thus, the way that banks are legally organized cannot be trivial for financial regulation.

Banks’ legal organization determines the ownership structure and the centralized contractual interaction node for different groups of stakeholders, including: owners, creditors, depositors, managers, financial regulators and supervisors and taxpayers.

[584] Gary B Gorton, *Misunderstanding Financial Crises: Why We Don’t See Them Coming* (OUP 2012).

Organizational forms also create bundles of property rights. Property rights generate incentives and interests for all groups of bank stakeholders. Thus, studying the different incentive structures of existing legal forms is important for the design of financial regulation.

One of the main objectives of this thesis was to introduce banks' legal organization into the analysis, given that is often sidelined – or even assumed that all banks are corporations. By leaving legal details out of the picture, one runs the risk of studying 'firms without organization' – as Ronald Coase distinctively put it.[585] In a 'real-world setting', one observes that across jurisdictions banks adopt a myriad of organizational forms. Commonplace legal forms include: (private and public) corporation, mutual associations, and co-operatives and commercial nonprofit entities.

Chapter 2 introduced the concept of organizational forms that is central to this book. It explained how legal forms are different to other related ideas, like business models and banking licenses. Moreover, it also described how legal forms fit within the wider set of reforms that have been discussed and implemented in the wake of the 2007-08 financial crisis.

Banks are not always corporations limited by shares. Chapter 3 discusses how banks are legally organized across some jurisdictions. The chapter describes that banks are typically set-up as investor owned firms, consumer owned co-operatives and also unowned entities. Thus, most contemporary banks are organized as either corporations, co-operative and mutual associations or nonprofit entities. This legal configuration is important because of the incentives and interests that different bank stakeholders have under each type of organizational form. The chapter further compares the most salient ownership features of co-operative, mutual banks and nonprofit banks against the foil of the business corporation. The analysis presents how different bank legal structures generate distinctive incentives for their constituencies.

[585] Ronald H Coase, *The Firm, The Market and the Law* (University of Chicago Press 1988) 3.

Chapter 4 discussed the relationship between capital and liquidity standards and legal form. The chapter concludes that some of Basel III's major components do not fully take into account the features of non-joint stock banks. This is particularly important because many non-joint stock banks do not issue shares or stocks. Shares are essential for a regulatory capital measure called 'common equity tier 1' capital (CET1) that is central to Basel III's composition of regulatory capital. CET 1 is also important for measuring additional loss-absorbing cushions, like the capital conservation buffer, the counter cyclical capital buffer, the G-SIFI surcharge and the leverage ratio. International standard setting bodies – like the Basel Committee and the Financial Stability Board – should take organizational forms into account when designing and implementing capital and liquidity standards. Otherwise, there is a risk that implementation gaps, coordination problems and legal and commercial uncertainty could ensue.

Chapter 5 focused on the nexus between bank legal form and resolution. The chapter analyzes how entity shielding (creditor priority and liquidation protection) interacts with bank resolution proceedings. Entity shielding can facilitate bank resolution by creating asset pools with their own creditor rank. However, this benefit comes at a cost, since entity shielding can also hinder cross-border resolution processes – creating challenges for multiple points of entry resolution strategies.

The final chapter of the book discussed banking structural reforms in the United Kingdom. In the UK, regulators have implemented the functional separation of deposit-taking activities from proprietary trading – considered by some as being of a riskier nature. This legal separation has been called 'ring-fencing' through subsidiarization. The chapter argues that ring-fencing through subsidiarization purports to achieve the partitioning of assets – something that has been widely studied in the organizational law and economic literature. However, ring-fencing has its own economic consequences, which are discussed with great detail in the chapter. Financial regulators should take such economic consequences into account when designing financial regulation.

2. WHAT HYPOTHESES COULD BE DRAWN FROM THIS THESIS

What has been learned from this research project? What propositions can one draw from its conclusions? What hypotheses could further be observed or empirically tested in the future?

Foremost, the cross-border comparative analysis of commercial bank legal forms undertaken in this project includes only a very small sample of jurisdictions. Future comparative studies could certainly be expanded in order to include more jurisdictions. In addition, future studies could challenge the conclusion that contemporary banks fall into one of three broad categories identified, namely: investor-owned corporate banks, consumer-owned co-operative and mutual banks, and ownerless commercial nonprofit banks.

Another hypothesis that can be empirically tested is whether non-corporate banks exhibit higher capital and liquidity levels, and are less levered than corporate banks (or if the converse is true, or they are more or less the same). An analysis of the type of assets that corporate and non-corporate banks invest in could provide some indications regarding the amount of risk-taking that different types of banks are prone to engage in. Similar studies regarding bank business models have been recently undertaken. Such studies could control for legal form (eg using dummy variables for labeling corporate and non-corporate banks) in order to see if these variables have any effect on the observed outcome.

Moreover, if capital liquidity and leverage rules were to create an uneven playing field between corporate and non-corporate banks, or even affect each group differently, one could expect to see the sheer number of non-corporate banks to diminish. For example, some non-corporate banks could have an incentive to demutualize, transform into business corporations or outright sell their business to corporate banks. The domestic implementation of Basel III rules in certain jurisdictions could also serve as an event to

observe and test if corporate banks and non-corporate banks are affected differently by such rules (eg whether their capital, liquidity and leverage measures vary disparately, or if their asset or funding composition changes, etc.).

The effect that asset partitioning has on bank resolution could also be observed or tested in the future. One way to observe this is simply by looking at the different outcomes that certain type of bank creditors (ranking pari passu) in one jurisdiction could face, when their creditor rank varies across the single market. The ensuing litigation that these differences could bring could also be further studied.

Another hypothesis that can be tested is whether corporate and non-corporate banks fare differently during bank resolution. Put differently, one could look at resolution data in order to study if it is quicker (or lengthier), or more (or less) costly, to resolve a corporate bank than it is to resolve a co-operative bank, for example.

The implementation of bank ring-fencing in the UK – now coupled with the expected exit of the UK from the EU, after the results of the referendum held on 23 June 2016, will also allow to observe some of the hypothesis discussed in the thesis. Will banks continue to see London as a leading global international financial center? Will international banks keep their European headquarters in The City – or will ring-fencing rules and the UK's imminent 'Brexit' from the EU motivate banks to setup their headquarters in other European cities? While at the moment of writing, the UK's exit procedure from the EU is still uncertain, 2019 is the year that ring-fencing is to become fully operational. One hypothesis is that combined with ring-fencing – Brexit could lead British and international banks based in London to resettle abroad.

3. SOME LIMITATIONS

This study has argued that legal forms are an important – but certainly not the *only* – factor that should be taken into account for designing more effective financial regulation as a response to the 2007-08 global financial crisis. As Gary Gorton's quote at the beginning of this conclusion suggests, when focusing on one particular point of view, one runs the risk of missing everything – or at least some things – that are important. As G. Calabresi and D. Melamed acknowledge, when working with frameworks or models these: '(…) can be mistaken for the total view of phenomena, like legal relationships, which are too complex to be painted in any one picture'.[586] Consequently, some necessary caveats regarding the limitations of this contribution are in order.

Foremost the study is entirely theoretical and descriptive. No formal empirical work has been done to support the claim that legal forms are important for capital and liquidity standards, resolution or banking structural reforms. The magnitude of this relevance has not been measured. From the outset, the objective has been to describe and explain the relationship and provide a starting point for a hypothesis that could be empirically tested in the future.

Moreover, the study does not prescribe any grandiloquent policy solutions, like championing for the adoption of one legal form other another. The conclusions are far more modest. As Bülbul and her co-authors have concluded in one notable study: '[w]e simply do not know which type of bank and which structure of a financial system are better under different circumstances'.[587]

Consequently, when faced against this uncertainty one feels inclined to agree with said authors that 'preserving diversity' should be a policy objective, since different legal

[586] Guido Calabresi and Douglas Melamed, 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral' (1972) 85 Harvard Law Review.
[587] Dilek Bülbül, Reinhard Schmidt and Ulrich Schüwer, 'Caisses D'épargne et Banques Coopératives en Europe' (2013) 111 Revue d'Economie Financière 159.

forms could fare better under different circumstances.[588] This means preserving market pluralism, organizational variety, as well as providing a level playing for different types of banks. In the words of Groeneveld '(…) it is important to acknowledge the benefits of organisational diversity for competition and, last but not least, stability in banking'.[589] More specifically, one cannot conclude that the prevalence of corporate banks over mutual, cooperative and commercial nonprofit banks is favorable or socially desirable. Thus, financial regulation should not aim to promote the convergence to a single type of organizational form.

4. WIDER POLICY IMPLICATIONS AND OPPORTUNITIES FOR FUTURE RESEARCH

Some of the ideas touched upon throughout the thesis could be extended to cover other related topics. These topics include the legal organization of non-bank financial institutions, the relationship between legal form and organizational complexity, and also an alternative view of the economic consequences of bank 'ring-fencing'.

The Legal Organization of Non-Bank Financial Institutions

From the outset of the book, it has been explicitly stated that in order to make the thesis more manageable, the focus of the study has been limited to commercial banks. However, the analysis of legal forms could also be extended to other types of financial institutions, including: insurance companies, investment banks, hedge funds and private equity funds.

[588] ibid.
[589] Hans Groeneveld 'A Snapshot of European Co-operative Banking' (April 2016) 3 <http://www.globalcube.net/clients/eacb/content/medias/publications/annual_reports/20160411_HG_EACB_FINAL_Snapshot.pdf > accessed 6 December 2016.

Systemic risk and moral hazard concerns are not exclusive to commercial banks. During the 2007-2008 financial crisis, international insurer AIG was bailed-out by the US federal government for USD 180 billion because of its systemic importance. The Financial Stability Board (FSB) now publishes a list of global systemically important insurers ('G-SIIs') that are regarded as 'too-big-to-fail'.[590]

Moreover, it is also common for some insurance companies worldwide – and particularly in the US – to be legally organized as mutual societies or other non-corporate legal forms. This includes the curious case of 'reciprocal inter-insurance exchanges', which are unincorporated contractual networks that widely operate without the need of centralized legal entity. Thus, an analysis of the role and features that result from organizational form is also warranted for insurers.

The same can be said of investment banks. Historically, it was commonplace for investment banks to be organized as employee owned partnerships, where partners were unlimitedly liable. Gradually, investment banks have experienced a 'run towards limited liability' and 'complete asset partitioning' typically achieved through the corporate form. Moreover, investment banks and securities brokers can also be systemically important – as was evidenced during the 2008 financial crisis with the failures of Lehman Brothers and Bear Stearns. This prompted legal changes for investment banks Goldman Sachs (aka '*the* partnership') and Morgan Stanley, which transformed into bank holding companies under the supervision of the US federal oversight.

The so-called 'shadow banking' sector has also generated concerns in the wake of the financial crisis. Shadow banks are not a specific type of institution (ie one will not find a building with a 'shadow bank' sign on the entrance) but rather 'entities or market activities'. These unregulated entities or activities can take on different legal structures. Thus an analysis of the 'law in shadow banking' could also shed some light on what financial supervisors should be on the lookout for.

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[590] See FSB, '2015 update of list of global systemically important insurers (G-SIIs)' (3 November 2015) <http://www.fsb.org/wp-content/uploads/FSB-communication-G-SIIs-Final-version.pdf> accessed 6 December 2016.

Consequently, legal forms prove to be important for commercial banking –but are also bound be important for other areas of financial intermediation. The same type of analysis could be extended to other market participants, such as securities exchanges and central counterparty clearing houses.

Legal Structure and Regulatory Compliance

Another related factor that could be further explored is the 'too-big-to-manage / too-big-to-supervise' problem that stems from having cross-border banks with complex legal structures (ie with a large number of subsidiaries). The sheer number of different legal entities that some banking conglomerates have can represent a challenge for both managers and supervisors.

On one hand, managers and board members could have difficulties making sure that their multiple subsidiaries comply with the existing domestic and international legal and tax rules in every jurisdiction where they operate. In many cases, a centralized approach raises credibility issues. A 'decentralized' governance structure can also lead to divergent approaches and standards being taken across different regions. This is also problematic – since a lack of global standards towards anti-money laundering (AML), counter terrorist finance (CTF) and sanctions compliance – for example – could allow criminals to game big banks.

The same challenges would also apply to both home and host country supervisors. Consolidated supervision can become muddled when dealing with cross border operations and asymmetric information. Full disclosure is no panacea either, if in turn, supervisors are inundated with organizational information that they cannot completely process. Additional complexity layers can arise whenever bank subsidiaries are incorporated in jurisdictions that provide secrecy regarding ultimate beneficial ownership.

Thus, questions regarding how complex the legal structure of banks should be – ie how many subsidiaries they should have and where should these subsidiaries be incorporated – also merit future analysis.

The Political Economy of Banking Structural Reforms

A political economy perspective of bank ring-fencing and other structural banking reforms raises some interesting questions regarding the tensions between preserving global financial stability and preventing the political costs of bank failures and bailouts.

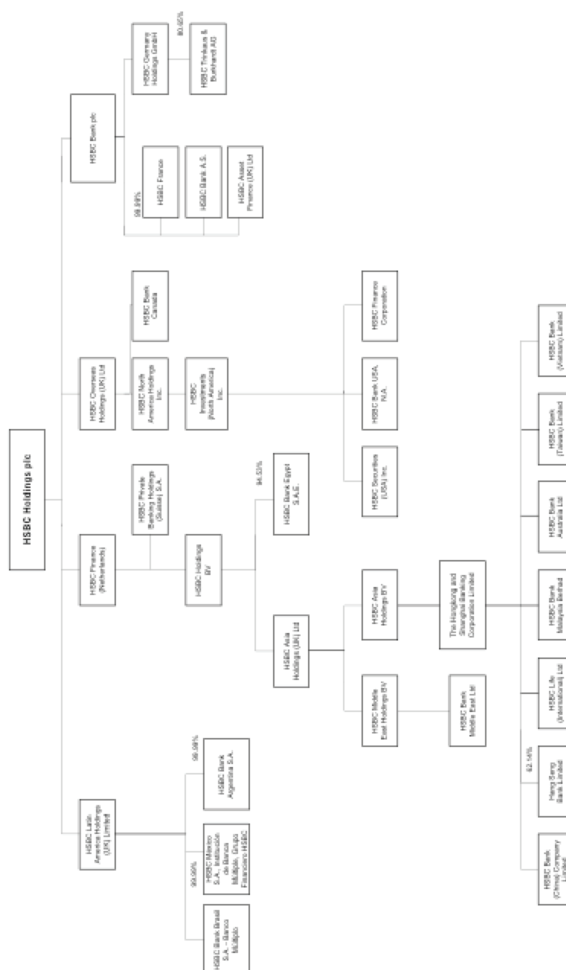
Through the lens of political economy, UK style bank ring-fencing could be interpreted as a tool aimed at protecting British depositors – and ultimately, taxpayers – from having to foot the bill of bank failures. Notwithstanding, countries like the UK will still expect their national banking champions to remain competitive abroad. The interplay between domestic and cross-border goals can ultimately create tension between the UK, acting in its home country capacity, and host countries to British banks. These tensions can be expected to augment in the face of the UK's exit from the EU.

As a response to these tensions, host countries to British banks could have the incentive to issue counteracting regulation or even ring-fence the assets and capital of foreign banks. In times of financial distress or when bank resolution is triggered, ring-fencing could lead to coordination problems that could undermine cross-border financial stability. If all countries were to follow the UK and would ring-fence their domestic deposits this could ultimately impinge on the benefits of the 'single-point of entry' (SPE) bank resolution approach, as each host supervisor would scramble to get a hold of local assets in order to protect domestic depositors – and ultimately in order to avoid taxpayer fueled bailouts – in their jurisdiction. These issues certainly merit additional analysis.

APPENDIX

Simplified Organizational Structure of HSBC Holdings Plc.

(Source: HSBC Holdings plc 2015 Annual Reports and Accounts[591])



[591] As of 31st December 2015. Does not include all intermediate holding companies and subsidiaries. Unless otherwise specified, companies are wholly owned. See 'HSBC Holdings plc Annual Reports and Accounts 2015', 474 <http://www.hsbc.com/investor-relations> accessed 6 December 2016.

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United States of America

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SUMMARY

Do the different ways that commercial banks are legally organized matter for the design of financial regulation? It is often assumed that most commercial banks are setup as investor owned business corporations. However, this is not always the case. In many jurisdictions, banks are legally organized using a plethora of organizational forms, which include: co-operatives, mutual associations and even nonprofit entities. Thus, some of the distinctive legal attributes and features of these non-corporate banks are not regulated by corporate law – but rather by specialized statutes (e.g. co-operative law, the law of nonprofit entities, etc.). Moreover, many banks are comprised of groups of many different legal entities.

Given such divergences in the legal attributes and the regulation of existing bank organizational forms, important questions arise. Does banking regulation take such organizational differences into account? And if not, what are the consequences of failing to take heed to such differences? This thesis attempts to answer some of these and other closely related questions, such as: what are the predominant legal forms used for organizing commercial banking activities in major jurisdictions today? What economic features make a co-operative bank different to a corporate bank, or different to a mutual bank? What is the relationship between bank capital, liquidity and leverage standards, and organizational forms? Do international standard setting bodies, like the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB), take into account non-corporate banks when they design, propose and implement capital and liquidity standards?

The study argues and concludes that bank legal forms matter for financial regulation. The study focuses on three specific instances were the interplay between legal forms and financial regulation is found to be significantly important. These are: (1) capital, liquidity and leverage standards (chapter four), (2) bank resolution and crisis management (chapter five) and (3) for the ongoing design and implementation of banking structural reforms in the aftermath of the financial crisis (chapter six).

The legal structure of banks is important because each type of organizational form entails a 'package' of economic attributes and a hierarchy of both creditors' and owners' rights (property rights). The economic features inherent to different legal forms interact with the incentives created by financial regulations, such as capital and liquidity requirements, deposit protection insurance schemes and bank resolution regimes. In order for financial regulation to be effective, it should acknowledge the incentives and the rules that the law allocates to different bank stakeholders through organizational forms.

SAMENVATTING

Zijn de verschillende manieren waarop commerciële banken juridisch georganiseerd zijn van belang voor het ontwerp van de financiële regelgeving? Vaak wordt verondersteld dat de meeste commerciële banken zijn opgezet als bedrijven, in het bezit van investeerders. Maar dat is niet altijd het geval. In veel rechtsgebieden kennen banken een enorm aantal verschillende organisatievormen, waaronder coöperaties, onderlinge maatschappijen en zelfs instellingen zonder winstoogmerk. Sommige onderscheidende juridische eigenschappen en kenmerken van deze niet-vennootschappelijke banken worden derhalve niet geregeld door het vennootschapsrecht maar door speciale wetten (bijv. het coöperatief recht, het recht van instellingen zonder winstoogmerk, enz.). Bovendien bestaan veel banken uit groepen die zijn samengesteld uit een groot aantal verschillende rechtspersonen.

Gezien deze verschillen tussen banken in de juridische eigenschappen en de regelgeving van bestaande organisatievormen, dienen zich belangrijke vragen aan. Houdt de bankregelgeving rekening met die organisatieverschillen? En zo niet, wat zijn dan de gevolgen van het feit dat er geen acht wordt geslagen op die verschillen? In dit proefschrift wordt getracht enkele van deze en hiermee nauw samenhangende vragen te beantwoorden, zoals: wat zijn op dit moment de meest voorkomende rechtsvormen voor de organisatie van commerciële bankactiviteiten in de belangrijkste rechtsgebieden? Welke economische kenmerken maken een coöperatieve bank anders dan een vennootschappelijke bank, of anders dan een onderlinge bank? Wat is de relatie tussen de normen voor vermogen, liquiditeit en leverage-ratio enerzijds en organisatievormen anderzijds? Houden internationale standaardiseringsinstellingen, zoals de Bazel-commissie voor Bankentoezicht (BCBS) en de Raad voor Financiële Stabiliteit (FSB), rekening met niet-vennootschappelijke banken bij het ontwerpen, voorstellen en invoeren van vermogens- en liquiditeitsnormen?

In deze studie wordt betoogd en geconcludeerd dat rechtsvormen van banken van belang zijn voor de financiële regelgeving. De studie richt zich op drie specifieke voorbeelden waar de wisselwerking tussen rechtsvorm en financiële regelgeving van significant belang blijkt te zijn. Dit zijn: (1) vermogens-, liquiditeits- en leverage-rationormen (hoofdstuk 4), (2) bankresolutie en crisismanagement (hoofdstuk 5) en (3) het verder ontwerpen en invoeren van structurele hervormingen in het bankwezen in de nasleep van de financiële crisis (hoofdstuk 6).

De rechtsvorm van banken is van belang omdat elke soort organisatievorm een 'pakket' van economische eigenschappen met zich meebrengt en een rangorde aan rechten van zowel crediteuren als eigenaren (eigendomsrechten). De economische kenmerken die inherent zijn aan verschillende rechtsvormen staan in wisselwerking met de stimulansen die gecreëerd worden door financiële regelgeving, zoals vermogens- en liquiditeitsvereisten, depositobeschermingsregelingen en bankresolutieregelingen. Wil financiële regelgeving effectief zijn, dan moet zij de stimulansen en de regels erkennen die de wet via organisatievormen toewijst aan de stakeholders van verschillende banken.

Curriculum vitae

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Short bio	
Corporate attorney and compliance instructor, trained in Finance and Economics. He has over 8 years of professional experience in corporate law, administrative law, trade law and finance, banking regulation and capital markets. He has also worked extensively as a facilitator of Anti-Money Laundering (AML), Counter Terrorism Financing (CTF) and Sanctions compliance training courses for a leading global bank, across several countries worldwide. He is a senior consultant (currently on academic leave) at OMG in Santo Domingo (a leading law firm in the Dominican Republic). He has been recognized by IFLR1000 as a leading lawyer in the Dominican Republic in the fields of Banking and Finance and Capital Markets (2012- 2015). Lecturer in Banking Law, Law & Economics and Financial Markets Regulation at the *Pontificia Universidad Catolica Madre y Maestra* and the *Instituto OMG* in Santo Domingo. Master of Laws (LLM) from the London School of Economics. Master of Science (MSc) in Law and Finance from Queen Mary, University of London. PhD Associate at the European Research Centre for Economic and Financial Governance (EURO-CEFG).	
Education	
Licenciado en Derecho (Bachelor of Laws, LLB), Pontificia Universidad Catolica Madre y Maestra, Santo Domingo	2006
Master of Laws (LLM) in Banking Law and Financial Regulation, London School of Economics and Political Science	2008
Master of Science in Law and Finance (MSc), Queen Mary University of London-Centre for Commercial Law Studies	2012
Work experience	
Senior Attorney – Practice Group Head, Oficina Melo Guerrero, Santo Domingo, Dominican Republic	2006-2012
PhD Researcher, European Doctorate in Law and Economics (EDLE)	2012-2015
Banking and Corporate Finance Trainer at Redcliffe Training Associates	2015-2016
Prizes and awards	

Winner of the "Microsoft Robert Cooter Research Award for Scholarship 2010 on Law and Economics", granted by the University of California, Berkeley and the Latin American and Caribbean Law and Economics Association (ALACDE)	2010
Chevening Scholar for Dominican Republic	2011
Recognized by IFLR1000 amongst the leading banking and capital market lawyers in the Dominican Republic	2012-2015
Winner of the first prize in the SDN Essay Competition (Concurso de Ensayos Académicos SDN 2015) by the Fundación Institucionalidad y Justicia (FINJUS), Santo Domingo, Dominican Republic	2015
Others	
Certificate in Anti Money Laundering & Sanctions Compliance. International Compliance Association (ICA) in association with Manchester Business School, The University of Manchester	2015

European Doctorate in Law & Economics

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PhD training

Bologna courses	*year*
Introduction to the Italian legal system	2012
Game Theory and the Law	2012
Economic Analysis of Law	2012
Behavioural L&E I - Game Theory	2012
Statistics	2012
Behavioural L&E II - Enforcement Mechanisms	2013
Experimental L&E - Topics	2013
European Securities and Company Law	2012
European Competition Law and Intellectual Property Rights	2013
Specific courses	*year*
Seminar 'How to write a PhD'	2013
Academic Writing Skills for PhD students (Rotterdam)	2013
Seminar Series 'Empirical Legal Studies'	2014
Seminars and workshops	*year*
Bologna November seminar (attendance)	2014
BACT seminar series (attendance)	2013
EGSL lunch seminars (attendance)	2013-2014
Joint Seminar 'The Future of Law and Economics' (attendance)	2014
Rotterdam Fall seminar series (peer feedback)	2013
Rotterdam Winter seminar series (peer feedback)	2014
Presentations	*year*
Bologna March seminar	2013
Hamburg June seminar	2013
Rotterdam Fall seminar series	2013
Rotterdam Winter seminar series	2014
EGSL lunch seminars	2014

University Seminar: "Quo Vadis Europa, Europe after the financial and sovereign debt crises?"	2014
Bologna November seminar	2014
Joint Seminar 'The Future of Law and Economics'	2015
EURO-CEFG's International PhD Workshop 'European Governance and Financial Regulation – Towards an Integrated Legal and Economics Approach' (Bad Homburg)	2015
VI Annual Conference of the Spanish Association of Law and Economics in Santander, Spain	2015
Annual Conference of the Latin American and Iberian Law and Economics Association in Santo Domingo (ALACDE)	2015
XII Harvard Course in Law & Economics, Harvard Law School	2015
Ronald Coase Institute Workshop on Institutional Analysis, Tel Aviv, Israel	2015

Attendance (international) conferences	*year*
University Seminar: "Quo Vadis Europa, Europe after the financial and sovereign debt crises?", Bad Homburg, Germany	2014
Joint Seminar 'The Future of Law and Economics', Paris, France	2015
Law and Economics of Regulation, Study Center Gerzensee, Law and Economics Courses for Doctoral Students and Faculty Members, Gerzensee, Switzerland	2015
EURO-CEFG's International PhD Workshop 'European Governance and Financial Regulation – Towards an Integrated Legal and Economics Approach', Bad Homburg, Germany	2015
VI Annual Conference of the Spanish Association of Law and Economics in Santander, Spain	2015
Annual Conference of the Latin American and Iberian Law and Economics Association in Santo Domingo (ALACDE), Santo Domingo, Dominican Republic	2015
XII Harvard Course in Law & Economics, Harvard Law School, Cambridge, USA	2015
Ronald Coase Institute Workshop on Institutional Analysis, Tel Aviv, Israel	2015
LEC Workshop for Law Professors on the Contractual Theory of the Corporation & Symposium on the Continuing Influence of Henry G. Manne, Virginia, USA	2016

Teaching	*year*
Introduction to Law and Economics, Pontificia Universidad Catolica Madre y Maestra, Santo Domingo, Dominican Republic	2014
Taxation in Dominican Financial Markets, Pontificia Universidad Catolica Madre y Maestra, Santo Domingo, Dominican Republic	2014
Others	*year*
Hamburg Summer School in Law and Economics	2013
Econometrics using STATA, Centro de Aplicaciones Económicas – EMPÍRICA, Santo Domingo	2014