The regulation of bank-based financial conglomerates

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DECLARATION

I declare that the work presented in this thesis is the result of my own research and that it has not been submitted anywhere for an award. Where other sources of information have been used, they have been acknowledged.

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ABSTRACT

This thesis seeks to provide a coherent conceptual framework for the regulation of bank-based financial conglomerates considering different models across jurisdictions.

This thesis examines the regulatory and corporate structure of a particular type of financial conglomerates, those that have a strong international presence and are banking focused (i.e. bank-based financial conglomerates or BBFCs). The thesis draws upon a tripartite classification of financial conglomerates (commercial, structural and regulatory) to focus on the types under the Structural classification. These are the Complet Integration (or German model), the "Bank-parent, non bank subsidiaries" model (or British model), the holding company model (or US model). The thesis further examines the types of capitalism involved in each model, how BBFC have influenced the industry and the legal regulation of BBFCs in its prototypical jurisdiction (Germany, United Kingdom and United States). Developments in the EU are also considered.

The thesis purports that the definition of financial conglomerate is contentious because of its cross-sectoral and cross-border dimensions. The same concept may have different meanings analysed through different lenses. The 'systemic risk lens' introduced after the Global Financial Crisis (GFC) has created new categories of SIFIs.

It also examines how the corporate structure of each model influences the resolution strategy: Single Point of Entry or Multiple Point of Entry. Based upon a four-factor analytic framework used in resolution planning (centralised or decentralised type of structure; retail or wholesale business; subsidiary or branch based structure and universal or territorial approach to resolution) the thesis proposes a resolution strategy for each of the different models.

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Abbreviations

ABCUL	Association of British Credit Unions
AICU	Association of Independent Credit Unions
AIF	Alternative Investment Fund
AIG	American International Group
BaFin	German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht).
BBFC	Bank-Based Financial Conglomerates
BHC	Banking Holding Company
BHCA	Banking Holding Company Act
BVR	National Association of German Cooperative Banks
CALD	Council of Australian Law Deans
CCC	Competition and Credit control
Citi	Citigroup
CBCA	Cross Border Cooperation Agreements
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
CSE	Consolidated Supervised Entity
CUSO	Credit Union Service Organization
DFA	Dodd Frank Act
DB	Deutsche Bank
D-INBI	Domestically Important non-bank institutions
DSGV	German Savings Bank Association Deutscher Sparkassen-und Giroverband
D-SIBs	Domestically Systemic Important Banks
D-SIIs	Domestically Important Insurers
EEA	European Economic Area
EU	European Union
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
FC	Financial Conglomerate
FCA	Financial Conduct Authority
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FHC	Financial Holding Companies
FIR	Financial Intermediation Ratio
FHLBB	Federal Home Loan Bank System
FICOD	Financial Conglomerates Directive
FMU	Financial Market Utilities
FRB	Federal Reserve Board
FSA	Financial Services Authority

FSB	Financial Stability Board
FSLIC	Federal Savings & Loan Insurance Corporation
FSMA	Financial Services and Markets Act
FSOC	Financial Stability Oversight Council
GAAP	General Accepted Accounting Principles
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GFC	Great Financial Crisis
GFCI 24	Global Financial Centres Index
GSA	Glass Stegall Act
G-SIBs	Globally Systemically Important Banks
G-SIIs	Globally Systemic Important insurance Firms
HK	Hong Kong
HSBC	The Hongkong and Shanghai Banking Corporation
IAIS	International Association of Insurance Supervisors
ICFC	Industrial and Commercial Finance Corporation
ILC	Industrial Loan Companies and Industrial Banks
ILCU	UK the Irish League of Credit Unions
IPO	Initial Public Offering
IPU	Intermediate EU Parent Undertaking
ISDA	International Swaps and Derivatives Association
LLC	Limited Liability Company
MiFID	Markets in Financial Instruments Directive
MPOE	Multiple Point of Entry
NAIC	National Association of Insurance Commissioners
NBA	National Banking Acts
NBNI G-SIFI	Non-Bank, Non-Insurance Systemic Importance Financial Institutions
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NOW	Negotiable order of withdrawal account
NYBA	New York Banking Act
OCC	Office of the Comptroller of the Currency
OECD	The Organization for Economic Co-Operation and Development
OLA	Orderly Liquidation Authority
OLF	Orderly Liquidation Fund
OTS	Office of the Thrift Supervision
PRA	Prudential Regulation Authority

SCOTUS	Supreme Court of the United States of America
SEC	Securities and Exchange Commission
SIBHC	Supervised Investment Bank Holding
SIFI	Systemically Important Financial Institution
SLCU	Scottish League of Credit Unions
SLHC	Savings and Loans Holding Company
SPOE	Single Point of Entry
TBTF	Too Big to Fail
THC	Thrift Holding Companies
TLAC	Total Loss Absorbing Capacity
UFCU	Ulster Federation of Credit Unions
UK	United Kingdom
UNICTRAL	United Nations Commission On International Trade Law |
US	United States
WTO	World Trade Organization
WWI	World War I
WWII	World War II

CHAPTER 1. INTRODUCTION

> *"Financial Regulation is thus the authorities´attempt to achieve the maximum efficiency of the financial sector while averting the risk of its transmitting potentially uncontrollable shocks to the real economy".*
>
> T. Padoa-Schioppa Conference on Financial Conglomerates, March 1988, Commission of the European Communities

1.1 The aim of the thesis

This thesis provides a comparative analysis of BBFC after the Great Financial Crisis (GFC), where the systemic risk lens was incorporated. The FC doctrine has developed mainly in Europe before the FICOD[1] and gained force again after the GFC, but there is no systemic or comparative analysis of BBFC after the crisis. The aim of this thesis is to fil the gap in the FC doctrine focusing on three aspects of BBFC: i) Capital structure (i.e capitalism), ii) legal regulatory framework and iii) impact on resolution.

This thesis selected a Structural classification of FC and identified three different models of FC based on traditional structures: the German model, the UK model and the US or Holding model. This thesis objective is to answer three research questions: 1) How BBFC influenced the industry, what were it philosophical foundations, and what type of capitalism has evolved in the chosen jurisdictions— that are traditionally identified with each model—Germany, the UK and the US.; 2) what is the legal regulatory framework in each of the three selected jurisdictions; 3) which are the most appropriate resolution strategies to selected SIFIs based on each of these jurisdictions.

The contribution of this thesis to the dialogue of FC is threefold. First, it is the first systematic effort to analyse BBFC from a structural perspective after the inception of systemic risk regulations post GFC. Second, it analyses the legal regulation of three jurisdictions to shed light on the conceptual definition of the BBFC. Further, it answers what intellectual forces affected the BBFC and how they influenced the industry. Third, it shows how the traditional Structural classification has proven resilient since it was key to design and structure the SIFI resolution strategies in each jurisdiction. Further research on how BBFC have influenced the industry and types of capitalism in other jurisdictions, mainly Latin America, Eastern Europe, the Middle East, Asia and Oceania may follow.

While FCs may be oriented to any of the three finance activities, banking, securities and insurance, this thesis has chosen to analyse the BBFC because of the relevance of banking in vast jurisdictions and because of the risks and challenges it poses to financial stability. Evidence from the investigation provides material for further research into aspects of securities or insurance-based FC.

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[1] FICOD

The "Conceptual Framework Chapter" (Chapter 2) will function as a toolbox and will examine the building blocks that will be used along the rest of the thesis. Because of this, this introductory chapter only deals with the aim of the research, its methodology, and the thesis structure.

1.2 Methodology

The research methodology focusses on examination and analysis of primary and secondary sources including legislations, regulatory consultations, policy documents and reports, scholarly opinion and case law. The thesis relies strongly on German, UK and EU law on one hand, and US law on the other. The approach is doctrinal and theoretical and provides a careful analysis from the legal perspective of BBFC.

The CALD report explains

> "(t)o a large extent, it is the doctrinal aspect of law that makes legal research distinctive and provides an often under-recognised parallel to 'discovery' in the physical sciences. Doctrinal research, at its best, involves rigorous analysis and creative synthesis, the making of connections between seemingly disparate doctrinal strands, and the challenge of extracting general principles from an inchoate mass of primary materials... If doctrinal research is a distinctive part of legal research, that distinctiveness permeates every other aspect of legal research for which the identification, analysis and evaluation of legal doctrine is a basis, starting point, platform or underpinning".[2]

This thesis also concentrates on multiple case study methodology. Case study is defined by Yin as a preferred method in situations where the main research questions are "how and "why". It also address situations where the researcher has no control over the behavioural events and it focuses on contemporary phenomenon.[3] Additionally, case studies or multiple case studies are relevant if the research questions require an extensive and "in depth" description of some phenomenon.[4] Multiple case study involve "examining several cases to understand similarities and differences" between them with the goal of replicating findings across cases.[5] It compares different models and selects a SIFI according to a criteria which is explained in each chapter, based in each jurisdiction: i) DB, ii) Barclays and iii) Citigroup, in order to find which resolution strategy best fit each BBFC.

Finally, when examining the legal regulations of BBFC in Germany, the UK and the US, this thesis focuses on comparative legal analysis. Reitz states

> "the comparative method involves explicit comparison of aspects of two or more legal systems…the step of actually drawing the comparison is crucial to realizing

[2] Council of Australian Law Deans, CALD Statement on the Nature of Research (May and October 2005), 3 < https://cald.asn.au/wp-content/uploads/2017/11/cald-statement-on-the-nature-of-legal-research-20051.pdf>. Accessed 18 August, 2020.
[3] R. Yin *Case Study Research. Design and Methods*. 5th edition, (SAGE Publications 2013) p. 2.
[4] Ibid, p. 4.
[5] P. Baxter and S. Jack "Qualitative Case Study Methodology: Study Design and Implementation for Novice Researchers". [2008] The Qualitative Report p. 548.

> the intellectual benefits of comparison."[6] Similarly, Eberle understands "[t]he key act in comparison is looking at one mass of legal data in relationship to another and then assessing how the two lumps of legal data are similar and how they are different. The essence of comparison is then aligning similarities and differences between data points, and then using this exercise as a measure to obtain understanding of the content and range of the data points."[7]

This thesis chooses these methods because they effectively help to answer the specific research questions it wants to address. As this is a PhD thesis in Law, doctrinal method is key to draw conclusions analysing primary law, secondary law, soft law and other sources. Comparative law analysis is vital in order to answer how BBFCs are regulated in the selected jurisdictions. Moreover, multiple case studies method is useful to compare and draw conclusions of which is the most suitable resolution strategy to different SIFIs based in selected jurisdictions.

1.3 Structure of the thesis

Chapter one of this thesis provides an overview of what this thesis is about dealing with the aim of the thesis, the research questions and its structure. It answers what the research will achieve, why it is important to advancing the agenda on FCs after the GFC, and describes its contribution to the field. As chapter two deals with a conceptual chapter, it only responds to the mentioned problems and do not introduce the building blocks that will build the different chapters of the thesis.

Chapter two focuses on the conceptual framework of FCs. It discusses what a bank is and why they are special. It draws a triple classification of financial institutions: a Commercial classification, a Structural classification and a Regulatory classification. The Commercial classification comprises banking groups, FCs and mixed conglomerates. The Structural classification relies on the legal and operational separation of FC and distinguish between the German model, the British model and the US model. Finally, the Regulatory classification relies on categories of systemic importance and distinguishes G-SIBs, G-SIIs and NBNI G-SIFIs. After introducing each model, the German model, the UK model and the US model, the thesis legally compares the regulation of BBFC in the jurisdictions where the models historically apply, Germany, the UK and the US.

Chapter three focuses on the first element of the Structural classification and examines the German model of BBFC. This chapter deals with the definition of universal banking and its historical and philosophical foundations. It analyses how the BBFCs influenced the industry in Germany and its implications in a bank-based type of capitalism. As universal banking is one of the most important types of BBFCs this thesis examines the benefits and costs of universal banking. In order to compare how the BBFCs are legally regulated in Germany, section 3.1.6 analyses the German banking system, the three pillar structure and introduces insurance regulation in Germany through Annex 3 to analyse interactions between universal banks and insurance. It argues that while there are benefits in universal banking, regulators need to be aware that concentrating the three financial

[6] J. Reitz "How to Do Comparative Law" [1998] The American Journal of Comparative Law, ps. 617-636.
[7] E. Eberle, "The Methodology of Comparative Law," [2011] Roger Williams University Law Review p.52.

functions under the same “roof” may create the peril of developing “mammoth entities” which may be potentially difficult to manage, supervise and resolve.

Chapter four outlines the British model which has been historically present in the UK. This chapter examines the British system, its specialised system and self-regulated industry. It also explains the ties between banks and finance in the UK and the City of London as a driving force in finance that shaped the entire British economy. As in Chapter two, chapter three examines the structure of the UK banking system, analysing what a bank is, the big four clearing banks, foreign banks and overseas banking. It also establishes the distinction between credit unions, building societies and investment banks. As the UK was one of the first to implement ring fencing, it details this process and introduces insurance regulation in the UK through Annex 3 to analyse the intersections between BBFC and insurance functions. It is argued that ring fencing regulations aim was to end universal banking. While this might have been a theoretical aspiration, UK did not mandate a complete separation and therefore universal banks in a broad sense continue to exist in Britain today.

Chapter five considers the US model. It introduces the historical and philosophical foundations of the US banking system and federalism, i.e. the “nerve” that sustained the whole structure. The US system developed a unique “unit bank” system underpinned by restrictive laws on branching. This chapter analyses the benefits and costs of unit banking. A following section concentrates on the US and the evolution of capital markets and explains how US banks could not finance the industry because of a mismatch between big firms and small unit banks. In order to answer the comparative legal research question, this thesis examines the US banking system, commercial banks, thrifts and credit unions. Finally, it analyses the insurance regulation in the US through Annex 3 and surveys the different legal structures allowed for a BBFCs in the US. This thesis argues the genesis dilemma of the emergence of BBFCs (a “chicken and egg situation”) is present in the American financial regulation and finally, it warns from the “Icarus effect” on financial regulation in the US.

Taking into account findings in chapters, two, three, four and five, chapter six concentrates on the resolution of BBFCs. Once the research has analysed the corporate structure that prevails in each one of the selected jurisdictions, the philosophical and historical foundations of each model, and the type of capitalism involved in each jurisdiction, based on four selected indicators this thesis analysed a multiple case study in order to assess which resolution strategy best fits three SIFIs: DB (Germany), Barclays (UK) and Citigroup (US). The first indicator relies on how FCs structure themselves, through branches or subsidiaries. The second indicator show the degree of centralization of FCs, centralised or decentralised. The third indicator concentrates on the business model, retail or wholesale. The forth indicator indicates the territorial or universal approach to resolution. It also analyses the costs and benefits of SPOE and MPOE resolution to finally answer the last research question: which resolution strategy best fits each model, analysing a representative SIFI of each jurisdiction.

Chapter seven sets out the concluding remarks which include the findings resulting from the comparison of the different models in chapters, 3, 4 and 5, the resolution strategies proposed in chapter 6, and the annexes –althogh not an integral part of the thesis-they further inform the research.

The thesis aims to state the law and major policy developments as of 1 May 2021.

CHAPTER 2. CONCEPTUAL FRAMEWORK

The concept of FC is difficult to define.[8] Firstly, because the concept has been transferred from the commercial to the financial law literature. In addition, different regulatory and legislative bodies have referred to similar concepts in different ways. Secondly, because the same concept has been described from different perspectives, i.e. the commercial, structural and regulatory. Thirdly, because the nature of FCs is evolving and the risks of different financial activities differ from each other. Fourth, because by their very nature, FCs tend to expand geographically and into new markets.

The aim of this chapter is to establish a concept of "financial conglomerates" by examining their different classifications, thus shedding light on a common conceptual framework that help the conversation on FCs in the future.

The first section analyses what a bank is, and why they are special. This thesis will mainly examine BBFCs, since the banking sector is most prone to affect financial stability and is the main source of financing for a vast zone of the world. The second section examines three different classifications of groups of financial institutions relying on the commercial activity they perform ("Commercial classification"), on the legal and operational separateness ("Structural classification") and on categories of systemic importance ("Regulatory classification"). This analysis follows below.

2.1 What is a bank?

The first question is to define what a bank is. According to Effros there are two approaches; the first one is to include a "list of activities" and the second consists of a "formula approach".[9] The list of activities may include: "receiving deposits, discounting bills and notes, lending money, conducting safe deposit functions, buying and selling currencies, effecting transfers between accounts and collecting and clearing negotiable instruments".[10] The second approach is based on a formula which relies on "the irreducible concept of accepting deposits and making loans".[11] Often, the legislative solution adopted in a jurisdiction combines the two approaches: a bank or credit institution is an entity which receives deposits and grants loans and does other activities.

2.1.1 List approach

Historically, this first approach was adopted by the SCOTUS in the Austen v. United States Bank of New York Case: "a bank, (…) is an institution usually incorporated with power to issue its promissory notes (…); or to receive the money of others on general deposit to form a joint fund that shall be used by the institution for its own benefit, for one or more of the purposes of making temporary loans and discounts.; of dealing in

[8] A definition is "an exact statement or description of the nature, scope, or meaning of something". Oxford Dictionary online <https://en.oxforddictionaries.com/definition/definition. > accessed 20 January 2018. When the defined object changes over time, the time variable needs to be taken into account. As Schweitzer contends "constant change has always been the hallmark of free-enterprise economy. P. Schweitzer "Banks and Banking- A Review of a definition" [1977] Banking L.J 6,7, p. 94

[9] R. Effros "Central Bank in the Age off Standardization" Manuscript (Effros, 1999). See also R. Effros *Current Legal Issues affecting Central Banks*, vol I, (IMF 1992) p. 9.

[10] Ibid.

[11]See E. Effros, "Central Bank in the Age off Standardization" above note 9 p. 2.

notes, foreign and domestic bills of exchange, coin, bullion, credits and the remission of money; or with both these powers, and with the privileges in addition to these basic powers, of receiving special deposits and making collections for the holders of negotiable paper, if the institution sees fit to engage in such business."[12]

The *list approach* was applied in the US by the United States NBA: "All National Associations…shall have power…to carry on the business of banking: by discounting and negotiation promissory notes, drafts, bills of exchange, and other devices of debt; by receiving deposits, by buying and selling exchange, coin, bullion, by loaning money on personal security, and by obtaining, issuing, and circulating notes according to the provisions of this chapter"[13].

Germany also followed this list approach when enacting the German Banking Act in 1998. For the German Act, banking business comprises: 1) the acceptance of funds from others as deposits […]; 2) the granting of money loans and acceptance credits (credit business); 3) discount business; 4) principal broking services; 5) safe custody business; […] 8) guarantee business; 9) bill collection business; 10) underwriting business; and, 12) "acting in the capacity of a central counterpart"[14].

This same approach has been taken by the European Union in Annex I to the "Bank Consolidation Directive" (2006/48/EC), recital 14. The EU has changed its approach from the formula approach to the list of activities approach, since in the First and the Second Banking Directive the former was adopted.[15]

It can be observed, nevertheless, in the EU the first two activities of the mentioned Annex are accepting deposits and lending, which resembles the second approach.

The *list approach* disadvantage is that the list has to be updated regularly because the purpose and activities of banks have changed over time. In order to address this disadvantage different solutions have been proposed: (1) periodical legislation update; (2) broad interpretations of the nature of the activities; and (3) procedures to delegate the authority/power to administrative authorities to make such changes.[16]

2.1.2 Formula approach

Before the UK adopted a statutory definition of a Bank, "the most prominent was the definition developed by Diplock LJ in the 1966 case of United Dominions Trust v. Kirkwood. "Common to all modern definitions and essential to the carrying on of the business of banking is that the banker should accept from his customers' loans of money on deposit, that is to say, loans for an indefinite period upon running account, repayable as to the whole or any part thereof upon demand by the customer."[17]

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[12] *2 Auten v. United States National Bank of New York, 174 U.S. 125, 141–42 (1899).*
[13] 12 U.S.C. § 24 (7).
[14] Banking Act <http://www.gesetze-im-internet.de/kredwg/ > accessed 2 May 2021.
[15] See First Banking Directive article 1.
[16] See R. Effros, above note 11, p.2.
[17] H. Schooner and M. Taylor *Global bank regulation: principles and policies* (Elsevier 2010), p.2.

This formula can be found in the legislation of different countries such as the UK[18] Spain[19], France[20], among others.[21]

The US, since the enactment of the Bank Holding Company Act (BHC) in 1956, takes the *formula approach* "For purposes of this chapter— (1) In general—Except as provided in paragraph (2), the term "bank" means any of the following: /…)— (i) *accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and (ii) is engaged in the business of making commercial loans*." [Emphasis added][22]

In 1962 SCOTUS defined a commercial bank in United States v. Philadelphia National Bank: "Commercial banks are unique among financial institutions in that they alone are permitted by law to accept demand deposits. This distinctive power gives commercial banking a key role in the national economy. For banks do not merely deal in, but are actually a source of, money and credit; when a bank makes a loan by crediting the borrower's demand deposit account, it augments the Nation's credit supply. Furthermore, the power to accept demand deposits makes banks the intermediaries in most financial transactions (since transfers of substantial moneys are almost always by check rather than by cash) and, concomitantly, the repositories of very substantial individual and corporate funds."[23]

The two components of the *formula approach* determined the name of the institutions on both sides of the Atlantic. While in the US the generic name for banks is "Depositary Institution", in Europe the chosen name is "Credit Institution".[24]

Even though the formula approach focuses on the main function of lending and deposit taking it might be restrictive. Taking into account the fast-paced change of finance technology and innovation, some of the activities of banks might fall outside the formula.

2.1.3 A Third approach

A third approach would be to address the formula approach with a sufficient range of discretion to include the necessary changes of the banking activity. A resulting possible definition would be that a bank is an institution that engages in "financial intermediation" where the characterization of the peculiarities of what financial intermediation is would

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[18] UK Financial Services and Markets Act 2000, Schedule 6.

[19] See Spanish Ley 10/2014.

[20] See French Code Monetaire et Financier <https://www.legifrance.gouv.fr/affichCode.do;jsessionid=9E64E5C022EFB33D9EB4FD9807BB2EE1.tplgfr41s_1?idSectionTA=LEGISCTA000006170352&cidTexte=LEGITEXT000006072026&dateTexte=20171101.> accessed 20 January 2018.

[21] Brazil, Argentina, Paraguay and Uruguay legislation tends to refer to a slightly different formula, that of those entities that engage themselves in "financial intermediation". See Brazil law No. 4595/64, <http://www.planalto.gov.br/ccivil_03/leis/L4595.htm> . accessed 20 January 2018. See Argentine law No. 21526 <http://www.bcra.gob.ar/Pdfs/SistemasFinancierosYdePagos/MarcoLegalCompleto.pdf> accessed 20 January 2018.

[22] BCHA. par. 1841.

[23] *United States v. Philadelphia National Bank et al., 374 U.S. 321, 397 (1963).*

[24] R. Lastra *Central Banking and Bank Regulation*, (LSE 1996) p. 73.

be transferred to the remit of the Financial Authority.[25] The room for maneuver in this field is important due to the fast changing nature of banking business.

As Keynes observes: "Perhaps the most difficult question is how much to decide by rule and how much to leave to discretion".[26] While this is not easy, a static implementation of both the list and the formula approach might not be sufficient in an ever-evolving area being challenged by technology.

2.2 Are banks special?

For centuries, banks have assumed special functions in the economy. Mainly because of this, governments and Central Banks have treated banks in special ways. Banks are special in various ways. Banks as financial intermediaries have the following basic functions: (1) transformation of short-term liabilities (generally in small amounts by depositors) into long-term credits[27]; (2) provision to bank customers of means of payment being themselves payment intermediaries[28]; (3) transmission by Central Banks of monetary policy[29]; (4) screening of potential borrowers, monitoring their activity and enforcing repayments[30]; (5) being subject to regulation and supervision, and having access to central bank facilities.[31] (See Annex 1).

2.3 Triple classification

This section will analyze a tripartite classification of financial institutions according to three different drivers.

A first classification relies on the commercial activities performed by the group ("Commercial classification"). The commercial activities will vary according to jurisdiction. It is common to distinguish between:

- Banking groups
- Mixed conglomerates
- Financial conglomerates

A second classification relies on the legal and operational separateness of FCs ("Structural classification") and was first developed by Herring and Santomero in 1990. They distinguish between:

[25] See Decreto 614/992 of Uruguay.
[26] John M. Keynes, *Proposals for an International Currency (Clearing) Union*, 1942. https://www.elibrary.imf.org/fileasset/IMF_History/IMF_45-65_vol3.pdf Accessed 30 March 202.1
[27] T. Beck, D. Coyle, M. Dewatripont, X. Freixas and P. Seabright "Bailing out of the Banks: Reconciling Stability and Competition- An analysis of state-supported schemes for financial institutions", [2010] CERP p. 9; T. Padoa Scioppa, "The Transformation of the European Financial System", [2002] ECB p.7, R. Lastra, *International Financial and Monetary Law* (OUP 2015), p. 141.
[28] See T. Beck et al above note 27 p. 9 and R. Lastra, above note 27 p. 141.
[29] E.W. Kelley Jr "Are Banks Still Special?" [1997] Federal Reserve <https://www.federalreserve.gov/boarddocs/speeches/1997/19970129.htm> accessed 20 January 2018.; E. Corrigan "Are Banks Special?" [1982] Federal Reserve of Minneapolis, <https://www.minneapolisfed.org/publications/annual-reports/are-banks-special> accessed 20 January 2018. T. Huertas, "Are Banks still special?" [2017] LSE, p.1.
[30] See T. Beck et al, above note 27, p.9.
[31] See E. Corrigan note above 29, T. Huertas, note above 29 p.1.

- Complete Integration model or German model
- Bank Parent, non-bank subsidiaries or British model
- Holding Company model or US model
- Holding Company parent, complete operational separateness

A third classification relies on categories of systemic importance (“Regulatory classification”). A first subdivision of classification distinguishes between:

- G-SIBs,
- G-SIIs and
- NBNI G-SIFIs.

At a local level, the subdivision comprises:

- D-SIBs
- D-INBIs

As of 2020 there is no FSB framework for Domestically Important Insurers (D-SIID-SIIs), nor a framework for Domestically Non-Bank-Non Insurance Systemically Important Financial Institutions (D-NBNI SIFIs). Also, the proposed methodologies for NBNI G-SIFIs have not been approved either.

The G-SIBs framework does not “capture the systemic impact of insurance subsidiaries of banking groups”.[32] At the same time the IAIS excludes bank owned insurance subsidiaries from the G-IIs network[33]. The result, apart from a gap in macro prudential regulation, is the lack of clashes between G-SIBs and G-SIIs.

At national level, FSB rules were applied in different ways. After the GFC one of the major institutional reforms in the USA was the creation by the DFA of a systemic risk regulator, the FSOC. It has among others the responsibility “to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace.”[34] FSOC’s main power is to designate the “SIFI label” to nonbank financial institutions and to FMU.[35]

According to the DFA there are three different “systemic importance” categories: i) banking SIFIs: those whose assets are beyond USD 50 billion; ii) non-banking SIFIs: those non-banking financial institutions whose material financial distress—or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities—could pose a threat to U.S. financial stability and iii) Financial Market Utilities.[36]

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[32] Basel Committee on Banking Supervision. Consultive document. Global systemically important banks-revised assessment framework. March 2017, p.5 < https://www.bis.org/bcbs/publ/d402.pdf. > accessed 20 January 2018.
[33] Ibid.
[34] DFA.
[35] About FMUs see Federal Reserve (2015) <https://www.federalreserve.gov/paymentsystems/designated_fmu_about.htm> accessed 20 January 2018.
[36] DFA§ 165(a)(1) and §115; C. D. Block “A Continuum Approach to Systemic Risk and Too Big to Fail”, [2012] & Brook J. Corp Fin &Com L p. 289; C. P. Skinner “Regulating Nonbanks: A Plan for SIFI Lite, [2017] 105 Geo. L.J. p. 1379.

In Europe the CRD framework[37] determined another classification of systemic importance: Global systemically important institutions (G-SIIs), and other systemically important institutions (O-SIIs).[38] Member States will have to identify both kinds of institutions according to the EBA methodologies. According to the EBA Guidelines of disclosure of indicators of global importance, institutions with an overall exposure of EUR 200 billion will be subject to the disclosure requirements.[39]

At the same time, at the SSM level there is a test of significance in order to determine the scope of supervision of the European Central Bank (ECB) which is determined by: (1) size (the total value of its assets exceeds €30 billion); (2) economic importance (for the particular EU country´s economy); (3) cross-border activities (Total assets exceed €5 billion and the ratio of its cross-border assets/liabilities to its total assets/liabilities is more than 20%); (4) public financial assistance (from the ESM or the EFSF). If banks fulfil at least one of these criteria they may be referred to as "significant" and be directly supervised by the ECB. [40]

Therefore, ECB supervises significant institutions which are all "banking groups". The ECB also supervises cross-border institutions and groups, and it participates in the supplementary supervision of FCs by way of supervisiong the credit institutions which integrate the same and assumes the responsibilities of the coordinator referred to in FICOD.[41]

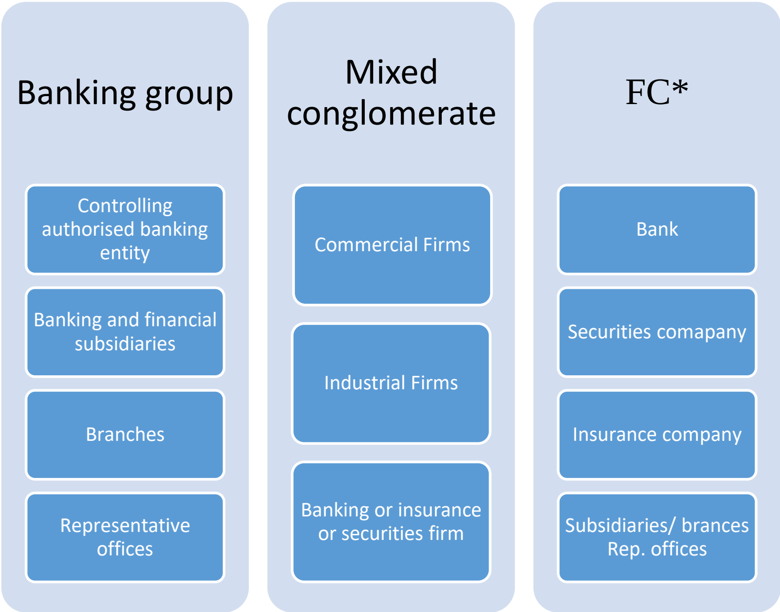
Every year the ECB reviews the list of authosrised banks in order to assess its status. It may change because of normal business activity or because of mergers and or acquisitions. For instance, if a significant bank fails to meet the significant test criteria three years in a row, it may be reclassified as "less significant".[42]

2.3.1 Commercial classification

The first classification comprises banking groups, FCs and mixed conglomerates.

[37] CRD.
[38] Directive 2013/36/EU, article 131.
[39] EBA *Guidelines on disclosure of indicators of global systemic importance* (2014).
[40] SSM Regulation.
[41] ECB *Guide to banking Supervision* (2014). R. Lastra, above note 27. p.363; J.H Binder "Banking Union and the Governance of Credit Institutions - A Legal Perspective" [2015] Working Paper No. 96, Leibniz Institute for Financial Research SAFE; List of List of supervised banks <https://www.bankingsupervision.europa.eu/banking/list/html/index.en.html > accessed 3 March, 2021.
[42] ECB "What makes a bank significant?" <https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html >

Figure 1. Differences between a banking group and a mixed and a financial conglomerate ("Commercial classification")



**at least two financial sectors. Source: R. Lastra and R. Olivares-Caminal* [43]

2.3.1.1 What is a banking group?

In a modern economy banks tend to expand into different countries and into different activities. In order to accomplish the internationalization process banks organize themselves in groups of companies.[44]

The general definition of "group of companies" applies generally to banking groups or financial groups.[45] The essential difference between the group of companies in general and the definition of "banking group" and "financial group" arises from the special activities banks and financial institutions provide.

Groups of companies are valid ways of organizing a business. They are generally recognized in company law as useful[46]. At the same time, different companies that form the group maintain their corporate personality and "lifting the veil" is exceptional.[47] As

[43] R. Lastra and R. Olivares-Caminal "Cross Border Insolvency: The Case of financial conglomerates in J. Raymon Laborsse, R. Olivares-Caminal and D. Singh *Financial Crisis Management and Bank Resolution*, (Informa 2009) p. 271
[44] According to the Oxford Dictionary a group is "A commercial organization consisting of several companies under common ownership." <https://en.oxforddictionaries.com/definition/group > Accessed 20 January 2018.
[45] E. Wymerersch, "Financial Institutions as Members of Company Groups in the Law of the European Union" [2001] European Business Organization Law Review p.2.
[46] Ibid.
[47] E. Hupkes "Form Follows Function- A New Architecture for Regulating and Resolving Global Financial Institutions", [2009] European Business Organization Law Review ps. 372-377.

Easterbrook and Fischel famously stated, "´piercing` seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled."[48]

A group of companies encompasses some general problems which are solved in various ways. In the first place, intra-group transactions are subject to restrictions due to the prevention of conflict of interest. In the second place, there might be some type of protection for individual company of the groups´ interest, minority investors´ interest, and creditors of the different companies' interest.[49] In the third place, there are techniques to avoid the parent undertaking from taking advantage of its "dominant influence" over the subsidiary or branch ("private benefits"). These private benefits might be: transfer pricing agreements, provision of non-market price services, and appropriation of corporate opportunities[50], among others.[51] In the fourth place, company law generally deals with directors' fiduciary duties, which are owed to the company involved and not to the group as a whole.[52]

As Lastra, Ayadi, Olivares-Caminal and Russo contend "the very definition of banking group is contentious".[53] One of the reasons for this is the lack of harmonization and regulatory convergence in the international arena. In the EU there is a reference to "banking groups" in the recital 48 of Directive No. 36 of 2013: "In the case of groups with diversified activities where parent undertakings control at least one subsidiary, the competent authorities should be able to assess the financial situation of each credit institution or investment firm in such a group. The competent authorities should at least have the means of obtaining from all undertakings within a group the information necessary for the performance of their function".[54] A group according to this concept would integrate parent undertakings, and subsidiaries (and branches), which apply diversified activities.

In the UK, The Banking Act 2009 (Banking group Companies) Order 2014 defines a "banking group of companies". As the explanatory note states: "A banking group company may be a parent or subsidiary undertaking of the bank or another company in the same group. There are excluded from the meaning of "banking group company"— a mixed activity holding company where the bank is a subsidiary of an intermediate financial holding company; a subsidiary of such a mixed activity holding company, other than a parent or subsidiary of the bank, if it is neither a financial institution nor a subsidiary of a financial institution; and a covered bond vehicle or securitization company

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[48] F.H. Easterbrook and D. R. Fischel "Limited Liability and the Corporation" [1985] The University of Chicago Law Review, p. 89.
[49] See E. Wymerersch, above note 45, p 3.
[50] M. Sheppard Gelsi "Desvío De Oportunidades De Negocios De La Sociedad Anónima: Un Supuesto De Responsabilidad De Los Directores", [2007] Revista de Derecho, Universidad de Montevideo.
[51] See E. Wymerersch, above note 45, p 3.
[52] See E. Hupkes, above note 47, and E. Wymerersch, above note 45.
[53] R. Lastra, R. Ayadi, R. Olivares-Caminal, C. Russo "The different and operational structures of banking groups in the euro area, and their impact on banks ´resolvability", [2016] European Parliament. J.H. Binder states referring to the EU ", there is no such thing as a European group law for the financial industry in a technical sense either." J.H. Binder "Financial Services Groups under EU Law" in in G. Okutan Nilsson *Comparative Corporate Group Law. Conference in honour of Prof. Dr. Unal Tekinalp´s 80th Birthday* (Twelve Plates Publishing, 2018).
[54] Directive No. 36 of 2013.

which is not an investment firm or a financial institution…"[55] The definition of the Banking Act 2009 includes, then, the complete "family tree" of the bank.[56]

The German Supervision of FCs Act refers to a group as different companies which include a parent, its subsidiaries and the entities in which the parent or a subsidiary holds an investment; or at least two companies connected in such a way that (1) they are under common control on the basis of a statutory provision or a contract or (2) the majority of their administrative, management or supervisory bodies are made up of the same persons who hold office during the financial year, if they have or should have consolidated accounts (horizontal group of companies).[57]

One of the consequences of the existence of banking groups in general is consolidated supervision. In the EU, the Banking Directive [58]requires consolidated supervision to every credit institution holding a credit institution or financial institution as subsidiary or hold a participation is such institution. Additionally, it requires consolidated supervision if a credit institution has a parent financial holding company. The Capital Adequacy Directive required consolidated supervision to groups including investment firms, which mirrors the EU Banking Directive. [59]

As Gruson affirms, consolidated supervision is not required for credit institutions and investment firms, which are subsidiaries of companies that are not credit institutions, investment firms or financial holding companies. Practically, consolidated supervision deals with consolidated financial situation in areas such as consolidated calculation of own funds, solvency ratio, adequacy of own funds to cover market risks, control of large exposures and restrictions on investments in the nonbank sector. [60].

In the US the DFA leave the Federal Reserve System as the unified consolidated regulator, covering holding companies owning insured depositories as well as holding companies that are considered potentially systemic.[61]

Financial groups are groups of companies which engage in financial activities. Wymeersch defines financial groups—before the FICOD—"as groups in which one or more components, legally independent companies, engage in offering financial services to the public, acting as a bank, a broker, an insurance company, an investment adviser or in any other capacity, offering their services to individuals, professional investment managers or other business firms".[62]

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[55] The Banking Act 2009 (Banking group Companies) Order 2014.
[56] A. Pavlovich "Banking group companies: which entities are caught by the Special Resolution Regime?" [2015] Journal of International Banking & Financial Law, p. 97. See also Código de Comercio (Spain) <http://www.mjusticia.gob.es/cs/Satellite/Portal/1292426984594%3Fbl, accessed 14 July 2018>.
[57] FC Supervision Act – FKAG, available at <http://www.gesetze-im-internet.de/fkag/__2.html.> accessed 20 January 2018. See also Code monétaire et financier, partie législative <https://www.legifrance.gouv.fr/Traductions/en-English/Legifrance-translations> accessed 20 January 2018. In Mercosur, the four founding members, Brazil, Argentina, Uruguay and Paraguay have included some types of banking group regulations in their internal law.
[58] Banking Directive.
[59] M. Gruson "Supervision of Financial Conglomerates in the European Union" in *Current Developments in Monetary and Financial Law, Vol. 4*, (IMF 2008).
[60] Ibid.
[61] A. Vir Bhatia "Consolidated Regulation and Supervision in the United States" [2011] IMF Working Paper Monetary and Capital Markets Department Strategy, Policy, and Review Department.
[62] See E. Wymerersch, above note 45, p 1.

This definition of a financial group, which was adopted before the rise of the FICOD in Europe in 2002, lead us to analyze in more detail the definition of the "financial conglomerate".

2.3.1.2 What is a financial conglomerate?

The increasing relevance of international FCs poses a double complexity due to its cross-sector and cross-jurisdiction dimensions.[63] The definition of a FC varies according to the practices and legislation within different jurisdictions.[64] The cross-sector dimension of the FC is the key element that distinguishes the banking group from the FC.[65]

It is fair to say the notion of a conglomerate might have been confused with the notion of "industrial conglomerate" before the term "financial conglomerate" was widely used by the financial sector. Such a misunderstanding was strengthened by the fact that one of the recognized features of the industrial conglomerate is "conglomerate diversification". This is defined as "a diversification into completely different activities with a completely different technology oriented towards markets".[66] As FCs involve sectors that might be complementary and tend to explore synergies, the term "conglomerate diversification" would not apply to FCs.[67]

The term "conglomerate" means "a thing consisting of a number of different and distinct parts or items that are grouped together" and "a large corporation formed by the merging of separate and diverse firms."[68] In the FC there is an element of differentiation on the activities performed by it, and at the same time an element of unity in the formation of a "unit".[69]

According to Walker, "the term conglomerate can be used to refer to any form of business structure that involves at least two distinct forms of industrial activity or service provision."[70]

A FC is defined by the Tripartite Group of Bank, Insurance and Securities Regulators as "any group of companies under common control or dominant influence, including any financial holding company, which conducts material financial activities in at least two of the regulated banking, securities or insurance sectors.[71] As stated by Lastra, Ayadi, Olivares-Caminal and Russo, "a financial conglomerate may be characterized primarily as a securities, insurance or a banking structure. The character would be determined by

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[63] R. Lastra and R. Olivares Caminal above note 43 p. 269.
[64] Ibid.
[65] Rosa M. Lastra, R. Ayadi, R. Olivares-Caminal, R. Russo above note 53.
[66] L. Van den Berghe *FCs. New Rules for New Players?* (Klewer Academic Publishers 1995) p 14.
[67] Ibid.
[68] Oxford dictionaries < https://en.oxforddictionaries.com/definition/conglomerate.> accessed 20 January 2018.
[69] See A.J. Veermat "Defining Financial Conglomerates" in L. Van den Berghe, above note 64, p.21.
[70] G. Walker "The Law of Financial Conglomerates: The Next Generation", [1996] p. 30 and see generally: J. Maycock, *Financial Conglomerates: The New Phenomenon* (Gower Publishing Company 1986); C. R. Spruill, *Conglomerates And The Evolution Of Capitalism*, (Southern Illinois University Press 1982); H. Mcvea, *Financial Conglomerates And The Chinese Wall: Regulating Conflicts of Interest*, (OUP, 1993).
[71] Bank of Financial Settlements "The Supervision of Financial Conglomerates" [1995] A Report by the Tripartite Group of Bank, Securities and Insurance Regulators, p.13

the sector represented at the holding company level and by the type of activity that constitutes the major business of the conglomerate”.[72]

As stated above, under SSM, ECB supervises significant banking groups which are determined by size, economic importance, cross border importance, cross border activities and public financial assistance. In 2021 ECB supervises 115 entities, which reflects how influential the supervision of ECB is for primarily banking FCs and how the supervisor is shaping the type of banking groups the EU will have in the near future.[73]

In 2002 the EU adopted the FICOD in order to tighten supervision of this kind of groups and to ensure the strength the financial system.[74]

According to Article 2(14) of the FICOD, a financial conglomerate “means a group or subgroup, where a regulated entity is at the head of the group or subgroup, or where at least one of the subsidiaries in that group or subgroup is a regulated entity, and which meets the following conditions:

(a) Where there is a regulated entity at the head of the group or subgroup:

> (i) that entity is a parent undertaking of an entity in the financial sector, an entity which holds a participation in an entity in the financial sector, or an entity linked with an entity in the financial sector by a relationship;
>
> (ii) at least one of the entities in the group or subgroup is within the insurance sector and at least one is within the banking or investment services sector; and
>
> (iii) the consolidated or aggregated activities of the entities in the group or subgroup within the insurance sector and of the entities within the banking and investment services sector are both significant; or

(b) where there is no regulated entity at the head of the group or subgroup:

> (i) the group’s or subgroup’s activities occur mainly in the financial sector;
>
> (ii) at least one of the entities in the group or subgroup is within the insurance sector and at least one is within the banking or investment services sector; and
>
> (iii) the consolidated or aggregated activities of the entities in the group or subgroup within the insurance sector and of the entities within the banking and investment services sector are both significant.”

According to the FICOD, a “group” means a set of undertakings which consists of a parent undertaking, its subsidiaries and the entities in which the parent undertaking or its subsidiaries are defined according to the Consolidated Accounts Directive.[75]

In order to be considered a FC by EU law they must: (1) contain at least one regulated entity in an EU member state; (2) comprise at least one entity in the insurance sector and at least another in banking/securities sectors; (3) include “significant” cross-sectorial activities. To assess the significant test, the banking/securities sector together must be

[72] See R. Lastra, R. Ayadi, R. Olivares-Caminal and C. Russo, above note 53 p.7.
[73] ECB “List of Supervised entities” 14 January 2021. <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.listofsupervisedentities202102.en.pdf?f532b1d8606bfdbb1cc4a5adcd66934f > Accessed 8 April 2021.
[74] FICOD.
[75] FICOD article 2(12).

significant, as well as the insurance sector assessed alone. The "relative criterion" assesses the relevance of the sector in the group´s total assets and solvency requirements, which need to be more than 10%. The "absolute criterion" determines that when the small sector as assessed by the relative criterion has a balance sheet of more than € 6 billion, it is also categorized as significant.[76]

In the case where there is no regulated entity at the head of the group's or subgroup's activities, the FICOD established they must "occur mainly in the financial sector". For the purposes of determining whether the activities of a group mainly "occur in the financial sector", the ratio of the balance sheet total of the regulated and non-regulated financial sector entities in the group to the balance sheet total of the group as a whole should exceed 40 %.[77]

At the same time, when a conglomerate involves an industrial or commercial company and a regulated company it is known as a mixed conglomerate.[78]

Main features of each financial sector

As stated before, FCs combine two of the three sectors of the financial sector: banking, insurance and securities.

Each sector has a set of characteristics that differ from each other, comprising a different balance sheet structure, involving different risks and different supervision processes.

As specified above, banks engage in transforming short-term liabilities into long-term assets[79]. The bank-customer relationship tends to happen in a net of branches, while the main risk involved in its activity is credit and liquidity risk.[80] According to the Joint Forum[81], "risk for banks has historically been credit risk - which can be amplified by concentration risk - on the asset side of the balance sheet. Risk arises on the liability side as well, in the form of liquidity risk posed by maturity mismatches between short-term deposits and long-term loans. Other banking risks include market risk (including volatility in the trading book), interest rate risk in the banking book, foreign exchange risk, funding risk, operational risk, country and transfer risk, legal risk, and reputation risk".[82]

Insurance companies underwrite risks for a premium, providing a safety net when adverse events arise.[83] In order to achieve their objectives, insurance companies rely on managing risks through "diversification and the law of large numbers". They can diversify policy liabilities by contracting reinsurance, and they rely on statistical calculations to estimate liabilities.[84] The typical risks of the insurance sector are underwriting risks, meaning that the technical provisions or premiums are below the real needs of a company to comply with their contracts, and the investment risk, meaning that the investments the firm

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[76] F. Dierick "The Supervision of Mixed Financial Services Groups in Europe", [2004] Occasional Paper Series No 20, ECB, p. 11; FICOD, articles 2 and 3.
[77] FICOD article 3.1.
[78] European Commission "Towards an EU Directive on the Prudential Supervision of FCs" [2000] MARKT/3021/2000.
[79] See T. Beck et al, above note 27, p. 9; T. Padoa Scioppa, above note 27, p 7, R. Lastra, above note 27, p. 141.
[80] See F. Dierick, above note 76, p12.
[81] See Joint Forum history < https://www.bis.org/bcbs/jointforum.htm >accessed 20 January 2018.
[82] Joint Forum *Core Principles: cross-sectorial comparison* (2001), p.9.
[83] See F. Dierick above note 76 and Joint Forum, ibid.
[84] See Joint Forum, above note 82 p. 10.

engages are insufficient to fulfill their obligations.[85] Typically insurance assets tend to be less risky, e.g. government bonds, and risk-linked bonds (catastrophe bonds) are uncommon. Therefore, insurance companies are assessed as "less fragile" than banks.[86]

The securities sector "is sensitive to macroeconomic factors in that there is typically a predictable correlation between macroeconomic indicators and market sentiment. Extreme macroeconomic conditions can lead to rapid changes in confidence, resulting in, for example, runs on assets by fund managers or rapid unwinding of futures positions with leverage on equity values".[87] The asset side of the balance sheet comprises inter alia receivables secured by securities and financial instruments, while the liabilities side includes payables to consumers. The assets and liabilities are both short term and market to market on a daily basis, "reflecting their true financial position".[88] The main risks involved in the securities sector are market and liquidity risk.[89] Generally, security firm regulators tend to ensure firms adopt correct record keeping and can easily distinguish their own assets from client assets.[90]

2.3.1.3 What is a mixed conglomerate?

As stated above, a mixed conglomerate is a group of companies where at least one company engage in an activity of a commercial or industrial nature, and at least one company is a regulated financial institution.

Traditionally, Anglo-Saxon countries relied on a separation between banks and commercial and industrial companies, as well as other financial companies. On the other hand, continental European, Latin American and Asian countries tended not to impose strict restrictions on non-banking corporations owing commercial or industrial companies. In recent years, Anglo Saxon countries have converged with the other regions in accepting FCs.[91]

The links between banks and commercial and industrial companies vary according to the bank´s role in the economy. Two models are identified. The first is the so-called "Anglo Saxon model" or capital market system. In this model the members of the public invest in shares of companies which may be traded individually or through institutional investors via the stock exchange. Companies rely on capital markets for financing. Banks, at the same time, have a role in "arm-length financing", mergers and acquisitions, and internal corporate restructuring.[92] On the other hand, the Continental European/Latin American/Asian model ("Continental model") or bank-based system comprises the following features: (1) banks generally own equity in corporations; (2) banks act as "commercial and investment bankers to their clients"; (3) bank representatives may serve

[85] See F. Dierick, above note 76 p. 12.
[86] I. Saapar and F Soussa "Financial Consolidation and Conglomeration: Implications for the Financial Safety Net in L. Halme, C. Hawkesby, J. Healey, I. Saapar and F. Soussa *Financial Stability and Central Banks Selected Issues for Financial Safety Nets and Market Discipline* (Bank of England 2000) ps. 71-94.
[87]See Joint Forum, above note 82 p. 11.
[88] See I. Saapar and F. Soussa, above note 86; See generally C. Goodhart, P. Hartmann, D. Llewellyn, L. Rojas-Suarez, S. Wesibrod *Financial Regulation: Why, how and where now?* (Routledge 1997).
[89] See F. Dierick, above note 76, p 12.
[90] Ibid.
[91] H. Schooner and M. Taylor above note 17 p 112.
[92] Ibid.

as directors for their clients; (4) banks may own industrial groups; and, (5) capital markets play a "limited role in financing corporations".[93]

The two systems help to understand why traditionally the Anglo Saxon world intended to separate commerce from banking, while the continental approach favoured it.

When the Bank of England was founded in 1694 it expressly forbade trade in merchandise.[94]The same can be said in the US. Even though the Manhattan Company-a water provider in NYC-in 1799 created the Bank of Manhattan Company as a subsidiary[95], some years later the law forbade a commercial company from performing banking activities. In 1825 the New York Statute stated banks would "possess all incidental and necessary powers to carry on the business of banking…but the said company shall have and possess no other powers whatsoever…"[96]

On the other hand, the European Continental model relied on banks to finance industry undertakings. For instance, a Deutsche Bank statute reads "the object of the company is to transact banking business of all kinds, in particular to promote and facilitate trade relations between Germany, other European countries and overseas markets." But soon it became the financier of industrial groups in Germany.[97] Sraffa understood in 1921 that bank financing of the industry was indispensable due to the shortage of capital in Italy, the unwillingness of households to invest their savings in the industry and the "timidity and ignorance" of capitalists in the country.[98] In Japan the *Keiretsu* model always includes a bank. The "*keiretsu*" is a group of industries "with one- and two-way agreements to favor each other in business deals and share in shouldering temporary burdens that would otherwise cause instability for the group... Like all *keiretsu*, there is a bank as a member, although it has less pull in a vertical orientation."[99]

Although traditionally the separation between commerce and banking existed in the Anglo-Saxon model, today both England and the US allow mixed conglomerates to operate, converging into the Continental approach.[100] Legislation, as Effros points out,

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93 Ibid, p.113.

94 Bank of England Act, 1694, article XXVI <http://www.legislation.gov.uk/aep/WillandMar/5-6/20/section/XXVI.> accessed 20 January 2018.

95 JPMorgan Chase "The History of JPMorgan Chase & Co. 200 Years of Leadership in Banking" <https://www.jpmorganchase.com/corporate/About-JPMC/document/shorthistory.pdf> accessed 20 January 2018; H. Schooner, above note 17, p 114.

96 W. C. Bryant *The Legislative History of Banking in the State of New York, During the Period of Fifty Years, from A.D. 1791 to A.D. 1841*, (1855) p. 19; See H Schooner, above note 17, p.114.

97 Deutsche Bank "Deutsche Bank History Chronicle – from 1870 until today" <https://www.db.com/company/en/media/Deutsche-Bank-History--Chronicle-from-1870-until-today.pdf.> accessed 20 January 2018.

98 P. Sraffa "The Bank Crisis in Italy" [1922] Economical Journal p.194.

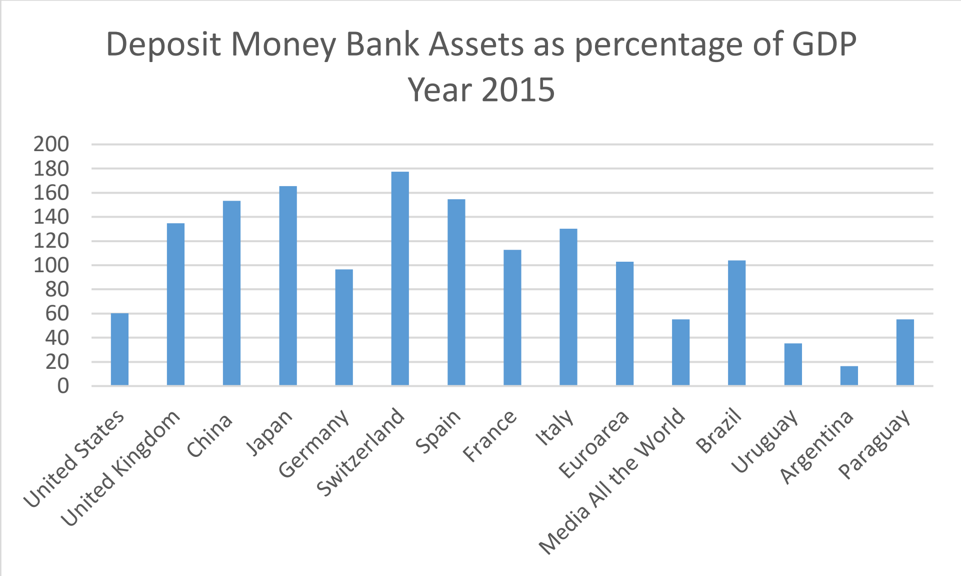
99 "M. Jancer "How Eight Conglomerates Dominate Japanese Industry" 7 Sep 2016, Smithonian.com <https://www.smithsonianmag.com/innovation/how-eight-conglomerates-dominate-japanese-industry-180960356/> accessed 20 January 2018 ; J. McGuire and S. Dow "Japanese keiretsu: Past, present, future" [2009] Asia Pac J Manag ps.. 333–351; L. Eliot Brouthers Y. Gao and S. Napshin "Keiretsu centrality — profits and profit stability: A power dependence perspective" [2014] Journal of Business Research ps 2603-2610; R. Suetorsak "Keiretsu and risk: An examination of the risk exposure of keiretsu banks in Japan" [2007] J Econ Finan 31: p. 268; J. Jay Choi, T. Hiraki and James A. Landi "The value of multinationality and business group for Japanese firms" [2014] Journal of Corporate Finance ps 88-110.

100 See Chapters 4 and 5.

has been a driver for the historical (relative) further development of capital markets in the US and Japan as opposed to Germany.[101]

One key aspect to understand the relevance of banking in the economy is to compare banking assets with the Gross domestic product (GDP) of different countries. The results reflect Europe, Asia and Brazil rely on banking much more than the US.[102]

Figure 2. Deposit Money Bank Assets to GDP for selected countries



Source: Own elaboration based on Federal Reserve of Saint Louis data

A question that has been raised is whether banks should be allowed to perform commercial activities. While the debate was first centrered on whether the same bank would be permitted to perform commercial activities, the rational for forbidding mixed activity remains valid for mixed conglomerates.

According to Effros the rationale behind forbidding banks performing commercial activities is threefold. In the first place, allowing the banks to compete with their consumers would imply that their decision making regarding loans to their competitors would be impartial. Secondly, as credit is a limited resource, if allocated in an impartial manner, society would pay “an economic penalty” for the “less than optimal allocation” of such credit. Thirdly, the safety and soundness of the bank might be endangered since bank officers might not have the experience to run a commercial activity. At the same time, customers of the bank would trust the investments of the bank are safe and not of a risky nature, as might be the case in the commercial business.[103]

Sraffa has explained banks with strong links with industrial or commercial companies might engage in long term loans, increasing the maturity transformation risk. The main

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[101] R. Effros, above note 11 p. 8. Also see generally R. La Porta, F. Lopez-De-Silanes, A. Shleifer and R. W.Vishny “Legal Determinants of External Finance, The Journal of Finance, [1997] ps. 1131-1150.

[102] For EU data see EU Report on Financial Data <https://www.ecb.europa.eu/pub/pdf/other/reportonfinancialstructures201610.en.pdf.>; For US see <https://fred.stlouisfed.org/series/TLAACBW027SBOG .> accessed 20 January 2018.

[103] See E. Effros, above note 9, p.5.

reason for this is banks would "immobilize" a large amount of funds where the short term debts would still be there to be triggered at any moment.[104]

Another problem is "insider lending" or lending in preferential terms to the commercially or industrially favoured company.[105] This has in turn two main concerns. Firstly, the lack of adequate assessment of lending risk, since the parent company may impose undue pressure on the board of the linked company, and secondly, the portfolio may be "insufficiently diversified".[106] Another perverse consequence of the ownership link between banks and commercial companies is the so-called "tunneling" effect, by way of which majority shareholders appropriate assets of their own bank through fake lending, loan guarantees and other illegal methods.[107]

Even though there are several arguments to disfavour the engagement of banks in commercial and industrial activities, the scholarly "consensus"[108] in forbidding this type of activity in the 1980s and 1990s in the US has now changed direction, and mixed conglomerates may be found both in the UK and the US, as well as in the EU, Latin America and Asia.[109]

2.3.2 Structural classification. Organizational structures of FCs

Herring and Santomero were the first to incorporate the distinction of legal and operational separateness and to draw a classification of FCs. For them, legal separateness implies "different products provided by separate corporate entities, each of which has its own management structure, set of accounts, board of directors, and capital. Its shareholders are legally protected from disastrous outcomes in the separate corporate entity by limited liability". On the other hand, operational separateness implies "self-imposed restrictions" or Chinese Walls that prevent the "integrated production" of different products within the group.[110] The building of firewalls within the group may prevent intra-group credit and information sharing and may also impose different distribution channels for some of the products of the conglomerate.[111]

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104 See P. Sraffa above note 98 p.194.

105 G. A. Del Angel "The nexus between business groups and banks: Mexico, 1932–1982" [2016] Buisiness History p 122; R. La Porta, F. López-de-Silanes and G. Zamarripa "Related Lending" [2003] The Quarterly Journal of Economics, ps. 231-268; N. Maurer and S. Haber "Related Lending and Economic Performance" [2007] The Journal of Economic History ps. 551-581 ; E. Laeven "Insider Lending and Bank Ownership: The Case of Russia" [2001] Journal of Comparative Economics ps. 207-229; R. Cull, S. Haber and M. Imai "Related lending and banking development", [2011] Journal of International Business Studies, ps. 406-426.

106 See H. Schooner, above note 17, p 121.

107 S. Johnson, R. La Porta, F. Lopez-de-Silanes and A. Shleifer "Tunneling" [2000] The American Economic Review, pp. 22-27; K-H. Bae, J.-Koo Kang, J-Mo Kim "Tunneling or Value Added? Evidence from Mergers by Korean Business Groups" [2002] The Journal Of Finance p.2695; Y. G. Shan "Can Internal Governance Mechanisms Prevent Asset Appropriation? Examination of Type I Tunneling in China" [2013] Corporate Governance: An International Review, ps. 225-241.

108 See E. Effros, above note 9, p. 4.

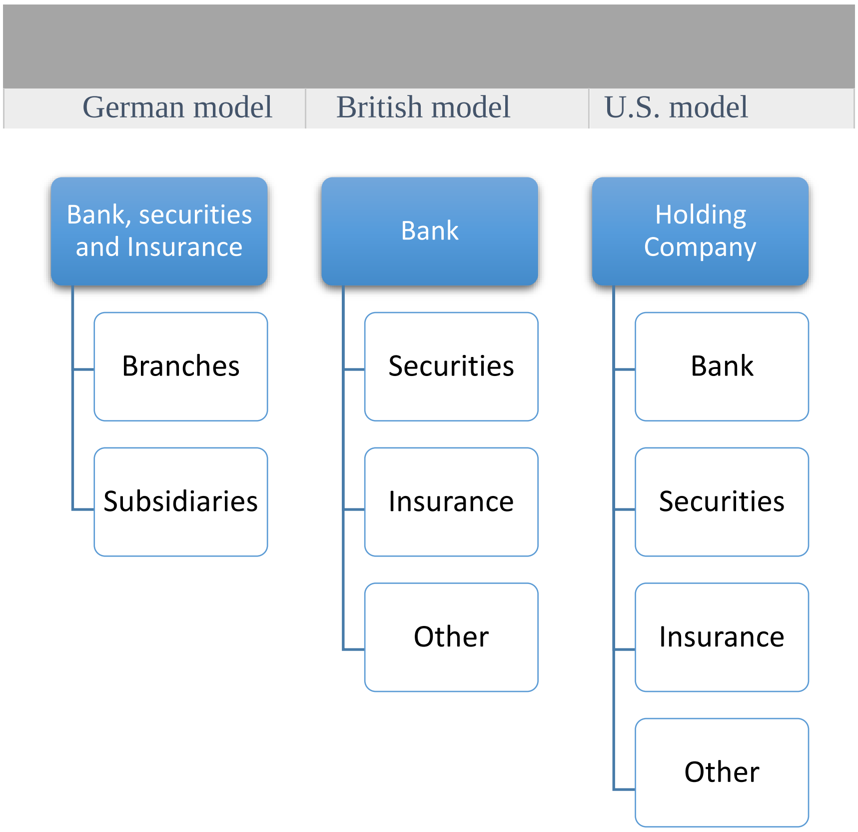
109 This theis will not assess the Commercial classification *per se* since it is merely descriptive, contray to the structural and Regulatory classifications.

110 R. J. Herring and A. M. Santomero "The Corporate structure of Financial Conglomerates" [1990] Journal of Financial Services Research, ps. 223-224.

111 Ibid, p. 223.

Herring and Santomero classified FCs in four different models: 1) the “complete integration” model or German model; 2) the “bank parent, non-bank subsidiaries” or British model; 3) the “holding company parent, all activities as subsidiaries” model or US model, and 4) holding company parent, complete operational separateness model or complete operational separateness model.[112]

Figure 3. FC Structures



Source: R. Lastra and R. Olivares-Caminal[113]

[112] Ibid, p 223-228. The following scholars also refer to the same or similar classification as used by Herring and Santomero: K. Koguchi, and G. Forestieri, *Financial Conglomerates*, (Organization for Economic Co-operation and Development 1993); A. Saunders and I Walker *Universal Banking in the United States. What could we gain? What could we lose?*” (OUP 1994); J. Santos “Commercial Banks in the Securities Business: A review, [1998] Journal of Financial Services Research; K. Verweire and L. Van den Berghe *Creating the Future with All Finance and Financial Conglomeartes* (Klewer Academics Publishers 1998); B. Shull and L.J. White “The Right Corporate Structure for Expanded Bank Activities [1998] Banking L.J. 446; I. Saapar and F. Soussa above note 86; H. Skipper “Financial Services Integration Worldwide: Promises And Pitfalls” in *Insurance Regulation, Liberalisation and Financial Convergence*, (OECD 2001); H E Jackson and C Half “Background Paper on Evolving Tends in the Supervision of Financial Conglomerates” [2002] Harvard Law School; R. Vander Vennet “Cost Efficiency of Financial Conglomerates and Universal Banks in Europe” [2002] Journal of Money, Credit and Banking.; F. Dierick above note 76; D. Arner *Financial Stability, Economic Growth, and the Role of Law* (Cambridge University Press, 2009); R. Lastra and R. Olivares Caminal above note 43, V.Peleckiene, K. Peleckies, G. Dudzeviciute “New Challenges of Supervising Financial Conglomerates” [2011] Intellectual Economics.

[113] See R. Lastra and R. Olivares Caminal, above note 43, p.272.

2.3.2.1 Complete Integration or German model

The Complete Integration or German model comprises a single corporate entity which may provide several financial activities such as insurance, banking and securities.[114] The Complete Integration model allows the conglomerate to engage in such activities even without firewalls or Chinese walls to separate distinct functions within it.[115] Therefore, the German model may involve no legal or functional separateness. Some scholars prefer to use the term "universal bank" to define such model.[116]

The main advantage of the German model is the maximization of synergies between different activities producing a "mix of outputs" at a lower cost.[117]

On the other hand, the German model may have the potential of maximizing anti-competitive behavior[118], conflict of interests[119] and "disruptive shocks".[120]

Centralizing all three financial activities in one single corporate entity would give more chances for management to restrict, prevent or distort competition in all three markets.

Conflict of interest "exists whenever one is serving two or more interests and can put one person in a better position at the expense of another."[121] When the same institution is serving more groups of customers the potential for conflict of interest increases.

The consequences of the collapse of a German model FC would be wider in scope since the disruption of its functions would encompass a wider scope of activities.

At the same time the FC may expand the safety net and "implicit subsidies" to non-banking activities. This would violate the policy behind these regulations which protects banking activity due to its specialty.[122] Also, the risks associated with non-banking activities might endanger the safety and soundness of the bank, triggering the insolvency or resolution of the entity.[123] Finally, the German model would be more difficult to regulate than other models where each function is performed by a different institution[124] and would imply an expansion of regulation to other non-banking activities[125], which would be "costly and imprecise".[126]

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[114] See R. Lastra and R. Olivares Caminal, above note 43, p.271.
[115] See R. Herring and A. Santomero, above note 110, p. 481.
[116]See J. Santos, above note 112, p. 46; See B. Shull and L. White, above note 112 p. 467; See D. Arner, above note 112 p. 278.
[117] See R. Herring and A. Santomero, above note 110, p. 481; See B. Shull and L. White above note 112, p. 470.
[118] See R. Herring and A. Santomero, above note 110, p. 482; V. Peleckiene, K. Peleckies, and G. Dudzeviciute, above note 112, p. 300.
[119]See J. Santos, above note 112, p. 47, See R. Herring and A. Santomero, above note 110, p. 482.
[120] See R. Herring and A. Santomero, above note 110, p. 482.
[121] F. R. Edwards, "Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act" in L. G. Goldbergand and L. J. White *The Deregulation of Banking and Securities Activities*, Lexington, Mass., (Lexington Books 1979) ps. 273-94.
[122] See B. Shull and L. White, above note 112. p. 471; See R. Herring and A. Santomero, above note 110, p. 482.
[123] B. Shull and L. White, ibid, p. 470.
[124] See R. Herring and A. Santomero, above note 110, p 482.
[125] See B. Shull and L. White, above note 112 p. 470.
[126] See B. Herring and A. Santomero, above note 110 p. 482; See K. Verweire and L. Van den Berghe, above note 112 ibid, p 62.

In fact, contrary to traditional wisdom in Germany the most common model comprises a Banking/securities company, with an insurance subsidiary.[127] Some scholars distinguish between complete integration and "partial integration" in order to include this kind of arrangement. By partial integration these scholars mean the existence of at least two activities provided by the same legal entity.[128] In Germany this process has been left to the "dwarfing" of securities' activities which were absorbed by the banks. The result is that independent securities firms are lacking in Germany and the security business is subsumed under banking.

2.3.2.2. Bank parent, non-bank subsidiaries or British model

The second model, as shown in Figure 3, includes a banking parent company and non-banking subsidiaries that may provide insurance and securities activities, among others. According to Herring and Santomero, this model may be referred to as the British model.[129]

One advantage of the British model is that it might allow a functional regulation of banking activity which would reduce the costs of supervision. Secondly, legal separateness would protect the banking parent from potential bad business of its subsidiaries.[130] Thirdly, as the subsidiary is "trapped" below the parent, its income will "naturally flow up" to the bank in times of necessity.[131]

The first disadvantage would be that even though legal separateness may isolate the parent from its subsidiaries' losses, parent solvency might be seriously affected by the failure of a subsidiary. This may be the case in at least four scenarios: (1) the creditors of the failed subsidiary obtain to "pierce the corporate veil" and seize the parent assets; (2) the bank suffers reputational damage and loses clients; (3) the parent makes "sizable loans" to the subsidiary; and, (4) the parent tries to avoid the subsidiary´s failure by relocating assets into it.[132] This might trigger the need to bail out the subsidiary in order to prevent further damage.[133]

Secondly, the confidence of the market in that the parent company will provide liquidity assistance to its subsidiary in times of trouble strengthens the subsidiaries' creditworthiness. However, while this could reduce funding costs of the FC, it may cause competition distortion and difficult regulation and supervision.[134]

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[127] Act on the Supervision of Insurance Undertakings Section 15(1); <https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Gesetz/VAG_va_en.html;jsessionid=8553395CC9C54E438FDC97A82EA1C078.2_cid290?nn=7859578> accessed 20 January 2021; Directive 92/49/EEC, Article 8 1 b; R. Vander Vennet above note 112, p. 260; I. Walter " Universal Banking: A Shareholder Value Perspective" [199] European Management Journal p. 345; Institute of International Bankers "Global Survey 2014"<http://c.ymcdn.com/sites/iib.siteym.com/resource/resmgr/Docs/2014GlobalSurvey.pdf .> accessed 20 January 2018.
[128] See I. Walter, ibid, p. 345; See H. Skipper above note 112, p. 5.
[129]See R. Herring and A. Santomero, above note 110, p. 225.
[130] Ibid.
[131] See B. Shull and L. White, above note 112, p.475.
[132] Ibid p.471.
[133] See R. Herring and A. Santomero, above note 110, p. 226.
[134] Ibid.

Thirdly, separating activities through an independent subsidiary would prevent a full maximization of the synergies and diversification advantages of the German model.[135]

Fourth, legal separateness would also demand capitalizing the subsidiary, which increases the costs of the group functioning. At the same time, it might create “agency problems” since there would be various management bodies involved.[136]

Fifth, creditors of the parent company would be able to seize all the assets of the company, which will include bank assets as well as securities unit capital (which is an asset of the bank), theoretically increasing the chance of recovering their investment. This would not be automatically the case if the lines of business were legally separated. From the group perspective, this would be a disadvantage of the British organizational form.[137]

2.3.2.3 Holding Company model: the US model

In the Holding Company model, since 1956, independent banking and nonbanking activities are functionally and legally separated under a holding company “umbrella” at the top of the structure, which is the owner of the banking, securities and insurance companies.[138]

Usually, the holding company would perform common group functions such as risk management, capital raising and allocation, auditing and information technology.[139]

The Holding Company model would theoretically have the “least likelihood” of internal contagion because of functional and legal separateness.[140]

Herring and Santomero argue the advantages of the legal separateness of the Holding Company model are: (1) limited liability allows the FC to limit the losses of a particular subsidiary or line of business; (2) independent subsidiaries can be funded more cheaply if the market believes the parent will aid the subsidiary in times of distress; (3) in cases of Mergers and Acquisitions, maintaining the existing corporate structures may allow the taking advantage of “reputational capital” of the existing company; (4) maintaining separate corporations may facilitate managerial control and balancing compensation packages to meet different lines of business that may differ considerably; and, (5) clients might be more comfortable in a separate entity if they feel they are protected from conflicts of interest that may arise if activities are provided by the same entity.[141]

An additional advantage of the separate line of business approach (banking, securities, insurance) is that it prevents culture clashes. Managerial business styles may be different in each financial sector.[142]

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[135] See H. Jackson and Half above note 112, p. 6; F. Dierick above note 76, p. 18; K. Koguchi et al, above note 112, p. 25.
[136] See F. Dierick, above note 76, p. 18.
[137] See J. Santos, above note 112, p. 48.
[138] See I. Saapar and F. Soussa, above note 86, p.83; R. Herring and A. Santomero, above note 110, p. 227.
[139] See F. Dierick, above note 76 p. 18.
[140] See I. Saapar and F. Soussa above note 86, p. 83.
[141] See R. Herring and A. Santomero, above note 110, p 231.
[142]See K. Koguchi et al, above note 112, p. 25.

Also, legal separateness in the holding model may limit the safety net implicit coverage easier than in an integrated or German model, aligning the regulatory purpose (i.e. lender of last resort) with the actual banking activities.[143]

However, as stated above, the first advantage is weakened by the fact that the market does not perceive the subsidiary to be different from the group as a whole.[144] Walter Wriston, former chairman of Citicorp, stated some decades ago: "it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all your capital funds are going to be behind in the real world. Lawyers can say they have separation, but the market place is persuasive, and it would not see it that way". Former FRB Chairman Paul Volcker stated "the practical realities of the market place and the internal dynamics of a business organization under central direction drive bank holding companies to act...as one business entity, with the component parts drawing on each other for marketing and financial strength. Certainly the market conceives of a bank holding company and its components in that way. And if market participants tend to consider the bank holding company as an integrated entity, problems in one part of the system will inevitably be transmitted to other parts". [145] Also, some regulatory measures like consolidated financial reporting may strengthen the market perception that the group acts as an entity and therefore would aid subsidiaries in need.[146]

Finally, legal separateness may involve "costs of its own". Firstly, the FC must capitalize the different subsidiaries. Secondly, it limits its capacity to fully achieve the scope of economies. Thirdly, similar to the British model, legal and functional separateness determines possible agency problems since the FC needs to create different managing teams. It may also stimulate conflicts of interest between the different subsidiaries.[147]

2.3.2.4 Holding company parent, complete operational separateness

Herring and Santomero complete their classification with this fourth model, where there is a complete operational and legal separateness. In this model there is a complete loss of economies of scope to producers and clients and operating synergies. The only remaining advantage would be the diversification of income to the holding company. As Herring and Santomero conclude, this model is not common in the financial industry.[148]

2.3.2.5 Assessment of the Structural classification

The main attraction of the Structural classification is its focus on legal separateness and operational separateness. The Structural classification may help the regulator to understand the different implications of risk assessment, taxation and resolution. It relies on objective and palpable data, which makes it easy to understand and to study.

After the GFC, the Structural classification has gained a new relevance, since the resolution strategies for G-SIFIs would be defined among the corporate structures of the

[143] See J. Santos, above note 112, p. 48.
[144]Ibid, p. 47.
[145] A. Wilmarth "Controlling Systemic Risk In An Era Of Financial Consolidation" in *Current Developments in Monetary and Financial Law Vol 3*, (IMF 2005) p. 603.
[146] See J. Santos above note 112, ps. 47-48.
[147] Ibid.
[148] R. Herring and A. Santomero, above note 110, p. 487.

financial group. According to the FSB, "The Key Attributes require the development of a resolution strategy for G-SIFIs that establishes an approach for resolving the failing firm in a way that protects its critical functions, government funds and systemic stability, and achieves other relevant resolution objectives. The resolution strategy is a key component of the overall resolution plan required under the Key Attributes".[149] The two resolution strategies are the Single Point of Entry Resolution (SPOE) and the Multiple Point of Entry Resolution (MPOE), respectively in which resolution powers are applied to the top of a group by a single national resolution authority, and in which resolution tools are applied to different parts of the group by two or more resolution authorities acting in a coordinated way".[150] In 1990, when Herring and Santomero instituted the Structural classification the new resolution strategies were far from existing. Nevertheless, it now proves its resilience in a way its authors would not have expected.

Van den Berghe has pointed out Herring and Santomero's classification has certain drawbacks. Firstly, he states the classification is "rather theoretical" and less "practical" for business managers. Secondly, he states the "German model doesn't exist" in practice, since "the production of insurance by banks and of banking services by insurers is generally prohibited in all countries". Thirdly, the author contends there are other forms of conglomerates which are based on weaker links such as joint ventures or marketing agreements that are not included in the classification. Fourth, Herring and Santomero focus strongly on FCs where "banks are dominant", whereas there are many FCs where insurance is dominant. Fifth, Van den Berghe argues the main concern of Herring and Santomero is legal separateness (even though they mention operational separateness) and therefore "the single use of legal distinction may be misleading and may be based on false hypothesis".[151]

The first argument is weak since the value of a classification should not be based on its practical relevance to managers of FCs, but on how they may help to understand its object and the consequences legislators and regulators can draw from it.

The second issue is true in Europe and may be solved by including a subdivision of the Complete Integration or German model by comprising a Partial Integration model which contains the actual structure of European FCs, where insurance is structured as a separate subsidiary.

The third topic is related to what the literature calls "horizontal groups". While horizontal groups exist and are regulated at the European level, the importance of such groups tends to be less significant than the other classifications. The Herring and Santomero Classification might be enlarged by adding a fifth category which would include "horizontal groups". In this sense, in 1993 Koguchi and Forestieri proposed a classification based on Herring and Santomero´s model but added "joint venture" and "sales agreement" as supplementary categories of FCs.[152]

The fourth qualification remains true. While Herring and Santomero´s classification underlines the bank as the epicentre of the FC, it is true there are FCs that are insurance-centered. This thesis, as stated in the Introduction chapter, will focus on the importance

[149] FSB *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies* (FSB 2013) p.5.
[150] Ibid.
[151] See K. Verweire and L. Van den Berghe above note 112 p. 63.
[152] K. Koguchi, and G. Forestieri, above note 112, p. 25.

of bank FCs, given the specialty of banks and the challenges they pose to the whole economy.

The fifth point raised by Van der Berghe is also relevant. While operational separateness is present in Herring and Santomero´s classification, legal separateness is central to their work as is clearly seen by examining Figure 3. That said, the classification remains relevant as structured by the authors. Stating that "single use" of the classification may be based on "false hypothesis"[153] tends towards exaggeration. The classification always relies on an angle of the concept. FCs are enormous creatures and one classification would not encompass all of its expressions.

Finally, even when a FC chooses to structure itself in certain ways, there are forces in place far beyond its control. For instance, certain legal doctrines, such as the doctrine of the "source of strength" in the US might change the way in which the group business strategies work. While in theory, the US model would help the holding company to "abandon" the subsidiary at any time, the source of strength doctrine would imply the need for the group to aid them in cases of distress.

2.3.3 Regulatory classification

After the GFC, regulatory bodies designed new regulations to prevent systemic risk and enhance macro prudential regulation. Until the GFC the issue of the size of banks and the implicit guarantees provided by governments were comprised in the Too Big to save doctrine. The GFC forced new regulations that ended up with new categories of financial institutions.

The rational behing financial regulation differs from general company law, in that the former seeks the preservation of financial stability and not primarily the protection of creditors and shareholders, although they regulate similar problems.[154]

The FSB has emerged with a new system of unilateral "designation" of certain groups of companies as "globally systemically important". The new system has two pillars: 1) a unilateral designation system; and, 2) the application of certain policies to those designated entities in order to tackle its systemic implications.The unilateral designation system is labeled as a "binary rule". A binary rule acts as an on-off switch (it applies or not), and so there is no graduation as in the continuous rule. [155]

Regulators such as Federal Reserve Board Daniel Tarullo affirm the "ideal approach would be a continuous function" and "systemic importance is not a binary determination but one of degree. A related point is that it is generally better to avoid cliff effects, whereby significant regulatory consequences ensue based on relatively modest differences among firms".[156] The DFA when addressing systemic importance includes two binary rules: 1) Bank Holding Company (BHC) with 50 billion or more in assets will be subject to enhanced supervision and early remediation; and, 2) non-banking

[153] See K. Verweire and L. Van den Berghe, above note 112, p. 63.
[154] J.H. Binder above note 53, p.113.
[155] C. D. Block see above note 36 p. 325; C. P. Skinner above note 36 p. 1379.
[156] D. Tarullo "Regulating Systemically Important Financial Firms" (Speech 3 June 2011) <https://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm> accessed 14 March 2018.

institutions designated by the FSOC as SIFIs will also be subject to the same consequences.[157]

In the US the "cliff effect" of the automatic banking SIFI labelling is that banks now have an incentive to remain below the 50 billion threshold in order to avoid enhanced supervision. This is particularly important in the US, since non-banking SIFI institutions will be subject to Federal Reserve supervision instead of the Securities and Exchange Commission (SEC) (i.e. investment banks and broker dealers) or instead of state regulation (i.e insurance companies) or limited or directly no regulation in some cases like asset managers of hedge funds.[158]

As Skinner points out, the binary system in the US for non-banking SIFIs has the following consequences. Firstly, SIFI labeling would endanger the relationship between industry actors and regulators through litigation, which may impede optimal supervision.[159] Secondly, financial institutions may find incentives to restructure in order to avoid labeling[160], changing business strategies with potential repercussions for consumers. Thirdly, there is a risk of politicizing regulators' decisions, where those institutions designated as SIFIs would object to the designated "room for manouvre" of regulators. Likewise, as FSB also designates SIFIs, there might be a perceived risk that FSOC would coordinate their agenda with an entity that has a political nature too, since FSB´s actions are designed by prerogatives of the G20.[161]

The application of new policies to the designated financial institutions would trigger the possibility of bank-like prudential regulation, capital requirements, enhanced supervision and resolvability requirements.[162]

The new labels for systemically important institutions according to FSB are: G-SIBs, G-SIIs, NBNI G-SIFIs, and D-SIBs. Possibly in the future regulators would develop new titles such as D-SIIs and Non-Bank Non-Insurance Domestically-SIFI (NBNI D-SIFI) in order to complete the whole dimension of alternatives. However, at the EU and US levels, there are systems in place to address domestic systemically important non-bank financial institutions.[163]

The new designation system is a result of the evolution of the "Too big to fail" doctrine and the impact of the GFC which has focused regulatory action on addressing systemic risk and macro prudential regulation.

While in the US non-banking institutions may be labelled as SIFIs and supervised by the Federal Reserve System, in the EU, only banks and banking groups may be labelled as SIFIs and supervised by the ECB.

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[157] C.D. Block above note 36 p. 325, See also J. B. Thomson "On Systemically important Institutions and Progressive Systemic Mitigation" [2009] DePaul Business and Commercial Law Journal p. 136.

[158] C.D. Block ibid p. 325. For a summary of the roles of regulatory entities see US Department of the Treasury, *Blueprint for a modernized financial regulatory structure* (UST 2008) p.3172.

[159] MetLife sued FSOC in 2015, see *MetLife, Inc. v Fin. Stability Oversight Council, 177 F. Supp 3d 219 (D.D.C 2016) (No. 15-0045).*

[160] GE restructured in order to avoid the SIFI label. In 2015 it announced selling most of GE Capital Assets, see GE "GE To Create Simpler, More Valuable Industrial Company By Selling Most Ge Capital Assets; Potential To Return More Than $90 Billion To Investors Through 2018 In Dividends, Buyback & Synchrony Exchange" <https://www.ge.com/stories/pivot> accessed 14 March 2018.

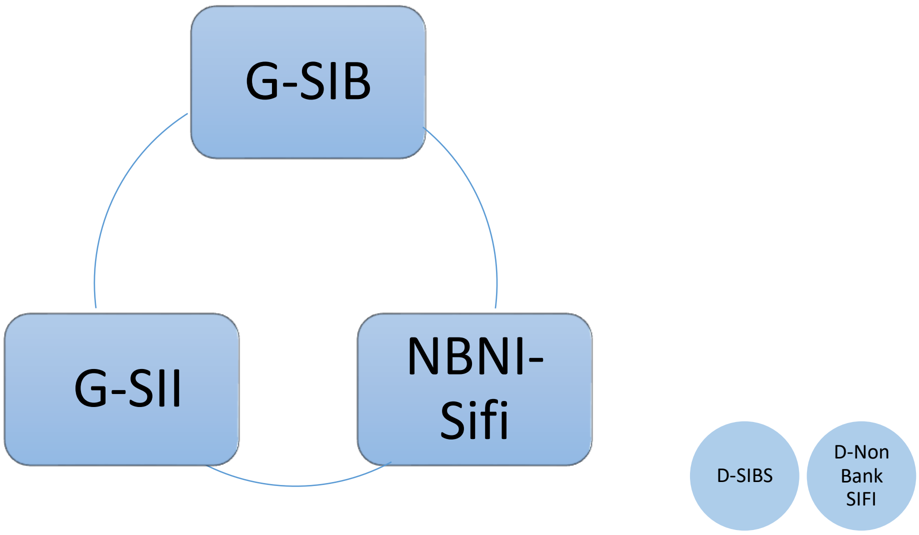
[161] C. Skinner, above note 36 p. 1379.

[162] FSB "2017 list of global systemically important banks (G-SIBs)" <http://www.fsb.org/wp-content/uploads/P211117-1.pdf > accessed 20 January 2018; C.P. Skinner ibid, p 1382.

[163] See Dodd Frank Act, above note 34 and CRD, above note 37.

The US, through DFA, developed a test of significance which assesses a “threat of financial stability to the US” by analysing material financial distress, the nature, scope, size, scale, concentration, interconctedness or mix of actiuvities. The lens is posed on financial stability. On the other side of the Atlantic Ocean, the EU developed a test of significance (SSM Regulation) for credit institutions only, which asseses i) the total value of their assets; ii) the importance for the economy of the country in which they are located or the EU as a whole; the scale of their cross-border activities; whether they have requested or received public financial assistance from the ESM or EFSF.Althogh both parties’ seconded FSB proposals, the lack of harmonization in the international arena of two major players may prove problematic when a crisis arises in the future.

Figure 4. Regulatory classification



Source: Own compilation

2.3.3.1 SIFIs

In April 2009 the G-20 Leaders required the FSB, IMF and BIS to develop a guide for national authorities to assess the systemic importance of financial institutions, markets and instruments. The main reason for this request was a response to an “unprecedented reach of the financial crisis that began in August 2007 and the growing awareness that the macroprudential orientation of financial stability policy would need to be strengthened”.[164]

The key criteria for identifying the systemic importance of financial institutions identified by the FSB, IMF and BIS in the 2009 G-20 leader´s report are: size, substitutability and interconnectedness. As stated in the report, “for institutions, the size of exposures, volumes of transactions or assets managed are indicative of the extent to which clients

[164] FSB, IMF, BIS “Report to G-20 Finance Ministers and Governors Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” (2009) <http://www.fsb.org/wp-content/uploads/r_091107c.pdf?page_moved=1.> accessed 20 January 2018.

and counterparties could be disrupted. Clusters of institutions can be individually small but collectively significant because they fall into distress at the same time. Some institutions, for example those providing key services such as clearing and settlement, lack immediate substitutes for this role. Interconnectedness captures situations when distress in one institution raises the likelihood of distress in others."[165]

In 2010 the FSB issued the Report 'Reducing the moral hazard posed by systemically important financial institutions. FSB Recommendations and Time Lines', where it refers to SIFIs as those financial institutions "whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity".[166]

As Lastra states the "definition of a SIFI is dynamic: what is systemic today is not necessarily what will be systemic in the future".[167] The key criteria for identifying a SIFI have been widened by the inclusion of other criteria like scope, nature, concentration, and provision of mix of activities that could pose a threat to financial stability.

This is the case in the US. The FSOC, which is in charge of determining if the SIFI in the US is subject to Federal Reserve supervision, "may determine that a nonbank financial company will be supervised by the Board of Governors and be subject to prudential standards if the Council determines that (1) material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States…or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States".[168]

In 2011 the BIS added two different categories of systemic importance for the assessment of global systemic banks: cross-jurisdictional activity and complexity.[169]

As stated above, policy-makers have focused on the enhancement of regulation and supervision of SIFIs to tackle moral hazard arising from these kinds of institutions that are regarded as too big, or "too complex" or "too interconnected to fail".[170] After the GFC the international regulatory bodies started looking for a methodology to assess the systemic importance of banking institutions, insurance institutions and other non-banking, non-insurance financial institutions. This is how the notions of G-SIBs, G-SIIs

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[165] Ibid, p. 2.

[166] FSB "Reducing the moral hazard posed by systemically important financial institutions. FSB Recommendations and Time Lines" (2010) <http://www.fsb.org/wp-content/uploads/r_101111a.pdf?page_moved=1 .> accessed 20 January 2018.

[167] R. Lastra, above note 27, p. 194.

[168] FSOC "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," [2011] Second Notice of Proposed Rulemaking and Proposed Interpretive Guidance, Federal Register, ps. 64264-83, available at <https://www.federalregister.gov/documents/2011/10/18/2011-26783/authority-to-require-supervision-and-regulation-of-certain-nonbank-financial-companies#p-265> accessed 20 January 2018.

[169] BCBS Consultative Document "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" (2011) available at <https://www.bis.org/publ/bcbs201.pdf. > accessed 20 January 2018.

[170] D. Gros "Too interconnected to fail = too big to fail: What is in a leverage ratio?" in *Vox.org*, (January 2010) <http://voxeu.org/article/too-interconnected-fail-too-big-fail;> accessed 20 January 2018. A. Jobst "Systemic Risk in the Insurance Sector. A Review of Current Assessment Approaches [2014] The Geneva Papers on Risk and Insurance, p. 440.

and NBNI G-SIFIs—which assess finance companies, security firms and investments funds—were born.[171]

2.3.3.2 What is a G-SIB?

In November 2011 the Basel Committee published a framework for G-SIBS. The Basel Committee has issued a number of reforms in order to enhance the safety and soundness of banks. One of the main reforms focused on capital requirements. The Basel Committee stated the capital adequacy measures applied to international banks may have a special impact on G-SIBs since they are active in trading and capital markets- which are more affected by the "enhanced risk coverage of the capital framework". Nevertheless, capital adequacy measures might not be sufficient to cover the "negative externalities posed by G-SIBs". Therefore the Basel Committee emphasizes the need for additional measures.[172] G-SIBS are designated by the FSB or the national authority.

FSB has designated G-SIBs for the years 2019-2020 (See Table 1). The main characteristic of G-SIBs is that they are subject to three main policies: (1) Resilience and Buffer Facilitating Results; (2) Resolvability requirements; and, (3) Higher supervisory expectations.[173]

One of the main proposals of the framework was the classification of G-SIBs into different categories of "systemic importance" based on the score produced by the "indicator-based measurement approach". The indicator based system approach classifies five categories of systemic importance: (1) size; (2) cross-jurisdictional activity; (3) interconnectedness; (4) substitutability, and (5) complexity.

Each of them has a weight of 20%. G-SIBs will be allocated to several "buckets" according to their scoring, which will be subject to different levels of additional loss absorbency requirements (1 to 3.5%). [174]

[171] Ibid.
[172] Basel Committee on Banking Supervision (BCBS) "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement". (2013) <https://www.bis.org/publ/bcbs255.pdf > accessed 20 January 2018.
[173] FSB "FSB publishes 2020 G-SIB list" < https://www.fsb.org/2020/11/fsb-publishes-2020-g-sib-list/ > accessed 9 April 2021; FSB, "Evaluation of the Effects of Too-Big-To-Fail Reforms Final Report" (2021).
[174] See BCBS above note 169.

Table 1. G-SIBs form 2019- 2020

BUCKET	2019	2020
5 (3,5%)	Empty	Empty
4 (2,5%)	JP Morgan Chase	Empty
3 (2%)	Citigroup HSBC	Citigroup HSBC JP Morgan Chase
2 (1,5%)	Bank of America Bank of China Barclays BNP Paribas Deutsche Bank Goldman Sachs Industrial and Commercial Bank of China Mitsubishi UFJ FG Wells Fargo	Bank of America Bank of China Barclays BNP Paribas China Construction Bank Deutsche Bank Industrial and Commercial Bank of China Mitsubishi UFJ FG
1 (1%)	Agricultural Bank of China Bank of New York Mellon China Construction Bank Credit Suisse Groupe BPCE Groupe Crédit Agricole ING Bank Mizuho FG Morgan Stanley Royal Bank of Canada Santander Société Générale Standard Chartered State Street Sumitomo Mitsui FG Toronto Dominion UBS UniCredit	Agricultural Bank of China Bank of New York Mellon Credit Suisse Goldman Sachs Groupe BPCE Groupe Crédit Agricole ING Bank Mizuho FG Morgan Stanley Royal Bank of Canada Santander Société Générale Standard Chartered State Street Sumitomo Mitsui FG Toronto Dominion UBS UniCredit Wells Fargo

Source: Own elaboration based on FSB data[175]

The second relevant set of policies for G-SIBs are special resolvability requirements. FSB determines the requisite of "group-wide resolution planning and regular resolvability assessments". The resolvability of each G-SIB is examined according to the FSB Resolvability Assessment Process (RAP) by Crisis Management Groups[176].

The FSB framework developed two different resolution strategies; (1) SPOE; and, (2) MPOE.

SPOE is the resolution strategy where the resolution authorities apply the resolution tools at the top holding or parent company by only one resolution authority (i.e, where the global consolidation supervision of the financial group). Losses are absorbed by the company at the top of the structure by bail in. If the top company has sufficient loss absorbency capacity, its subsidiaries would continue operating without being resolved.[177]

MPOE is the resolution strategy where various resolution authorities apply the resolution tools to different companies of the group where the most probable outcome would be the spin-off of the financial group. Possible outcomes would be the division of the group within national or regional boundaries, or by business lines, or both. Resolution

[175]FSB< https://www.bis.org/press/p191122.htm > accessed 8 April 2021.
[176] FSB "2020 Resolution Report "Be prepared" (2020).
[177] FSB above note 149.

authorities will be free to apply different resolution tools, but would need to coordinate across borders in order to prevent conflicts of interest, run of assets and contagion among the whole group.[178]

Both resolution strategies would fit different groups depending on various factors that would facilitate resolution and maintain the critical functions of the group.[179]

The third special policy applicable to G-SIBs by FSB is the necessity of higher supervisory expectations. These include "supervisory expectations for risk management functions, risk data aggregation capabilities, risk governance and internal controls".[180] The timetable for meeting these requirements was included in the updated 2013 FSB document.[181]

In the US, the system is hybrid. Banking companies are considered SIFIs if they have over 50 billion in assets.[182] However, for non-banking SIFIs, the FSOC is mandated to designate "nonbank financial institutions" as systemically important.[183]

2.3.3.3 What is a G-SII?

The experience of the GFC showed the TBTF doctrine, which mainly focused on banking and size, had not contemplated all the perils other financial institutions posed to financial stability. In the insurance sector AIG was the main example of that.

In 2010 the FSB recognized insurance companies should be covered by the SIFI framework.[184]

In July 2013, the IAIS set up a methodology in order to identify "global systemically important insurers" (G-SIIs). The IAIS "has developed an assessment methodology to identify insurance-dominated FCs whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity."[185]

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[178] Ibid.

[179] See Chapter 6 for the analysis of resolution strategies in different FC models.

[180] FSB "Reducing the moral hazard posed by systemically important financial institutions FSB Recommendations and Time Lines" (2010) <http://www.fsb.org/wp-content/uploads/r_101111a.pdf?page_moved=1 > accessed 20 January 2018.See FSB above note 146.

[181] FSB "2013 update of group of global systemically important banks (G-SIBs)" (2013) <http://www.fsb.org/wp-content/uploads/r_131111.pdf> accessed 20 January 2018.

[182] Even though the DFA does not adopt the term SIFI, the Federal Reserve papers refer to these institutions as SIFIs: D.E. Nolle "US Domestic and International Financial Reform Policy: are G20 Commitments and the Dodd Frank Cat in Sync?" [2011] 2 No4 (Board of the Federal reserve Sys.; International Finance Discussion papers No. 1024; See DFA, Section 165 a). A. Winkler "Primer: FSOC`s SIFI Designation Process for Nonbank Financial Companies. (AAF, 2014)< https://www.americanactionforum.org/research/primer-fsocs-sifi-designation-process-for-nonbank-financial-companies/> accessed 7 March 2018; C. P. Skinner above note 36 p. 1381; A. E. Wilmarth Jr. "The Dodd Frank Act: A Flawed and Inadequate response to the Too-Big-to fail Problem" [2011] 89 Or.L. Rev p. 1009.

[183] DFA Section 124 Stat 1395 (2012).

[184] See FSB above note 166.

[185] IAIS "Global Systemically Important Insurers: Initial Assessment Methodology" July 2013 <https://www.iaisweb.org/file/34257/final-initial-assessment-methodology-18-july-2013> accessed 20 January 2018.

As stated above, in the US the FSOC designates the "non-bank systemically important institutions". In July 2013, the Council of FSOC voted to designate American International Group, Inc. and General Electric Capital Corporation. Prudential Financial, Inc. was included in 2013, and MetLife in 2014. On September 29, 2017, the FSOC rescinded the designation of American International Group, Inc. [186]

In July 2013, the FSB, in consultation with IAIS and national authorities, created a list of G-SIIs (9), applying the assessment methodology developed by the IAIS.[187]

Table 2 List of G-SIIs 2015-2016

2015	2016
Aegon N.V. Allianz Se American International Group, Inc. Aviva Plc Axa S.A. Metlife, Inc. Ping An Insurance (Group) Company Of China, Ltd. Prudential Financial, Inc. Prudential Plc	Aegon N.V. Allianz SE American International Group, Inc. Aviva plc Axa S.A. MetLife, Inc. Ping An Insurance (Group) Company of China, Ltd. Prudential Financial, Inc. Prudential plc

Source: Own Compilation, FSB data[188]

G-SIIs are Globally Important Insurance Companies designated by the FSB in consultation with IAIS. FSB has identified G-SIIs from 2013-2016. G-SII`s are subject to the following main policies: 1) Higher loss absorbency (HLA); 2) Enhanced group-wide supervision, and 3) Group-wide recovery and resolution planning and regular resolvability assessments.[189]

The first policy which applies to G-SIIs is a higher loss absorbency rule. The IAIS has created new capital requirement framework rules for G-SIIs in order to address the need to avoid further bailouts. To do so, it has established two new capital requirement frameworks, (1) the Basic Capital Requirement (BCR) in 2014, and (2) HLAin 2015. According to the IAIS the third step would be to complete the capital requirement network with "the development of a risk based group-wide global Insurance Capital Standard (ICS)", and to "be applied to Internationally Active Insurance Groups (IAIGs)".[190]

The second main policy applied to G-SIIs is enhanced group-wide supervision, which includes the exercise by the supervisor of "direct powers over holding companies" and to

[186] US Department of the Treasury. "Designations" <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.> accessed 20 January 2018.
[187] FSB "2016 list of global systemically important insurers (G-SIIs)"< http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-insurers-G-SIIs.pdf > accessed 20 January 2018.
[188] FSB in coordination with IAIS has decided not to publish lists after 2017 G-SII list. FSB "FSB statement on identification of global systemically important insurers" (2017) < http://www.fsb.org/2017/11/fsb-statement-on-identification-of-global-systemically-important-insurers/ > accessed 20 January 2018.
[189] Ibid.
[190] IAIS "Basic Capital Requirements for Global Systemically Important Insurers" (2014) <https://www.iaisweb.org/page/supervisory-material/financial-stability-and-macroprudential-policy-and-surveillance//file/34540/iais-basic-capital-requirements-for-g-siis> accessed 20 January 2018.

"oversee the development and implementation of a Systemic Risk Management Plan and a Liquidity Management Plan".[191]

The third main policy applicable to G-SIIs is that they will be subject to the recovery and resolution planning requirements of the FSB's Key Attributes of Effective Resolution Regimes. Those applicable to G-SIIs are: (1) the formation of a Crisis Management Group (CMG); (2) the implementation of a recovery and resolution plan (RRP), and a liquidity risk management plan; (3) being subject to the CMG for resolvability assessments, and (4) the development of cross-border cooperation agreements between relevant resolution authorities for the specific G-SII.[192]

The FSB determines a framework for resolving insurers: "A resolution strategy should make it feasible to resolve an insurer while protecting vital economic functions, without severe systemic disruption or exposing taxpayers to loss, through mechanisms that make it possible for shareholders and unsecured creditors to absorb losses. Key Attributes II-Annex 2 (Resolution of Insurers) sets out the specific objective of protecting the insurer's policyholders, beneficiaries and claimants (collectively, 'policyholders')."[193]

In 2017 and 2018 the FSB, decided not to publish a new list of G-SIIs because it relied on IAIS work to develop an activities-based approach to systemic risk. IAIS adopted the "holistic framework" in 2019, after which FSB decided to suspend G-SII identification as of the beginning of 2020.[194]

2.3.3.4 What is a NBNI G-SIFI?

After the GFC, in November 2011 the G20 Leaders requested the FSB, in consultation with IOSCO, incorporate methodologies for systemically important non-bank non-insurer financial entities.[195]

The framework would not have been completed if other financial institutions other than banks and insurers were not covered. Major players in the financial sector such as asset managers, investment funds, market intermediaries and finance companies were not within the consideration of the FSB framework. At the local level, this is currently not the case. In the USA, for instance, the FSOC has the power to designate a broad category of "non- bank systemically important banks".[196]

In January 2014 the FSB-IOSCO published a document for public consultation outlining a proposal with methodologies for identifying NBNI G-SIFIs. These included a

[191] FSB "Global systemically important insurers (G-SIIs) and the policy measures that will apply to them" July 2013 <http://www.fsb.org/wp-content/uploads/r_130718.pdf?page_moved=1 > accessed 20 January 2018.
[192] Ibid
[193] FSB "Developing Effective Resolution Strategies and Plans for Systemically Important Insurers" (2016) <http://www.fsb.org/wp-content/uploads/Final-guidance-on-insurance-resolution-strategies.pdf > accessed 20 January 2018.
[194] NAIC "Global Systemically Important Insurers (G-SIIs)" (2021) <https://content.naic.org/cipr_topics/topic_global_systemically_important_insurers_G-SIIs.htm > accessed April 4, 2021.
[195] FSB-IOSCO "Consultative Document (2nd) Assessment Methodologies for Identifying Non-Bank Non Insurer Global Systemically Important Financial Institutions Proposed High-Level Framework and Specific Methodologies" (2015) <http://www.fsb.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf > accessed 20 January 2018.
[196] See DFA above note 34.

“operational framework for identifying G-SIFIs that would apply across all NBNI financial entities, and detailed NBNI sector-specific methodologies for (1) finance companies; (2) market intermediaries (securities broker-dealers); and, (3) investment funds (including hedge funds).”[197] Most of the responses from the public were concentrated on the methodology for investment funds and its risks; risks associated with asset management entities; and leverage as a category of systemic risk in the investment fund industry.[198]

In view of these responses, the FSB-IOSCO published a second public consultation paper in March 2015 which took into account most of the comments and suggestions of the public. However, while the paper engaged in special methodologies, it did not propose designation of specific entities, as in the G-SIB and G-SII system.[199]

In July 2015 the FSB announced it has suspended the assessment methodologies for NBNI G-SIFIs until it finishes the financial stability risks from asset management activities.[200]

In January 2017 the FSB published the ‘Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities’, where it proposes fourteen policy recommendations to address certain asset management structural vulnerabilities such as “liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units; leverage within investment funds; operational risk and challenges at asset managers in stressed conditions; and securities lending activities of asset managers and funds”.[201] The NBNI G-SIFI proposed framework would be based on the following two principles:

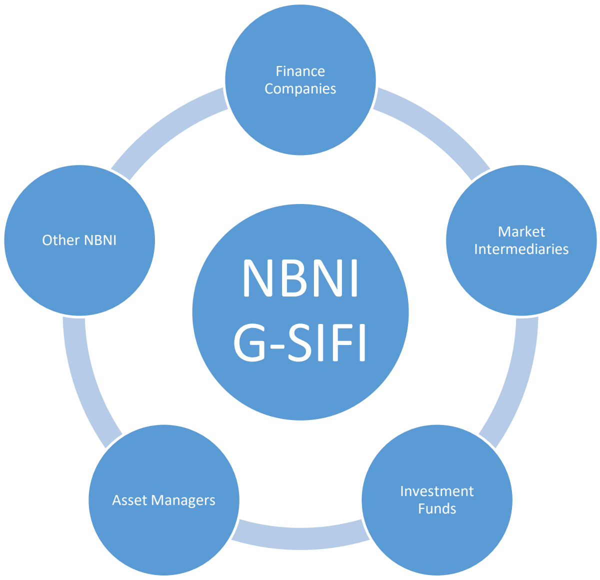
1) The main objective is to identify NBNI financial entities whose “distress or disorderly failure, because of their size complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions”.
2) The new framework needs to be consistent with G-SIBs and G-SIIs methodologies, “i.e. an indicator-based measurement approach where multiple indicators are selected to reflect the different aspects of what generates negative externalities and makes the distress or disorderly failure of a financial entity critical for the stability of the financial system (i.e. “impact factors” such as size, interconnectedness, and complexity).” [202]

The proposed methodologies identify five impact factors: (1) size; (2) interconnectedness; (3) substitutability; (4) complexity, and (5) global activities (cross-jurisdictional activities).[203]

[197] See FSB-IOSCO above note 195.
[198] Ibid.
[199] Ibid.
[200] FSB “Next Steps on the NBNI G-SIFI Assessment Methodologies” (2015). <http://www.fsb.org/2015/07/next-steps-on-the-nbni-g-sifi-assessment-methodologies/ > accessed 20 January 2018.
[201] FSB “Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities” (2017) < http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf > accessed 20 January 2018.
[202] See FSB-IOSCO above note 195.
[203] Ibid.

The document identifies five main groups of NBNI which would be subject to different methodologies, applying to them the five categories of systemic importance: (1) finance companies; (2) market intermediaries (Securities Broker-Dealers); (3) investment funds; (4) asset Managers, and (5) other NBNI.[204]

Figure 5. Regulatory classification



Source: Own compilation

The document proposed certain limits to the amount of assets the institution shall have in order to be a NBNI G-SIFI.[205]

While the process of acquiring data is in effect, the industry has opposed the methodology. Stevens, president of the Investment Company Institute, stated in 2017 "If the FSB engages in an evidence-based analysis, we believe the FSB will conclude—at a minimum—that there is no basis for considering regulated funds and their managers for possible G-SIFI designation."[206]

As stated above, in the US the FSOC has the power to designate non-banking financial institutions. It has designated in the past three insurance-based groups (Prudential, AIG and MetLife) and a savings and loans based group (General Electric Capital Corporation). So far, no asset managers, finance companies, or investment funds have been designated.

2.3.3.5 What is a Domestically Important Financial Institution?

The Regulatory classification deals with both a global and a domestic dimension. The BCBS has issued a framework for dealing with domestic systemically important banks. As of today, the BCBS has not prepared a framework for other financial institutions.

[204] Ibid.
[205] Ibid.
[206] Investment Company Institute "Consultative Document; Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (2016) < https://www.fsb.org/wp-content/uploads/Investment-Company-Institute-ICI1.pdf.>, accessed 9 April 2020.

However, at the level of both the EU and the US, regulations regarding domestic systemically important financial institutions are in place.

In October 2012 the BCBS issued a 'Framework for dealing with domestic systemically important banks' with the aim of addressing negative externalities which apply at a domestic level. The rationale behind the new framework is that certain banks, although not significant on the global level, nevertheless have a wide impact on the local or regional financial system and economy (some of these may well have cross border externalities, though not global) if they are compared to "non-systemic institutions".[207]

The D-SIB framework deals with the impact that the "distress or failure of banks" might have on the domestic economy. Therefore, it gives the national authorities a degree of discretion in the implementation of the assessment and policy tools chosen by it, which diverges from the prescriptive G-SIB framework.[208]

The framework establishes a minimum of twelve principles which might be extended by the national authorities, or the "minimum approach".[209] The scope of application of the principles is designed to consolidate groups and subsidiaries, while the national authorities may include branches if they want to.[210].[211]

The BCSB framework has been internalized in different jurisdictions. In the EU, CRD has established Member States need to designate the authority which will identify global systemically important institutions (G-SIIs), on a consolidated basis and, on "an individual, sub-consolidated or consolidated basis, as applicable, other systemically important institutions (O-SIIs)".[212] O-SIIs are the equivalent of D-SIID-SIIs at the European level. National authorities may require each O-SII to maintain an "O-SII buffer" of up to "2% of the total risk exposure amount", which needs to be CET1 capital.[213] In April 2016 the EBA published the first list of O-SIIs in the EU[214] and disclosed another list in March 2017.[215] For D-SIBD-SIBs maintaining the D-SIB capital surcharge, it is very important since they are requested to meet it at any time, whereas the capital conservation buffer and counter-cyclical capital buffer are requested when the institution has "severe downturns". [216]

In the US, as stated above, the Dodd Frank Act- section 165- authorizes the Board of Governors of the Federal Reserve System to impose enhanced prudential standards on bank holding companies with over $50 billion in total consolidated assets and on nonbank financial companies that the FSOC has designated for supervision by the Federal Reserve.[217] In a peculiarity of the American system, the US "considers the US G-SIBs to

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[207] BCBS *A Framework for dealing with domestic systemically important Banks* (BIS 2012) p. 1
[208] Ibid, p. 2.
[209] P. Brämer and H. Gischer "An Assessment Methodology for Domestic Systemically Important Banks in Australia" [2013] The Australian Economic Review, ps. 140–59.
[210] See BCBS above note 207 p. 2.
[211] Ibid, p.4
[212] See CRD above note 37, article 131.
[213] See CRD ibid, article 131 (5).
[214] EBA "EBA discloses first list of O-SIIs in the EU" (2016)< https://www.eba.europa.eu/-/eba-discloses-first-list-of-o-siis-in-the--1 > accessed 9 March 2018.
[215] EBA ibid.
[216] C. Briault "D-SIB designation and capital surcharges" KPMG (2016) <https://home.kpmg.com/xx/en/home/insights/2016/05/d-sib-designation-and-capital-surcharges-fs.html >accessed 9 March 2018.
[217] See DFA above note 34.

be those that would be designated as US D-SIBs".[218] As the BCBS emphasized, the US D-SIB framework is aligned to the Basel Committee D-SIB´s principles, since it replicates the G-SIB assessment methodology. The US does not actually designate any D-SIB beyond the designated G-SIBs.[219]

2.3.3.6 Assessment of the Regulatory classification

In order to assess the Regulatory classification it is important to bear in mind its birth is a consequence of the lack of focus in systemic risk and macro prudential regulation before the GFC. The new focus on systemic risk and macro prudential regulation is always a supplement to, not a substitution for micro prudential regulation.

The first question is whether the binary designation, or "shame and blame" system, is the best in order to avoid systemic risk. The literature on binary regulation and systemic risk concludes the binary regulation is flawed. The main reasons for this, as previously stated, are the increase of litigation and erosion of relations between the industry and the regulators; the increase in restructuring of labeled institutions; and the politicization of the process.[220]

The binary regulation has two different families of risks. First, there are risks derived from the lack of inclusion of true SIFIs. Under-inclusion would prevent a realistic measure of systemic risk. At the same time, a SIFI which is not regulated as such would create more systemic risk than a labeled entity since it would not be subject to regulatory restraints. Also, these institutions would be able to take competitive advantages over regulated SIFIs.[221] Secondly, there are risks derived from including non-systemically important institutions as SIFIs. Over-inclusion would for some commentators enhance moral hazard, since the labeling would create in the market a perception the government would bail out the institution if it were to fail, lowering borrowing costs and giving them a competitive advantage against non-designated SIFIs. Another danger of over-inclusion is the fact that regulating SIFIs with banking-like regulations would force non-bank institutions to act like banks even though their nature is different. The cost of regulation would be very dangerous for a non-systemic entity, especially with regard to capital rules.[222]

The second question is whether or not non-banking activities pose systemic risk. While there is a consensus within the literature that core insurance does not pose a systemic risk, some non-core activities- which resemble banking activities- may pose a systemic risk.

Assessing systemic risk in the asset manager industry is difficult since there are still data gaps.[223] According to Elliot there "are no true SIFIs in most of the financial sectors, including: private equity, venture capital, hedge funds, property casualty insurance, and

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[218] BCBS *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III G-SIB framework and review of D-SIB frameworks-United States* (BIS, 2016) p. 16.
[219] Ibid, p.5.
[220] C. Skinner, above note 36, p.1381
[221] D. Elliot and R. Litan "Identifying and Regulating Systemically Important Financial Institutions: The Risks of Under and Over Identification and Regulation" [2011] Brookings Institutions Policy Brief, ps.1-20.
[222] Ibid.
[223] Office of Financial Reaserch Report (2013), <https://www.financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2013.pdf > accessed 23 March 2018.

mutual funds management, with the possible exception of money market funds”[224]. On the other hand, OFR introduce some factors that need to be analyzed case by case in order to assess the final degree of systemic risk of these institutions. While some commentators have disputed these factors, even Blackrock understands leverage is a better metric to screen systemic importance.[225]

The question is, then, whether banking-like regulation is appropriate to tackle systemic risk of non-banking SIFIs. This thesis contends regulators should avoid “tarring all birds with the same brush”.[226] Because of the different natures of banking and asset management capital, leverage based tools might not be appropriate to tackle market failures.[227] At the asset manager level, the capital requirements are not meaningful since they do not engage in proprietary trading and client assets are generally segregated, while these tools at the fund level would violate the asset manager fiduciary duty to follow client instructions.[228]

A different approach, focused on regulating similar activities along the entire industry[229], instead of focusing on binary regulation or a “SIFI lite”[230] regulation which aligns a continuum regulation with enhanced supervision as a first step, and banking-like tools as a second step- only if necessary-, would be a better approach, respecting the asset manager and core insurance nature better than “catch-all” FSB banking tools.

2.4 Summary

Table 3 below, summerises the three differnet models analysed in this thesis in chapters three, four and five. The purpose of this table is to provide a synopsis of this three chapters (plus additional information obtained in the annexes) regarding the main aspects of BBFC based on key characteristics (e.g. type of capitalism, type of BBFC, resolution corporate development, etc.).

This will inform the reading of chapters three, four and five. Finally, it is worth stressing that this comparative analysis will be developed in chapter six and the conclutions.

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[224] D. Elliot “Designating Systemically Important Financial Institutions: Balancing Costs and Benefits”. Testimony before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit (2012)< https://www.brookings.edu/wp-content/uploads/2016/06/16_sifis_elliott-1.pdf > accessed 23 March 2018.

[225] Blackrock “Comments on the Consultative Document of Assessment Methodologies for Identifying Non-Bank, Non-Insurer Global Systemically Important Financial Institutions” (2014) p. 9.

[226] A. Haldane “The age of asset management” [2014] BIS Central Bank Speech LSE. For an analysis if there is common ground ground for cross-sectoral resolution regime see J-H Binder “Resolution Regimes in the Financial Sector. In Need of Cross-sectoral Regulation?” In V. Colaert, D. Busch and T. Incalza *European Financial Regulation: levelling the cross-sectoral playing field* (Bloomsbury, 2019).

[227] A. Haldane ibid; J. Wan “Systemically Important Asset Managers: perspectives on Dodd-Frank´s Systemic designation Mechanism” [2016] Columbia Law Review ps. 804-841; J. Danielsson, J.P Zigrand “Are Asset Managers systemically important” *Vox* (2015); PIMCO Submission to the Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non- Insurer Global Systemically Important Financial Institutions (2015); D. Elliot *Systemic Risk and the Asset Management Industry* (The Brookings Institution 2014) ps 1-16; C. Skinner above note 36 p. 1381.

[228] PIMCO, ibid.

[229] D. Waters, *Financial Stability and Regulated Funds* (ICI Global 2014); PIMCO, ibid; J. Wan, above note 227 p. 804-841.

[230] C. Skinner above note 36, p. 1381

Table 3 Summary

Key Features of the Different BBFC Models					
Key Features		**Germany**	**UK**	**US**	**France**
Type of capitalism		Bank-based	Hybrid	Capital market-based	Hybrid
Philosophical foundations		Saint Simon	Classic liberalism	Federalism	Originally Saint Simon, State centered system
BBFC model		German model	British model	Us model	German model-hybrid
Types of BBFC		-Commercial banks -Saving Banks Cooperatives	-Banks -Credit unions -Building societies -Investment or Merchant banks	-Commercial banks -Thrifts -Credit Unions	-Banks -Cooperatives -Municipal Banks -Finance Companies -State Owned banks
	Sample Entity	DB	Barclays	Citi	Credit Agricole
	Branches or subsidiaries	Both	Both	Both	Both
	Centralised or decentralised	Centralised	Centralised	Both	Centralised
	Retail or no retail	No retail	No retail	Hybrid	No retail
	Universal or Territorial approach to resolution	Universal	Universal	Universal for US BBFC and Territorial for US branches of foreign BBFC	Universal
	SPOE or MPOE	SPOE	SPOE	SPOE	SPOE

2.5 Concluding remarks

This chapter has proposed a conceptual framework which identified the FCs by way of examining three classifications: the first one relying on the commercial activity they perform (Commercial classification), the second relying on the legal separateness (Structural classification) and the third relying on categories of systemic importance (Regulatory classification).

Drawing on the practices of various countries this chapter has analyzed the definition of a bank through the lens of these three different approaches: the list of activities approach, the formula approach, and the hybrid of intermediation approach. Following a description of the first two approaches, the thesis pointed out the need to allow regulators some "room for maneuver", or discretion to adapt the definition and description of bank activities to a fast-changing reality challenged by technology.

The Commercial classification relies on the commercial activities performed by the group: banking groups, mixed conglomerates, and FCs.

By way of comparing the definitions of banking groups in different jurisdictions, it can be concluded banking groups are a group of banking organizations consisting of several companies under common ownership or other links. As part of a group of companies, they are subject to company law, which regulates the protection of minority shareholder's interests, as well as intra-group transactions and the avoidance of private benefits.

FCs are defined as groups of companies under common control which conduct material activities in at least two regulated banking, securities or insurance sectors. In Europe, the FICOD has established the conditions for a group of companies to be considered a FC. In order to understand the main features and risks of each sector, this thesis briefly examines the balance sheet structures and risks involved in the banking, insurance and securities sectors.

While mixed conglomerates- or groups of companies where at least one company engage in activities of a commercial or industrial nature- were historically disfavoured in the Anglo-Saxon world, today both Continental and Anglo-Saxon traditions allow certain mixed activity. This Continental/Asian/Latin American tradition of relying on banks to fund commercial activities has been a driver for the further development of capital markets in the US as opposed to continental Europe.

The Structural classification incorporates the distinction of legal and operational separateness. When Herring and Santomero first proposed the classification in 1990 they would have not imagined the resilience of their work, since after the GFC the resolution strategies of G-SIFIs would be defined according to the corporate structure of the FCs. Their classification has the advantage of helping regulators to understand the implications of risk, tax and resolution. The original classification might be updated with some improvements such as the inclusion of a "partial integration" model in order to adapt it to the new structure or European FCs. Another improvement would be to include a fifth category to include horizontal groups, joint ventures and sales agreements.

The Regulatory classification is a by-product of the evolution of the Too Big to Fail Doctrine. After the GFC the focus has turned to macro prudential regulation and systemic risk. FSB has proposed a designation or binary regulation which implies the entities labelled as SIFIs will have to apply banking-like regulations. The different entities are G-SIBs, G-SIIs, NBNI G-SIFIs, D-SIBS and D-Non Bank SIFIs. This thesis concludes binary regulation is flawed since its disadvantages outweigh its advantages. Litigation, politicization of the process, and forced restructuring are among the most weighted arguments. Also, the costs of "under inclusion" and "over inclusion" of an entity in the system are reasons for the regulator to adopt a more nuanced regulation, such as an activity-based regulation or "SIFI lite" regulation. These kinds of regulation would help to tackle potential systemic risk associated with those banking-like activities of non-banking groups such as money market funds, finance companies, and some non-core insurance activities.

Finally, banking-like regulations founded on capital requirements base their rationale on the nature and needs of banks. If the nature of non-bank SIFIs is different from banking, then the rationale of the regulation needs to adapt to the new recipient. If that is not the case, non-bank SIFIs will have to bear the cost of banking-like regulations without benefiting from the protection of banking regulation such as Lender of Last Resort (LORL) and deposit insurance. Potentially, this would have non-intended consequences for competition and consumer welfare.

CHAPTER 3: GERMAN MODEL

3.1 German model

According to Herring and Santomero´s classification, the Complete Integration or German model allows the service provider to deliver insurance, banking and securities activities in one FC.[231]

Due to historic and to some extent philosophical reasons, universal banking developed primarily in Germany and, after the Second Banking Directive, into the European Community at large.[232] Because of the development of "*bancassurance*" in the 1980s, and because France initially also embraced universal banking, Annex 4 will focus on France as well.

In the first section the chapter will examine what universal banking is, the reasons why it developed and will provide a short overview of the history of universal banking in Germany.

In the second section the chapter will analyze the links between banking and industry in Germany and the three pillar banking structure of the German financial system.

3.1.1 Definition of Universal Banking

Universal Banking is defined as a system in which a single FC or institution provides different activities such as banking, insurance and securities.[233] Universal banks differ from specialized banks – those which limit their activities to selected types of business (building societies, home-loan savings banks, etc.).[234]

Universal banking can be defined as "the conduct of a range of financial services comprising deposit-taking and lending, trading of financial instruments and foreign exchange (and their derivatives) underwriting of new debt and equity issues, brokerage, investment management and insurance".[235]

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[231] See R. Lastra and R. Olivares Caminal, above note 43, p.271.
[232] F. Fiordelisi and O. Ricci *Bancassurance in Europe. Past, present and Future* (Palgrave Macmillan Studies in Banking and Financial Institutions 2012), p. 7; M. Gruson and W. Nikowitz "The Second Banking Directive of the European Economic Community and Its Importance for Non-EEC Banks" [1988] Fordham International Law Journal, p. 215; N. B. Murphy "European Union Financial Developments: The Single Market, the Single Currency, and Banking" [2000] FDIC Banking Review, p. 4; J. Manvell Jeannot "An International Perspective on Domestic Banking Reform: Could the European Union's Second Banking Directive Revolutionize the Way the United States Regulates its Own Financial Services Industry? [1999] American University International Law Review p. 1734; G. S. Zavvos "Banking Integration and 1992: Legal Issues and Policy Implications" [1990] 31 Harv. Int'l. L. p.480. R. Vander Vennet above note 112, p. 255; A. Dixon *The new Geography of Capitalism: Firms, Finance and Society* (Oxford Scholarship Online, 2014), p. 19.
[233] Ibid, D. Dietrich, U Vollmer "Are universal banks bad for financial stability? Germany during the world financial crisis. [2012] The Quarterly Review of Economics and Finance, p.123; A. Saunders and I. Walter note 112 p. 84; G.J. Benston "Universal Banking" [1994] Journal of Economic Perspectives, p.121.
[234] R. Faltermeier "The German Banking System-Types of Banks and Experience from the crisis" [2013] Universitätsverlag Potsdam p. 15; See generally J. Canals *Universal Banking: International Comparison and Theoretical Perspectives* "Universal Banks versus Specialized Banks" (OUP 1997).
[235] A. Saunders and I. Walter above note 112, p. 84; G.J. Benston above note 233, p. 121.

According to Effros, the question of the scope of permissible activities for banks may be analyzed under a narrow or broad vision. The financial sector comprises three fields of activities: banking, insurance and securities. For Effros "it is not clear that insurance should necessary be outside the sphere of bank activity", while in many countries, securities business is considered to be "a normal and traditional banking activity".[236] Universal banking would be defined by the type of scope of permissible activities performed by a bank rather than by applying the "formula approach" of "accepting deposits and making loans". Universal banking would encompass a broad vision of the scope of permissible activities of banks, which includes commercial, insurance and securities.

Some authors define universal banking as the combination of banking and securities activities, without mentioning the insurance sector.[237] Morrison defines universal banks as "institutions that combine the lending and payment services of commercial banks with a wider range of financial services. In particular universal banks underwrite securities, and hence offer their clients firms access to a broader range of sources of funds that can specialist commercial or investment banks".[238] The focus on the banking and securities sectors (without mentioning insurance) may have an explanation in that since Directive 92/49/EEC, the Complete Integrated model has been restricted in the EU, since the insurance activities need to be developed in a separate subsidiary.[239]

In terms of the scope of permissible activities a universal bank can do, there is generally a catalogue of services offered anchored around a "core of traditional deposit-financed lending business".[240]

Steinherr, Huveneers and Vander Vennet argue the key feature of the universal bank is the repertoire of activities performed and particularly the capacity of being holders of equity shares of corporations large enough to be able to monitor them.[241]

The German banking system has been identified as the prototype of universal banking,[242] mainly because it was in this country that the main characteristics of the model developed over time, namely: 1) universal banking means a bank may provide all kinds of financial services to its customers; 2) universal banking means a bank is permitted to own equity interests in other commercial and industrial firms or financial firms, 3) universal banking means non-financial firms may invest in, and own, 100% of shares or control a bank if

[236] R. Effros: note 9 p. 5.
[237] G. S. Zavvos above note 232, p.480. M. Gruson and U.H Schneider "The German Landesbanken" [1995] Colum. Bus.L., p.340; C. Fohlin "Universal banking networks in pre-war Germany: new evidence from company financial data" [1997] Research in Economics p. 203. J. Edwards and S Ogilvie "Universal banks and German industrialization: a reappraisal". [1996] Economic History Review p.428; D. Verdier *Moving Money: Banking and Finance in the industrialized World* (CUP 2003), p. 102.
[238] A. Morrison "Universal Banking" in A. Berger, P- Molyneux and J.O.S. Wilson *The Oxford Handbook of Banking.* (OUP 2010), p. 171; M. Gruson and U.H Schneider ibid.
[239] Directive 92/49/EEC, Article 8 1 b.
[240] Deutsche Bundesbank Monthly Report April 2015 "Structural developments in the German banking sector" (2015), p. 36.
[241] A. Steinherr and C. Huveneers "On the performance of differently regulated financial institutions: Some empirical evidence" [1994] Journal of Banking and Finance p. 273; R. Vander Vennet above note 112, p. 255.
[242] B. Schull "The Separation of Banking and Commerce in the United States: an examination of Principal Issues" [1999] OCC Economics Working Paper, p.25

the regulator approves the transaction.[243] The key historical, philosophical and political foundations of universal banking are examined in the next section.

3.1.2 Historical and Philosophical foundations of Universal Banking

The evolution of universal banking in Germany is linked to its history from 1648 to 1815. Germany had been in the middle of the battlefield in Europe during these years, and suffered "spoliation and devastation" throughout as a consequence of the campaigns of Louis XIV, the Spanish War of Succession, the Seven Years´ War and the war against Napoleon.[244] From 1815 to 1848 the country engaged in the rehabilitation of its economy.

According to Riesser´s classic study of the *Grossbanken* (great banks), by 1845 England was engaging in a transition to becoming a great industrial country supplying more than 50% of the "world requirements". An estimation made in that year showed the ratio of capital per head in Prussia was 720 marks while the same ratio in England was 2860 marks.[245] In Prussia, in 1843, the percentage of people engaged in agriculture ranged from 60.84% to 61.34%. 23.37% of people were involved in industrial pursuits while only 0.97% of people were employed in commerce.[246]

At the time, private bankers, who "were called money changers", mainly carried on with commission business and forwarding business. A good example of the dimension of the industry can be shown by the total number of employees in the state of Prussia during 1858. The total amount of employees amounted to 1774 in 602 enterprises (where 602 were overseers and the rest assistants).[247] In general, these private banks were unincorporated partnerships and operated with their own capital. At this time private banks based their business on the reliance on personal relationships and involvement with local firms. The fact they had a low capitalization and they had limited liability determined a low risk strategy.[248] The most famous *Privatbanken* was founded by Mayer Amschel Rothschild (1744-1812).[249]

In the beginning of the 1850s the State of Prussia started a fast development of the railway system as well as the mining and machine industries. According to Riesser, the rise of the mining and smelting industries were "mainly responsible for the spread of capitalism and the development of large scale production, as well as the gradual and radical change in the general economic conditions of the country". Following the new railway enterprises there arose a new number of joint stock companies, which included banks. [250]

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[243] T. Baum and M. Gruson "The German Banking System-System of the Future? [1993] Brooklyn Journal of International Law p. 113.
[244] J. Riesser *The German Great Banks and Their Concentration in connection with The Economic Development of Germany* (National Monetary Commission 1911), p. 27.
[245] Ibid.
[246] Von Reden *Vergleichende Kulturstatistik*, (1848), p 412, cited by J. Riesser above note 244.
[247] W. Sombart, *Die Deutsche Volkswirtschaft*, (2d ed. 1909), ps. 190-191. Cited by J Riesser above note 244.
[248] M. Da Rin "Understanding the development of the German Kreditbanken, 1850-1914: an approach from economics on information" Financial History Review [1996] p. 32. T. Guinnane "Delegated Monitors, Large and Small: Germany´s Banking System, 1800-1914" [2002] Journal of Economic Literature, p. 96.
[249] T. Guinnane Ibid p. 96.
[250] J. Riesser, above note 244, p. 45.

The sums needed to fund the railways tended to exceed the resources of private bankers, who needed to create syndicates. As the formation of such syndicates were, practically speaking, difficult to form, the private bankers needed to seek an alternative source of funding such as large incorporated banks.[251] These banks were the *Kreditbanken* (credit banks), a number of which later became the *Grossbanken* that have dominated the German finance system since then.[252]

The first credit bank was formed in 1848 with the name Abraham Schaaffhausen´scher Bankverein of Cologne (A. Schaafhausen), as a result of the reorganization of the old banking of Abraham Schaaffhausen, with the purpose of financing railways in the Lower Rhine.[253] However, the model of the credit banks was the famous Societé General de Crédit Mobilier (Credit Mobilier) which opened its doors in Paris in 1852.[254] Credit Mobilier influenced the foundation of the Bank für Handel and Industrie in 1853 with headquarters in Darmstadt.[255]

3.1.2.1 Saint Simon and the philosophical foundations of Universal Banking

Credit Mobilier was chartered by a decree of Napoleon III on November 1852, two weeks before of the proclamation of the Second Empire. The founders of the Credit Mobilier idea were the Pereire brothers. Emile and Isaac Pereire were Portuguese Jews who settled in Bordeaux. They became active members of the Saint Simonian Brotherhood.[256]

Claude Henri de Saint Simon thought the mission of banks was strictly defined in servicing the development of industries, which was ultimately realizing the general interest.[257] He understood that the "industrial class is completely organized around the bank".[258] He thought the only way to maintain public peace was to place the industrial class in charge of managing public wealth.[259] According to Saint Simon "work is the source of all virtues; the more useful jobs should be the most considered; accordingly, both divine and human morals call the industrial class to perform the first role in society".[260]

For Saint Simon banks had a hierarchical status. The role of banks was to be "general agents of the industry".[261] According to Saint Simon, the industrials (all active citizens involved in production) are hierarchized in different steps. In the lower step he positioned

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[251] R. Tilly "German Banking, 1850-1914: Development Assistance for the Strong" [1986] The Journal of European economic history p. 119; H. Hikino and A. Chandler *Scale and Scope: The Dynamics of Industrial Capitalism* (Harvard University Press, 2009), p. 415-416.
[252] H. Hikino and A. Chandler ibid p. 416.
[253] J. Riesser, above note 244 p. 46; H. Hikino and Chandler, ibid, p. 416.
[254] H. Hikino and Chandler, ibid, p. 416.
[255] R. Tilly "Universal banking in Historical Perspective" [1998] Journal of Institutional and theoretical Economics p. 13; H. Neuburger and H. Stokes "German Banks and German Growth 1883-1913: an Empirical View" [1974] The Journal of Economic History p. 712; H. Hikino and Chandler, ibid, p. 416; J. Riesser, above note 244 p. 46.
[256] R. Cameron "The Credit Mobilier and the Economic Development of Europe" [1953] The Journal of Political economy, p. 465.
[257] F. Yonnet "Claude-Henri de Saint Simon, L`Industrialisme et les banquiers" [2004] Cahiers d` économie Politique, p. 154.
[258] Ibid, p. 155.
[259] H. de Saint Simon *Catecismo Político de los Industriales* (Aguilar, 1960), p. 56.
[260] Ibid, p. 85.
[261] M. Ballet "Saint-Simonism and Utilitarianism: the history of a paradox. Bentham's Defense of Usury under Saint-Amand Bazard's Interpretation" [2011] Working paper GATE, p. 13.

the entrepreneurs or workers. In the second step he located the great industrial or commercial capitalists. In the third step he placed the bankers, who are the elite leaders of the industrial class. In the final step he situated the Banque de France, which had the mission of being the unifier and centralizing force of the industrial class.[262]

Banks, in Saint Simon's opinion, underpin a social order based on confidence. For him the bank is a means by which the relationships of the "idles" and the "workers" are determined. Lending puts capital at the disposition of workers, which is distributed according to workers´ capacities. Banks play a role in the ordering and vigilance of labour relations.[263]

With this in mind, the Pereire Brothers founded Credit Mobilier. The influence of the Saint Simon doctrine is palpable in Credit Mobilier bylaws. The new bank's founding documents stated "considering the important services that the establishment of a bank may favour the development of the industry…"[264] The French government welcomed the formation of Credit Mobilier, as well as the general public, since they believed the new bank would be a counterpoise to the private banks, especially the House of Rothschild.[265]

The organization, growth and rapid decline (in 15 years) of Credit Mobilier made people in the 1910s designate the *Grossbanken* as "Credit Mobilier banks".[266] As stated above, Credit Mobilier directly participated in the formation of the Bank für Handel *und Industrie* in Darmstadt. All the other great German banks were modelled directly upon the Darmstadt bank, and therefore indirectly upon Credit Mobilier. [267]

In the first business report of the Bank für Handel und Industrie it stated "it is in no way the task of the bank to pave the way for stock-jobbing operations, and to stimulate capitalists to unproductive gambling on change. On the contrary, the bank is expected to promote sound and extensive undertakings by its own operations and by investing outsider´s funds entrusted to its care. By means of its imminent position and clear insight into the whole situation of German industry it is fitted to assist to the fullest extent of its powers in directing capital and the spirit of enterprise into the channels corresponding to the requirements of the moment"[268].

The influence of Saint Simon and his disciples in the formation of Credit Mobilier, and indirectly through the formation of *Bank für Handel und Industrie* and the other great German banks can be traced to the bylaws and other corporate documents. Cameron thinks the influence was much stronger, since Credit Mobilier was a "potent force for economic development in the environment in which it existed".[269] This opinion turns the section to the analysis of the influence of universal banking in the development of Germany.

[262] H. de Saint Simon *L´Industrie*, 1966, p. 137 cited by F. Yonnet above note 257, p. 156.
[263] S. Charlety *Historia del Sansimonismo*, (Alianza Editorial, 1969), p. 47.
[264] Decret No. 7433 "Decret portant autorisation de la Societé anonyme formé a Paris sous la denomination de Societé Generale de Crédit Mobilier" Bulletin des lois de la Republique Francaise, 11 Dic 1852, p. 783
[265] J. Riesser, above note 244 p. 50.
[266] Ibid, p. 51.
[267] R. Cameron, above note 256.
[268] J. Riesser, above note 244 p. 49.
[269] R. Cameron "Founding the Bank of Darmstadt" [1956] Explorations in Entrepreneurial History p.113.

3.1.3 Universal Banking and Germany´s economic development

Since Alexander Gerschenkron´s seminal work *Economic Backwardness in Historical Perspective*, many economic historians have attributed universal banks a leading role in the development of the industry in Germany,[270] especially if compared to other jurisdictions such as the US and the UK.[271]

Gerschenkron argued Germany and many other countries in the continent had to lead with a state of "backwardness". In a country with a state of relative backwardness like Germany, where capital was scarce and disseminated, universal banks played a very important role.[272] While in England banks were obsessed with liquidity and lent on a short term basis, firms that required capital for industrial investment had to rely on other sources of financing such as family wealth or friends, and growing firms had to rely on retained earnings. Another source of financing was the issue of equity and bonds, something that was underdeveloped in Germany.[273]

German banks were structured to build miles of railways, establish mines and build ports. The Pereire brothers' business enterprises started in France but expanded into Spain and Russia and clearly influenced the German Great Banks. According to Gerschenkron the most important effect of the Pereire brothers was in the business environment. The Pereire brothers engaged in a conflict with representatives of "old money", especially with the Rothschilds. The Pereire brothers could not form a Credit Mobilier in Austria (Credit-Anstalt) only because the Rothschilds were predisposed to create a bank like Credit Mobilier, which would invest in building railways and develop the industry in the country. This was disruptive in the sense that the "old money" was developing the industry.[274]

The German banks combined short term financing, common in the English commercial banks, with strong links with industrial firms.[275] According to Gerschenkron, German banks had provided more help to industry than English banks because "the German Banks, and along with them the Austrian and Italian Banks, established the closest possible relations with industrial enterprises. A German Bank, as the saying went, accompanied an industrial enterprise from the cradle to the grave, from establishment to liquidation throughout all the vicissitudes of its existence."[276] Until the First World War the primary activity of German banks was the financing of the extraction of coal, steal

[270] H. Hikino and A. Chandler, above note 251 p. 415; J Cable "Capital Market Information and Industrial Performace: the role of West German Banks" [1985] The Economic Journal, 95, ps 129-130; R. Cameron above note 269 p.113; S. Baliga and B. Polak "Banks versus bonds: A simple theory of comparative financial institutions" [1995] Cowles Foundation discussion paper p.1 ; C.W. Calomiris "Corporate-Finance Benefits from Universal Banking: Germany and the United States 1870-1914" [1993] NBER Working Paper Series, ps 1-21; J. Riesser, above note 244 p. 49; W. Sombart *Volkswirtschaft im neunzehnten Jahrhundert* (Georg Bondi, 1909) cited by C. Fohlin "Universal Banking in Pre-World War I Germany: model or Myth? [1999] Explorations in Economic History p.307.

[271] T. Guinnane, above note 248, p. 74.

[272] A. Gerschenkron "Economic Backwardness in Historical Perspective" (Harvard University Press 1962). ps 1-15.

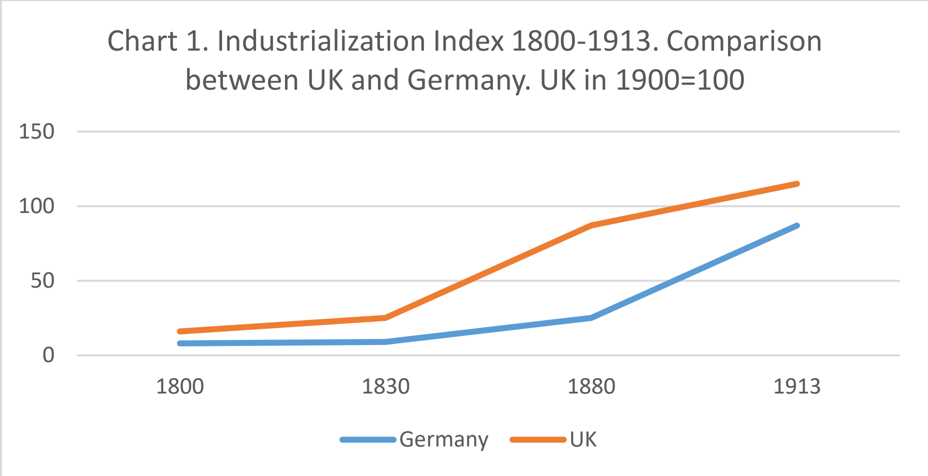
[273] T. Guinnane, above note 248, p. 77, A. Gerschenkron, above note 272 ps 1-15; J. Riesser, above note 244 p. 772.

[274] A. Gerschenkron above note 272. ps 1-15.

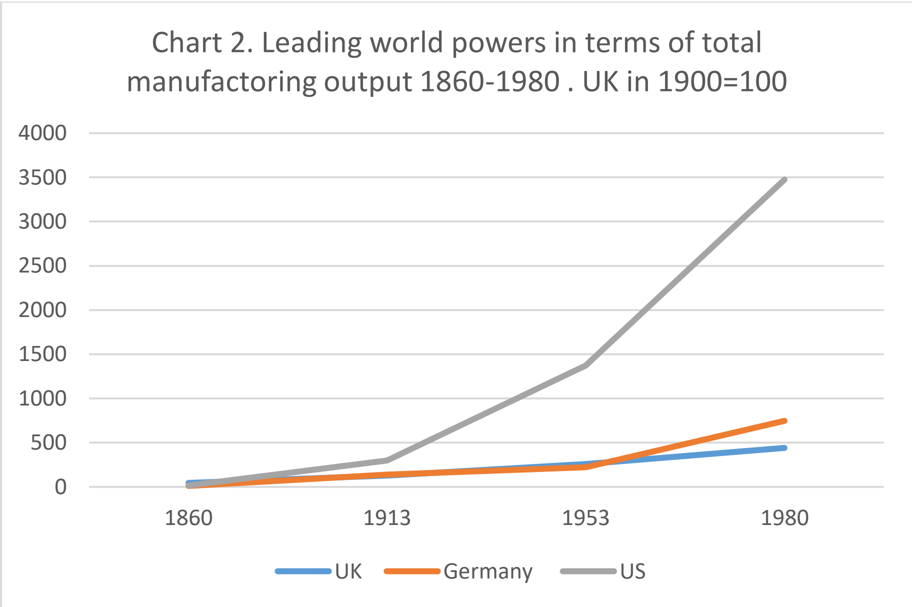
[275] Ibid.

[276] A. Gerschenkron, above note 272, p. 14; J. Edwards and K. Fischer, *Banks, finance and investment in Germany* (CUP, 1994), p.9.

production, electrical engineering and heavy industry in general.[277] Available data based on Bairoch´s index of Industrialization shows the estimated per capita levels of industrialization[278] in the United Kingdom in 1830 ascended to 25 points against 9 in Germany (considering the United Kingdom in 1900 ascended to 100 points. See Chart 1). In 1880 the United Kingdom moved to 87 points while Germany grew to 25 points. By 1913 the United Kingdom had 115 points while Germany moved to 87 points.[279]



Source: Own compilation based on Bairoch[280]



Source: Own compilation based on Bairoch[281]

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[277] Ibid.

[278] For Bairoch levels of industrialization mean the volume of manufacturing output per capita. “International Industrialization Levels from 1750 to 1980” [1982] The Journal of European economic history p. 294.

[279] Ibid.

[280] Ibid.

[281] Ibid.

Another interesting index (see Chart 2) shows the total manufacturing output of 20 leading world powers. In 1860 the UK was the leader with 45 points, while Germany was in the 11th position with 11 points. In 1913 the leading position was taken by the US with 298 points, Germany was second with 138 points, and the UK third with 127. In 1980 the US remained first with 3475 points, Russia second with 1630, Japan third with 1001 points and West Germany fourth with 590 points. The UK appeared in the 6th position with 441 points.[282]

Tilly shows between 1870 and 1913 the value of *Kreditbanken* assets rose from 600 million to over 17.5 billion marks, of which almost half were located in the largest Berlin banks. In 1913 the three largest incorporated companies were banks, and 17 of the largest companies were banks. According to Tilly "those figures reflect a degree of prominence which can be found in the banking institutions of no other major industrial country at the time".[283]

Both German industrialization indexes, referred in Charts 1 and 2 and Tilly, increased between 1830 and 1880. The question here is if the two indexes are related by a causal link. According to Gerschenkron there is a causal link, which characterized the German industrialization scenario in the period.

Gerschenkron's views have been labeled as the "orthodox view" by Fohlin, who argues financial institutions in Germany were not just a response to economic backwardness but a result of social, political and regulatory environments. She also argues the benefits of universal banking requires a "careful reexamination" since many of the "growth and efficiency-enhancing features" of the German financial system arose only during industrialization and many of those features were unrelated to German banks' universal structure.[284] In the same line of thinking, T. Guinnane argues Gerschenkron erred since he focused on the Great German Banks and not on the whole German financial system which comprises various types of complimentary financial institutions which had not been present in the UK or the US. He also pointed out the great universal banks were "much the product as the cause of economic growth" and the consideration of the financial system as a whole sharpens the understanding of today´s financial intermediation system.[285] A similar conclusion was reached by Deeg, who affirms all types of financial institutions taken together played a major role in industrialization in Germany, something that did not happen in the UK.[286]

Tilly focused his analysis on universal banking "development assistance for the strong". He concludes the great German banks were interested in aiding large and strong businesses. Gustav Mevissen, a Rhenish entrepreneur and co-director of A. Schaaffhausen and Bank of Darmstadt instructed the management of the latter, stating:

> "A basic principle of our bank is that it is to conduct business only with banking firms of the highest rank and with industrialists of importance, furthermore that it

[282] Ibid, p. 284.
[283] R. Tilly, above note 251, p. 114.
[284] C. Fohlin above note 270, p. 306.
[285] T. Guinnane above note 248 p.74.
[286] R. Deeg "On the development of universal banking in Germany" in D. J. Forsyth, and D. Verdier *The Origins of National Financial Systems Alexander Gerschenkron Reconsidered* (Routledge, 2002), p. 87.

> must in principle reject any ongoing connection which does not promise to generate a business volume of at least 50.000 Gulden per year." [287]

These instructions explain the focus of great German Banks on large scale heavy industries in the "take off" period from 1840 – 1870.[288] In Tilly´s opinion, this focus "systemically neglected an important part of their country´s financial business".[289]

Neuburger and Stokes' findings suggested the credit allocation policy of the *Kreditbanken* in the take off period inhibited the German economy. They pointed out banks' biases in favour of heavy industry and "against light industry", as well as a bias in favour of export industries and national defense industry.[290] In a similar vein, Feldenkirchen states he could not dispute the "pioneering role of banks" in formation and financing firms in the heavy industry sector but "we should not overrate" the influence of banks on the "economy in general".[291]

Edwards and Ogilvie explained the available evidence does not support the argument that universal banks extensively financed German industrial joint stock companies. The fact that a large amount of non-joint stock industrial firms existed, and banks which were not *Kreditbanken* also existed, combined with the fact universal banks did not broadly supported joint stock industrial companies, led these authors to conclude the role of universal banks had been exaggerated.[292]

3.1.4 Germany and the evolution of capital markets

1850 marked the commencement of a "truly global securities market". Capital markets moved beyond government debt instruments and started to deal with the financing of business. By 1900 national securities markets became integrated and international as in no other stage of history.[293]

While in the UK securities as part of national assets stood at 22% during the period 1850 – 1900, in Germany the percentage was only 3.7%[294] .

Verdier explains Anglo Saxon countries (US and UK) in the period 1850 – 1913 had specialized commercial banks and large markets, while Germany had universal banking and small markets.[295] He argues the development of the securities market in Germany was affected by the action of government taxation and legislation. In 1881 a turnover tax was introduced and in 1896 prohibited buying and selling for future delivery as "being tantamount to speculation". This legislation was not revised until 1908, favouring London as a centre for trading in securities. Part of the securities business that was not channeled

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287 Provisional Norms for Management of the Bank and Commerce and Industry Darmstadt in R. Tilly above note 251 p. 121.
288 Ibid.
289 Ibid, p. 150.
290 H. Neuburger and H Stokes note 255 p. 711, 729.
291 W. Feldenkirchen "Banking and Economic Growth: Banks and Industry in Germany in R. Lee *The Nineteenth Century and their changing relationship during industrialization" in German Industry and German Industrialization. Essays in German Economic and Business History in the Nineteenth and Twentieth Centuries* (Routledge 1991) p.121.
292 J. Edwards and S Ogilvie, above note 237, p 444.
293 R. Michie *The Global Securities Market: A History* (OUP 2006) p. 84.
294 R. Michie ibid p. 84; R. W. Goldsmith, *Comparative National Balance Sheets* (University Of Chicago Press 1985) Table 47 p. 134.
295 D. Verdier, above note 237, p. 117.

outside Germany was internalized between the German Grossbanken. “Such links help explain the development of integrated commercial and investment banking in Germany, as that shielded activity in securities from both taxation and external scrutiny. The combination of taxation and legislation, the direct participation of the banks in the stock exchanges, and the nationalization of the railway system impeded the development of the German securities market. Instead, German banks were forced to play a greater role in meeting the financial needs of the economy through extending long-term loans to their business customers whilst banks elsewhere were retreating from such practices because of the risks involved if depositors rushed to withdraw their savings during a financial crisis.”[296] Fohlin, on the other hand, understands the tax effect on the increasing of universal banking and substitution of universal banking services for securities market trading “is not tremendously robust” since there is no evidence of shift of business from the market to universal banks.[297]

While a causal relation might be difficult to prove, there remain a twofold fact. First, there was a great growth of universal banking from the period 1850 – 1913. Second, the development of the securities market in Germany in the same period was weaker than the UK and the US.

The index of securities as part of national assets in Germany in the period 1911 –1912 was 11.1%, while the UK index was 41.4% and the US was 18.5%.The period 1927 – 1930 shows Germany with a 4.6% index, UK with 47.4% and the US with 28%. The period 1947 – 1955 saw Germany decreasing to 4.4%, the UK 33.3% and the US 24.2%. Between 1970 and 1973, Germany obtained 6.7%, the UK 17.8% and the US 19.1%.[298]

However as some authors remind us, provisions in the German Civil Code that established onerous requirements on the transferability of securities impeded the development of a deep capital market ‘à la americana’.[299] Effros argued that Glass-Steagal Act[300] permitted this development of vibrant capital markets separate from money/banking markets.[301]

In the mid-1980s a consortium of big German banks launched the idea of the creation of a *Finanzplatz Deutschland* to encourage the increase of securities markets in Germany, and particularly the city of Frankfurt as a financial centre. This was to some extent a fruit of the internal market and the work of internalizing European directives,[302] and the realization that to compete with the UK reform was needed.[303] The Government accompanied the initiative by issuing some new laws on the promotion of financial markets. Nevertheless, the role of securities markets in Germany still played a restricted

[296] Ibid. See also R. Tilly above note 251, p. 125; J. Riesser, above note 244, p. 772.
[297] C. Fohlin “Regulation, taxation and the development of the German universal banking system 1884-1913” [2002] European Review of Economic History p. 252.
[298] R. Michie above note 293, p. 127.
[299] In Germany, “limitations on transferability of ownership are less pronounced. However, the transfer of control is restricted by rights of workers and managers, and the power of banks.” J. Franks, C. Mayer, J. Hardie and E. Malinvaud “Capital Markets and Corporate Control: A Study of France, Germany and the UK” [1990] Economic Policy, p 209.
[300] Act of June 16, 1933, 48 Stat. 162.
[301] R. Effros, above note 9.
[302] S. Vitols “Changes in Germany's bank-based financial system: A varieties of capitalism perspective” [2004] WZB Discussion Paper, p.6; J. H. Jr. Freis, “An Outsider's Look into the Regulation of Insider Trading in Germany: A Guide to Securities, Banking, and Market Reform” [1996] Finanzplatz Deutschland, B. C. Int'l & Comp. L. Rev. p.28
[303] J.H. Freis, above note 302, p. 10.

role. By 2010 outstanding bonds amounted to 145 billion euros, while outstanding bank loans in 2012 stood at 1,474 billion euros. On the other hand, market capitalization in 2010 was equal to 43% of GDP (below 67% in the EU and 119% in the US). Finally, the number of citizens that held shares was 3.9 million in 2011, despite the effort of the government in developing an "equity culture". [304]

The following section analyses the benefits and costs of universal banking from the perspective of the bank and of the regulators.

3.1.5 Benefits and Costs of Universal Banking

The costs and benefits of universal banking may be analyzed from the viewpoint of the banks and from the viewpoint of public policy.

From the perspective of the bank, the literature has examined a list of arguments in favour of universal banking: (1) universal banks enjoy advantages of economies of scale and scope; (2) universal banks benefit from being a "one-stop supplier" for various financial services; (3) the existence of alternative revenue sources and a reduction of economic risk due to diversified activities; (4) universal banking may encourage the creation of long-term relationships, easing monitoring. [305]

From the perspective of the public policy viewpoint there are concerns about universal banking costs: (1) universal banks may increase the risk of financial instability; (2) universal banks might injure stock markets; (3) universal banks might engage in anti-competitive behaviour, concentration of power and/or monopoly practices; (4) Universal banks might lead to abuse of information or conflicts of interest. From the perspective of the bank itself, there are organizational costs of its own.

The literature on benefits and costs of universal banking can be traced back to two different moments in time: first, in the 90s with the discussion in the US of the liberalization of the Glass-Steagal Act. A second trend of literature can be found after the GFC, where the Vickers Commission and the ring-fence proposals inter alia looked at universal banking from a different perspective, watering down in part the enthusiasm for universal banking of some scholars in the 90s. An analysis of the costs and benefits of universal banking follows.

[304] D. Detzer, N Dodig, T. Evans and H Herr "The German Financial System" [2013] FESSUD, p. 85; Deutsche Bundesbank "The shadow banking system: Small but internationally connected" Financial Stability Review [2012] p.1.

[305] See J. Canals above note 234 p. 103; D. Dietrich and U. Vollmer, above note 233, p. 124; T. Guinnane above note 248; C. Fohlin, "Financial Systems and Economic Development in Historical Perspective" [2014] J. Hopkins University and Emory University p.6; T. Baum and M. Gruson above note 243 ps 101-129; A. Tombini "Universal Banking: The view of Brazil" [2012] The Quarterly Review of Economics and Finance p 154; K. Fischer and C. Pfeil "Regulation and Competition in German Banking: An Assessment in J.P. Krahnen and R. Schmidt *The German Financial System* (OUP 2004) ps 291-350; R. Vander Vennet above note 112 p. 255; G. Benston, above note 233 p. 121. A. Steinherr and Ch. Huvenners above note 241; C. Calomiris above note 270 ps 1-21; H. J. Krummel "German Universal banking Scrutinized. Some remarks concerning the Gessler Report" [1980] Journal of Banking and Finance 4 ps 33-55.

3.1.5.1 Benefits of universal banking from the perspective of the bank

1. Economies of scope and scale

According to this argument, universal banking would benefit from economies of scale. Economies of scale exist if assuming a constant product mix; the bank faces "declining average costs as its size expands".[306] Universal banks would have potential for scale economies attributable to administrative overhead, agency problems and other cost factors if the bank is sufficiently big.[307] On the other hand, economies of scope exist if the total cost of offering different services in different units are bigger than offering the same services together.[308] Universal banks would bring scope economies to firms in need of funding. If the universal bank has a close relationship with the firm, it would be easy and cost efficient for the bank to perform due diligence for underwriting purposes. This is a case of reutilization of information. Another example of economies of scope are the use of "spillovers" of reputation acquired in one business to use in another. Additionally, a universal bank can "amortize the fixed costs" of setting up a relationship over different products among the business lines of the bank. Finally a universal bank may find easier ways to fund itself than specialized banks, for instance by combining lending activities with fee activities such as securities business.[309]

However, empirical studies performed to examine economies of scale in universal banks are not categorical.[310] De Young explains the statistical tools to measure scale economies deliver the most accurate results for average firms. As in the banking sector, the size distribution of firms is enormous; statistical estimates of scale economies can be sensitive to the financial result of just one of the largest firms. Also, using models designed for small banks to make conclusions of large banking companies might be misleading.[311] In the same sense, the empirical evidence of economies of scope is also unclear.[312] Economies of scope are not always found immediately since the management of universal banks has become very complex.[313]

2. Benefits of one-stop shopping

One argument in favour of universal banks is that they can offer a wide range of financial products under the same roof. The possibility of offering different products would help the universal bank to offer new and diversified products that might help it to gain new customers or to retain traditional ones. An example of this was the demand of investment funds in the 90s as an alternative to deposit product, which made many banks in that decade to follow the universal banking model in order not to lose this segment of customers.[314] Another feature of the one-stop shop banking would be the need to adapt to

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[306] R. Vander Vennet above note 112 p.257.
[307] I. Walter, note 127, p. 6.
[308] J. Canals above note 234, p.104.
[309] R. Rajan "The entry of Commercial Banks into the securities Business: A selective Survey of Theories and Evidence" [1995] NYU p. 10; C. Fohlin Above note 270, p. 319.
[310] I. Walter above note 127, Exhibit 4. For a literature review on economies of scale in the US and Europe see E. Becalli, M. Anolli, G. Borello "Are European banks too big? Evidence on economies of scale" [2015] LSE Research Online.
[311] R. De Young "Scale Economies Are a Distraction" The real issue for policy is credible resolution of failing financial firms, not bank size". [2010] Scale Economies in Banking Symposium, p.15.
[312] R. Rajan, above note 309, p 12.
[313] J. Canals, above note 234, p.104.
[314] J. Canals, above note 234, p. 105.

new customer financial needs by adding new services, which in turn make universal banks expand into new business.[315] Products that at the beginning were designed for sophisticated clients may be adapted to small clients at a low marginal cost for the bank.[316]

One of the benefits of one-stop shopping is universal banking centralizes a lot of infrastructure and support functions, reducing interlinkages with different providers, and thus reducing counterparty risk, while gaining transparency.[317]

However, there is little evidence customers really want one-stop shopping. There are some individual case studies like the attempt of Sears to set up financial supermarkets that did not succeed. According to Rajan, the reason might be that unlike firms, individual investors prefer to face small transaction costs to choose the best specialist for their investment.[318] Accordingly, Canals believes when a universal bank has a firm as a customer it has "great chance of satisfying a greater number of financial needs".[319]

At the end of the day, as Canals properly notes, when an organization has the "ability to adapt", it is not so important if it is universal or specialized. What really matters is the capacity and resources to adapt to the new realities and demand for new services.[320]

3. Alternative revenue sources and reduction of economic risk due to diversified activities

A third argument states universal banking would benefit from alternative revenue sources from different financial activities and that economic risk is reduced due to diversified activities. Revenue synergies relate to cross-selling and cross-referencing across business divisions; for instance a sophisticated product such as derivatives for hedging risks designed for corporate clients might be offered to small customers at no extra cost.[321]

As banks need to live with risks, universal banks seek to compensate market fluctuations by offering services that do not have "parallel profit curves". Offering lending and securities activities decreases the probability of à large "overall loss" since losses in one sector would be balanced by the other.[322] The diversification benefits may arise when episodes of disintermediation (when the public raise funds directly from the markets) happen. Universal banks would be less affected by the decline of lending business by a possible increase of their underwriting and placing business. However, as Rajan affirms, there is little evidence of these effects.[323] Additionally, having access to information of a full range of financial assets would enable universal banks to obtain an "optimal diversification" of investments that specialized firms would find harder to obtain.[324]

[315] H. E. Buschgen "The Universal Banking System in the Federal Republic of Germany" [1979] Journal of Comparative Corporate Law and Securities Regulation p. 8.
[316] J. Schildbach "Universal banks: Optimal for clients and financial stability. Why it would be wrong to split them up" [2012] Deutsche Bank Research, p. 6.
[317] Ibid p. 14.
[318] R. Rajan, above note 309, p. 11.
[319] J. Canals, above note 234, p. 106.
[320] Ibid.
[321] J. Schildbach above note 316 p. 13.
[322] H. E. Buschgen above note 315, p. 5.
[323] R. Rajan above note 309, p. 15.
[324] C. Fohlin, above note 270, p. 319.

Drawing on historical data Benston shows bank involvement in securities activities have mitigated bank failure in the pre Glass-Steagal Act in the US.[325] Saunders and Walter devote a whole chapter using aggregated and individual firm data to conclude

> "The simulation analysis based on US data suggests that there are potential risk reduction gains from allowing banks to expand their activity set in a limited fashion – and similarly for non-bank financial firms to expand their set of activities – and that these gains increase with the number of activities undertaken. The main risk reduction gains appear to rise from banks' expanding into insurance rather than securities activities. Moreover, quite substantial risk-reduction gains …appear to exist at the most comprehensive level of universal banking when all five areas of financial service activity are combined."[326]

Benston concludes that theory, and evidence shows permitting banks to perform securities, insurance and other financial services would reduce rather than increase the expected risks.[327]

Conclusions on the advantages of diversification on combining activities are mixed and according to Calomiris they are ill suited to measure the diversification advantages of universal banking. The main reasons for this are that combining firms is not the same as combining balance sheets; the behaviour of firms might change as a result of combining activities.[328]

4. Long-term relationships

One advantage of universal banking is that it fosters long term relationships between banks and customers. This would allow the customer to change the financing of the firm as it matures, while keeping the "optimal financial arrangements" across the "life-cycle" of the firm. The long term relationship implies a credible implicit agreement to continue the relationship over time. Initially the bank would lend to the firm, then it would underwrite the firm issuance, and probably later it would own shares of the firm. The advantage of this relationship is that banks are encouraged to lend on favourable terms from the beginning of the relationship. Monitoring costs would be spread among long periods of time, reducing initial costs for the firm. [329] This specific "implicit contractual arrangement" between the bank and the firm is called "*Hausebank* financing" or "relationship lending".[330]

From the bank perspective, once it has lent to the firm, it already has valuable information that would reduce the costs of underwriting. In order to prevent the firm from changing

[325] G.J. Benston above note 233, p. 124.
[326] A. Saunders and I. Walter above note 112, p. 204.
[327] G.J. Benston above note 233, p. 126.
[328] C. Calomiris "The Costs of rejecting Universal Banking: American Finance in the German Mirror, 1970-1914" in N. Lamoreaux and D Raff *Coordination and Information: Historical Perspectives on the Organization of Enterprise* (University of Chicago Press 1995), p. 271.
[329] Ibid, p. 265; C. Mayer "New Issues in Corporate Finance" [1988] European Economic Review ps. 1167-89; C. James and P Wier "Borrowing Relationships, Intermediation and the Cost of Issuing Pubic Securities" [1990] Journal of Financial Economics ps. 148-171; B. Petersen and R. Rajan "The Benefits of Lending Relationships: evidence from Small Business data" [1994] Journal of Finance ps.3-37; C. Fohlin, above note 270, p.319.
[330] R. Elsas and J.P.Krahnen "Is relationship lending special? Evidence from credit-file data in Germany" [1998] Journal of Banking and Finance p. 1284; R. Elsas and J.P.Krahnen "Universal Banks and Relationships with Firms" in J.P. Krahnen and R. Schmidt above note 305 p. 227.

bank in the middle of its life cycle and to avoid a time consistency problem – where the firm gains a free ride by obtaining cheap financing at the beginning of its life while changing bank when it matures and is then able to obtain financing on its own – it would be wise to allow banks to hold shares and underwrite securities in the firm as a form of compensation for the bank.[331]

Long term relationships would promote stronger and efficient investment since in these relationships a close monitoring ingredient exists. This monitoring may be facilitated by placing bank directors on the boards of the firms. This in term would substitute collateral and allow banks to finance good projects which might have insufficient collateralized assets.[332] Also, long term relationships may help improve corporate control, since close monitoring might detect poor managers and protect good managers. However, this would be more difficult in market-based systems where mergers and acquisitions are common and in general, old managers are changed without discernment of the quality of their work.[333]

The good reputation of the underwriter might increase the market for the firm´s shares, and the access to accurate information may allow a better valuation of its shares. Relationship banking would improve the efficiency of securities underwriting.[334] Through bank members on the firm's board or through the acquisition of the firm's equity by the bank, the firm would gain a seal of quality that investors would be aware of when acquiring securities of the firm's shares. Formal bank relations would give the firm more options to finance, since it would have better access to lending, securities and equity underwriting.[335]

On the other hand, three arguments are offered against the advantages of long term relationship banking based on historical facts. First, it is affirmed only joint stock enterprises had supervisory boards (where a bank appointed its representatives to the firms). While most large industrial firms were joint stocks, these kind of firms were a small minority of industrial capital in Germany from 1800 to 1914. A second argument states that being the bank representative on the supervisory board was a "purely formal" job; they received reports, but the position of power they actually held was not quite clear. A third argument affirms the monitoring position of the supervisory board was not different from a normal bank-customer relationship, where the bank would generally request reports, balance sheets and other information that may help it determine the risks of lending.[336]

However, this is probably one of the strongest arguments that determines which type of capitalism a country chooses: one built on short term profits à la USA or one built on a more inclusive, long term model that many in Germany have claimed contributed to Germany's industrialization. Populism has exposed the deficiencies of being too focused on short term profits.[337]

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331 Ibid, p. 268; T. Guinnane, above note 248, ps. 108-109.
332 C. Fohlin, above note 270, p. 319.
333 Ibid.
334 J H. Boyd and E. C. Prescot "Financial Intermediary-Coalitions" [1986] Journal of Economic Theory ps. 211-232.
335 C. Fohlin, above note 270, p. 321.
336 T. Guinnane above note 248 ps 107-108; J. Edwards and S Ogilvie above note 237 p. 441.
337 C. Goodhart and R. Lastra "Populism and Central Bank Independence", [2018] Open Econ Rev p. 51.

3.1.5.2 Costs of universal banking from the perspective of public policy

1. Universal banks may increase the risk of financial instability

One common feature of universal banks is that they are on average larger than specialized banks. Since size is a category of systemic importance and may have implications with respect of asymmetric information and agency problems, it may also increase financial instability.[338] A first implication would be universal bank might have the problems of TBTF. If the bank served different activities under the same umbrella it would be costly for governments to permit liquidation. Bankruptcy of universal banks would be especially costly because of their complexity and interconnecting role in the financial industry.[339] If one or several universal banks were to fail it might lead to a systemic financial crisis. A second consequence of TBTF would be the incentives for managers to take excessive risks. Regulators, recognizing this danger would tighten universal banking regulation, "hindering economic efficiency" or bailout.[340] However, this has more to do to size than to specialization or universality of banks.[341]After the GFC it is now clear that size is just one of the categories of systemic importance and the focus is more placed on the interconnectedness and contagion rather than just the size of the bank. The regulatory response of the FSB and national regulators imposed new requisites on G-SIBs in order to tackle systemic risk of these type of financial institutions.

As universal banks may manage their risks in a diversified way easily reallocating funds from a business line to another, universal banks may take on riskier assets and a more fragile capital structure. This excessive risk-taking may make the universal bank more fragile. Freixas, Loranth and Morrison argue universal banks may also abuse deposit insurance and finance their securities business with insured deposits, which may increase the risk-taking in that line of business.[342] Rajan believes this argument is misplaced since the actual flow of funds between divisions of the bank can be limited by "mandating firewalls" which restrict direct transactions between sub units.[343]

Another reason why universal banks may increase instability is that diversification may ease internal bank contagion. If the securities division of the bank reports large losses, the commercial division might experience financial constraints as a consequence.[344]

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338 G. Benston above note 233, p. 123; D. Dietrich and U. Vollmer, above note 233, p. 124. A. Wilmarth in his book *Taming the Megabanks: Why we need a New Glass-Stegal Act* (OUP, 2020) p. 6, indicates that universal banks "are inherently dangerous because their business model promotes dangerous boom-and-bust cyles" since they use deposits to fund risky loans, and in turn package risky loans into asset-baked securities that are sold to poorly informed investors. M. Adalet "The effect of financial structure on crises: universal banking in interwar Europe", [2009] Working Paper, No. 0910, TÜSİAD-Koç University Economic Research Forum, p.15, suggests that countries with universal banking were more likely to experience crises.

339 D. Dietrich and U. Vollmer, above note 233, p. 124.

340 Ibid.

341 J. Canals, above note 234 p 128; J. Schildbach above note 316 p. 4.

342 X. Freixas, G Loranth and A. Morrison "Regulating Financial Conglomerates" [2007] Journal of Financial Intermediation ps 479-514; D. Dietrich and U. Vollmer, above note 233, p. 124.

343 R. Rajan, above note 309, p. 14.

344 D. Dietrich and U. Vollmer, above note 233, p. 124.

In addition, a focus of instability for universal banking might be reflected by the fact that universal banks hold equity stakes in firms. This would expose banks to the firms' business fluctuations and capital market volatility.[345]

2. Universal banks may hurt stock markets

One argument against universal banking states the latter would hurt capital markets since they trade and hold equity and securities discouraging the development of active stock exchanges.[346] While there is little empirical evidence of this element, Benston believes there might be different factors that may explain why Germany has a less developed capital market system than the US. First, perceived accounting rules that may lead the German individual investor to prefer other investments; second, investors might simply have less preference to invest in the stock markets than US investors; and third, pension funds were kept within firms, without pension firm investment in stocks of other firms.[347] Additionally, as stated above, Verdier believes legislative and tax restrictions might have challenged the development of capital markets in Germany. To sum up, there is no empirical evidence allowing to establish a causal link between universal banks and the injury of capital markets. However, as showed above, the comparison of German and US securities markets display a better development of the US markets, where specialized banks were the norm.

3. Universal banks may engage in anti-competitive behaviour, concentration of power and/or monopoly practices

The anticompetitive behaviour of universal banks is one of the most important arguments in terms of costs, since "mammoth entities" are more difficult to manage, supervise, and resolve and competition in banking should provide the salutary market practice that only the best succeed.

Universal banking might induce two types of anticompetitive behaviour. First, the multiple services of universal banking may lead to financial services concentration, which, if excessive may lead to market power.[348] Additionally, the capacity of competing in various markets may induce to "limit pricing" or "predatory pricing" and stave off competition from specialized intermediaries.[349] Second, universal banks may (mis)use information to lead industry cartelization. By use of strategic information of several firms in the same sector, universal banking may enhance mergers and acquisitions or "enforce cooperation".[350]

On the first issue, as stated by Baum and Gruson, under German law these problems of limit pricing and predatory pricing are dealt by the application of competition law.[351] As of the second issue, Calomiris points out two arguments. First, he states the "development and enforcement of industrial cartels by intermediaries is not a weakness peculiar to concentrated universal banking systems", while quantitative studies were not conclusive in responding the question of whether industrial cartelization was a "historically an important function of intermediaries", and that this question remains a "murky area" in

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[345] C. Fohlin above note 270, p. 321.
[346] G. Benston, above note 233, p. 128.
[347] Ibid.
[348] C. Fohlin, above note 270, p. 322.
[349] G. Benston, above note 233, p, 131; C. Fohlin, above note 270, p. 322.
[350] C. Fohlin, above note 270, p, 322; G. Benston, above note 233 p, 131.
[351] T. Baum and M. Gruson, above note 243, p. 128.

economic history. In summary, Calomiris concludes even if there is an argument in favour of cartelization, the problem would be one of all forms of "interbank coalitions" and not a specific problem of universal banking.[352] Riesser, drawing on the German experience before 1911 argues the influence of banks in enhancing industry cartels was volatile; while in some cases it was decisive, in others it was "hardly perceptible".[353]

Additionally, it is argued universal banks might dominate non-banks through capital participations in non-banking firms, exercise of proxy voting rights in shareholder´s meetings, and presence in supervisory and advisory boards.[354] During the 70s in Germany two official commissions studied the involvement of universal banks with non-banks: the Monopoly Commission (1976, 1978) and the Commission on Banking Structure, or Gessler Commission (1979). The Gessler Commission lasted 4 years and included 74 large corporations and 343 banking institutions by 1975. It concluded "The universal bank´s total holdings in non-banks measured by nominal values are small relative to the total equity of non-banks" except in two sectors, brewing and construction.[355] Regarding proxy rights, it stated "the inquiry into the banks´ proxy rights show that the banks´ influential power from voting of shares is not very great compared with non-banks on the whole".[356] Concerning the domination through supervisory boards and boards of directors, the Gessler Commission affirmed "at the end of 1974 members of bank management had supervisory board seats in about 1/3 of all German joint stock companies. In 2/3 of these companies, only one banker was represented".[357] A general conclusion of the Gessler Commission reads as follows:

> "The Commission could not subscribe to the undiscriminating criticism that universal banks by holding shares in non-banks reduce, to their own benefit, the independence and the scope of the action of those companies in which participations are held. Nor did it subscribe to the opinion that banks take up shares in non-banks that are, at the same time, their borrowers with the purpose of reducing their credit risks. It follows implicitly from the Commission report that banks consider their holdings mainly as independent investments. The Commission found that abuse of influence on non-banks cannot be attributed to the banking institutions."[358]

The actual debate of liberalization versus regulation and protection under the WTO in financial services rules, which has emerged again after Brexit, offers further elements to the discussion. Some argue the rules of financial services under the WTO would not be sufficient to safeguard competition since there is a broad "prudential curve out" in place under GATS rules.[359] As the Luxembourg Court of Justice recognized in the *Züchner*

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[352] C. Calomiris above note 328 p. 274.
[353] J. Riesser, above note 244, p. 712.
[354] H. Buschgen, above note 315, p. 14.
[355] H. Krummel, above note 305, p. 48; G. Benston, above note 233, p. 135.
[356] Ibid.
[357] Ibid.
[358] Ibid.
[359] Prudential Curve Out Annex 2 of the Annex to Financial Services, GATS; Eric Leroux "Trade in Financial Services under the World Trade Organization" [2002] Journal of World Trade p. 430; B. De Meester "The Global Financial Crisis and Government Support for Banks: What Role for the GATS? [2010] JInt Economic Law p. 27-63 60; A. Van Aaken "Prudence or Discrimination? Emergency Measures, the Global Financial Crisis and International Economic Law" [2009], J Int Economic Law p. 859; M. Yokoi-Arai "GATS´s Prudential Carve Out in Financial Services and Its Relation with Prudential regulation" [2008] The International and Comparative Law Quarterly, p. 639.

case, EC competition law is applicable to the banking sector.[360] The EU has enacted State Aid rules which runs parallel to competition policy.[361] A universal bank would have more "advantages" under the WTO rules in comparison to those subject to EU state aid rules. In a post Brexit world with a "no deal" scenario, theoretically a UK based FC/group would be able to receive financial support in a crisis without the need to comply with the EU state aid rules, which are stricter than the WTO in financial services rules.However, the Trade and Cooperation Agreement ("TCA") that was agreed on Christmas Eve 2020 assured a "common playing field" on state aid between the parties.[362]

As will be stated below, *Landesbanken* in Germany had to change their *Anstaltslast* (maintenance guarantee) and the *Gewahrtragerhaftung* (guarantee obligation) in order to comply with EU State Aid and competition rules.

To sum up, problems of enhancing anticompetitive behaviour are solved by the application of competition law in the corresponding jurisdiction. With Calomiris, it can be concluded fighting cartelization requires different legal tools than mere restricting universal banking. Baum and Gruson correctly stress the importance of competition law rather than banking law to address anticompetitive behaviour.[363]

4. Universal banks may lead to abuse of information and conflicts of interest

A fourth argument against universal banking is the possible abuse of information by them. As universal banking serves commercial and investment banking under the same umbrella it could use information gathered, for instance, in the lending business to invest or disinvest in shares of the mentioned firm. A second misuse of information by universal banks might be to deliver information to a non-bank affiliate of a competing firm that is at the same time creditor of the bank. A possible solution to mitigate this risk is the use of effective Chinese Walls. Additionally, the risks of information misuse such as civil liabilities and reputation risk might also work to dissuade the misconduct by the bank. As Baum and Gruson conclude, this risk is not only a universal bank issue, but also present in the US system.[364] An example of information abuse may be present if the insurance company obtains information of a client and at the same time releases that information to the Mergers and Acquisitions division that is handling an operation with a firm´s competitor.[365]

Traditionally the conflict of interest referred to a financial firm "benefiting one client at the expense of another".[366] Yet the concept is much broader. As stated above, when

[360] Case 172/80 *Züchner v Bayerishce Vereinsbank (1981) ECR 2021*.
[361] R. Lastra above note 27 p. 157.
[362] UK "Guidance State aid if there's no Brexit deal" (23 August 2018) <https://www.gov.uk/government/publications/state-aid-if-theres-no-brexit-deal/state-aid-if-theres-no-brexit-deal>, accessed 11 October 2018; G. Forwood, M. Israel, and K. Kelliher "State aid and the Brexit Trade Agreement: what's new, what's not, and what's next" White and Case, 4 February 2021 <https://www.whitecase.com/publications/alert/state-aid-and-brexit-trade-agreement-whats-new-whats-not-and-whats-next> Accessed 14 April 2021.
[363] T. Baum and M Gruson above note 243, p. 128.
[364] Ibid, p. 126; H. Buschgen above note 315, p. 14.
[365] See, for instance "Willis Re (Pty) Ltd Fsp: 24845 Conflict Of Interest Policy" Section 2.4 <http://www.willisre.com/documents/Media_Room/Publication/Willis_Re_Conflict_of_Interest_Policy_South_Africa.pdf >accessed 20 July 2018.
[366] See e.g *Washington Steel v TW Corp, 602 F2d. 594 (3rd cir. 1979)* abrogated by Clark v K-Mart Corp 979 F 2d 965 (3rd cir 1992); J. Fanto "Breaking Up is Hard to do": Should Financial Conglomerats be dismanteled? [2010], Brooklyn Law School p. 553

financial institutions offer more products and the scope of customers increase, the possibilities of conflicts of interest arise.[367]

With respect to commercial banks' incursions into the securities business, conflicts of interest may arise from the advisory role of the bank towards its depositors. First, the bank may be tempted to promote the securities it underwrite even though there might be better investment options in the market.[368] In other words, when the bank has the power to sell an "in-house" product it may be tempted to offer it against the best interest of the customer.[369] Second, it may also have the incentive to "stuff fiduciary accounts". When a bank is acting as underwriter and it has difficulties to place the securities, it might sell the securities to managed accounts where they have discretionary authority.[370] Third, the bank may use its influence as a lender to tie-in its securities products, for instance by threatening the client to finish the lending relationship if the investment in the securities business is not closed.[371] Fourth, banks who had lent to a firm whose bankruptcy risk has risen may induce their customers to issue bonds or equity to the public, in order to repay the loan with the proceeds of the issuance. In doing so, the bank would have transferred the debt risk to the public, while earning a fee for the underwriting.[372] At the same time, this type of conflict of interest might weaken bank monitoring, since the firm might expect to be bailed out by the universal bank instead of being liquidated.[373] Fifth, as banks have evolved from being client centred to employee and shareholder centred, information might escape from compliance and other controls and used to favour themselves. An example of this is the SEClawsuit against Goldman Sachs for favouring itself in the "structuring and sale of synthetic collateralized debt securities".[374] Finally, after the GFC, some authors claimed the universal banks were responsible for the creation and distribution of opaque financial innovations. Securitization has enabled universal banks to increase the volume of their lending activities, and to move loans off the balance sheet, and it has permitted banks to transfer their credit risk to investors.[375] The movement of commoditization and "opaqueness" may be a problem if the universal banks place products "beyond an appropriate customer base".[376]

A second set of conflicts of interest arises from the incursion of commercial banking into the insurance sector. A first example of conflict of interest in this area can be found in

> "That many sellers of various financial services offered by banks and insurance companies have traditionally been presented as investment advisors rather than

[367] J. Santos note 112, 1998 ps. 35-60. See also A. Wilmarth, *Taming the Megabanks* above note 338, p.6
[368] Ibid, above note 123.
[369] I. Walter, above note 127, p. 19.
[370] Ibid. J. Santos, above note 112.
[371] I Walter, above note 127, J. Santos, above note 112.
[372] I. Walter, above note 127; J. Canals, above note 234, p. 130; J. Santos, above note 112. R. Kroszner and R. Rajan "Is the Glass-Steagal Act Justified? A study of the U.S. Experience with Universal Banking Before 1933" [1994], The American economic Review, p 814; G. Hebb "Conflicts of Interest in Commercial Bank Security Underwritings: United Kingdom evidence" [2003], Quarterly Journal of Business and Economics ps. 79-95; L. Nyberg "How do conflicts of interest in universal banking emerge and what are the arguments for a separation of commercial and investment banking? [2004], BIS Review ps1-4.
[373] L. Xie "Universal Banking, Conflicts of Interest and Firm Growth" [2007], Journal of Financial Services Research, p. 178.
[374] *Complaint SEC v Goldman Sachs & Co. No. 1:10 cv BSJ-MHD* (SDNY filed April 16, 2010). J. Fanto above note 366, p. 553.
[375] A. Wilmarth "The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis" [2009], Connecticut Law Review ps. 984-991.
[376] J. Fanto above note 366, p 566; See also A. Wilmarth, Taming the Megabanks above note 338, p.6

> salespeople. The risk of a conflict of interest lies in the fact that their suggestions for investment have been designed more to promote the seller's or the company's interests rather than to fulfil the needs of the investor."[377]

A second possible conflict of interest may be present if the bank uses its lender influence to tie in insurance products.[378]

A third group of conflicts of interest may arise from the relation of the universal bank and the non-bank company it owns. A universal bank may give credit to a non-bank firm it owns in order to increase its share value. This would be in conflict with its depositors, it may endanger the safety and soundness of the bank and the integrity of its deposit insurance fund. Likewise, a bank may purchase the debt of a company it owns to increase its share value, and may even lend funds to repay the bank loans. Other combinations might be present if the bank purchases bad assets of the non-bank company it owns to protect its reputation and "future profitability". [379]

Empirical research on conflicts of interest in Germany in the late 70s by the Gessler Commission concluded

> "On the whole, consideration of potential conflicts of interest in universal banking did not lead the Commission to recommend the separation of the banking functions but rather to conclude that restraints of competition caused by such conflicts of interest are small and can be remedied or abolished by provisions within the existing system".[380]

Empirical research in the 90s conducted by Kroszner and Rajan on data before the Glass-Steagal Act in the US concludes the argument that commercial banks inducing the public to invest in low quality securities is flawed, since the performance of securities underwritten by commercial and investment banks show no evidence of such attitude. For them, the "public appears to have rationally accounted for the possibility of conflicts of interest" and this has moved banks to underwrite "high quality securities".[381] A paper by Gande, Puri and Walter in the late 90s that examined debt securities underwritten by Section 20 subsidiaries of banks holding companies compared to those underwritten by investment houses found no "evidence of conflict of interest even when an issue is used to repay bank debt".[382] In 2016, Klein, Wuebker and Zoeller studied the relationship between "IPO underpricing, secondary market IPO returns and the lead underwriters bank structure". They conclude

> "While the market recognizes that conflicts of interest can arise if commercial and banking are combined in one institution, our results suggest that investors are aware of those potential problems and require – and receive – an appropriate

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[377] L. Nyberg, above note 372.
[378] V. Lazen, C. Eguiluz "Conflictos De Interés En Servicios Financieros: Taxonomía y Mecanismos De Control Regulatorio" Superintendencia de Valores y Seguros – Chile (2006) <https://www.svs.cl/sitio/publicaciones/doc/documento_trabajo_6.pdf >, accessed 20 July 2018.
[379] B. Shull "The Separation of Banking and Commerce in the United States: an examination of Principal Issues" [1999], OCC Economics Working Paper p. 40.
[380] H.J. Krummel above note 305 ps 33-55.
[381] R. Kroszner and R. Rajan, above note 372 p. 810.
[382] A. Gande, M. Puri, A. Sanders and I Walter "Bank Underwriting of debt Securities: Modern Evidence" [1997], The Review of Financial Studies p. 1175.

> discount. For this reason it seems unnecessary to prohibit the combination of commercial banking and investment banking to protect investors."[383]

As Santos explains, the real issue regarding conflicts of interest is not its mere existence, but whether the bank has incentives and opportunities to exploit them.[384] There are different mechanisms of control of conflicts of interest: market based, regulation based or a combination of both.[385] Market based mechanisms rely on reputational risk, credit rating monitoring, and supervision by regulatory agencies. Regulation based mechanisms rely on the implementation of "walls" between activities, such as the Glass-Steagal Act in the US.

While empirical evidence shows conflicts of interest are somehow internalized by the public and the effects of conflicts of interest can be "abolished" by mechanisms of control, the conclusion might be the mere existence of conflicts of interest, that arise not only in universal banks, but also in specialized institutions, is not a fundamental argument to prohibit the expansion of commercial banks in other financial sectors such as securities and insurance. While market based mechanisms might be effective in some cases, a combination of market and regulation based control mechanisms might be a useful tool to tackle the exploitation of conflicts of interest by universal banks. That being said, it is also true the sole regulatory standard would not be capable by itself to stop dishonest behaviour.[386] A whole new ethical environment should be developed, possibly based on a virtue based system, which by definition would take time to develop, and at the end it would rely on the human conduct of leaders and employees of the banks.[387]

Insider dealing was a normal way of doing business in Germany until the advent of the EU directives forbidding it.

> "In Germany, no regulations regarding insider trading existed before 1970. From 1970 to 1994, only voluntary guidelines existed. In 1994, the Securities Trading Act, or *Wertpapierhandelsgesetz*, was passed, prohibiting trading on private information by corporate insiders."[388]

The whole development of securities regulation in the EU mirroring the US development (albeit a few decades later in the case of the EU) was a massive change in the way Germany had to do business. Transparency and disclosure reformed German financial markets, leaving behind decades of transparency underdevelopment.[389]

3.1.5.3. Costs from the perspective of the bank itself: organizational costs

The German model may have organizational problems of its own. First, there may be costs of coordination of the various units of the bank. Coordination may jeopardize the necessary synergies a universal bank needs to create in order to lower the general costs

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383 P. Klein, R. Wuebker, and K. Zoeller "Relationship banking and conflicts of interest: Evidence from German initial public offerings" [2016], Journal of Corporate Finance p. 220.
384 J. Santos above note 112 p. 42.
385 I. Walter, above note 127, p. 19.
386 J. Canals, above note 234, p. 130.
387 R. Lastra and M. Sheppard Gelsi "Ethical Foundations of Financial Law" in C. Russo, R. Lastra and W. Blair *Research Handbook on Law and Ethics in Banking and Finance* (Elgar 2019) ps 55-72.
388 James H. Thompson "A Global Comparison of Insider Trading Regulations" [2016], International Journal of Accounting and Financial Reporting p.11; see also J. H. Jr. Freis, above note 302 p.30.
389 J. H. Jr. Freis above note 302 p.6.

or increase revenues.[390] Second, there might be a "motivation problem" between managers with the same qualifications, but working in different units of the bank, such as commercial and investment banking. As the competitive features are different, the market would differ the salary and bonus scales. However, these compensation differences within the same entity may create distrust and endanger coordination between different units.[391]

A second organizational cost is the existence of "influence costs". These are activities that are not productive "which seek to modify income distribution between different groups". In order to manage the influence costs the universal bank needs to establish ways to distribute the costs and profits within itself, which is generally controversial among managers. [392]

3.1.6 German Banking System.

In 1991 a document from the Department of Treasury described the German banking model as "arguably the most liberal in the world and is generally perceived to be the model for the future in the European Community".[393] The Bush administration was looking for a new deal for US banks, arguing the Glass-Steagall Act separation was unnecessary. The German model has changed little from that time to the present and the Treasury prophecy that Germany´s model would be an example for the EU was largely fulfilled. The main features of the universal banking system comprise: 1) a broad scope of allowed activities, 2) a variety of allowed investments and a scope of allowed owners.[394]

1. Permissible Activities

As stated in Chapter 2, according to the Banking Act, section 1, credit institutions "are undertakings which conduct banking business commercially or on a scale which requires commercially organized business operations" and they may offer a variety of financial services such as 1) the acceptance of funds from others as deposits […]; 2) the granting of money loans and acceptance credits (credit business); 3) discount business; 4) principal broking services; 5) safe custody business; […] 8) guarantee business; 9) bill collection business; 10) underwriting business; and, 12) "acting in the capacity of a central counterpart".[395] However there are some limitations. The same Act defines Financial Services Institutions, which "are undertakings which provide financial services to others commercially or on a scale which requires commercially organized business operations, and which are not credit institutions." Financial services comprise: 1) investment broking, 2) investment advice), 3) operation of a multilateral trading facility, 4) the placing of financial instruments without a firm commitment basis (placement business), 5) contract broking, 6) portfolio management, 7) proprietary trading, 8) the brokering of deposit business with undertakings domiciled in a state outside the European Economic Area (non-EEA state) (non-EEA deposit broking), 6th) crypto custody business , 9) foreign

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[390] J. Canals, above note 234, p 119.

[391] Ibid. Wilmarth, *Taming the Megabanks* above note 338, p.10 suggest, based in T. Philipon and A. Reshef "Wages and Human Capital in the US Finance Industry" [2012], Quarterly Journal of Economics ps. 1551-112, there is a close connection between the rise of bonuses for insiders when universal banking was deregulated in the US, in the 1920´s and 1990´s and 2007.

[392] Ibid. See R. Herring and A. Santomero, above note 110, p 231.

[393] US Department pf the Treasury "Modernizing the Financial System. Recommendations of safer, more competitive banks" (1991) ps 54-61.

[394] See generally T. Baum and M. Gruson above note 243 ps 101-129.

[395] Banking Act <http://www.gesetze-im-internet.de/kredwg/ > accessed 2 May 2021.

currency dealing, 10) factoring, 11) financial leasing, 12)asset management 13) limited custody business. Both entities, credit institutions and financial services require authorization pursuant to section 32 (1) of the Banking Act. Banking supervision in Germany is shared by the Bundesbank and the Federal Financial Supervisory Authority (BaFin).

A first limitation of the universal banking model is that banks may not engage in the insurance business by issuing insurance policies.[396]Insurance Companies require a license pursuant to the Act on the Supervision of Insurance Undertakings (*Versicherungsaufsichtsgesetz* – VAG). Section 15 (1) requires

> "Beyond insurance business, the insurance undertakings are only permitted to carry on such other business as is directly related with insurance business. Such a relationship shall be deemed to exist in the case of dealings in futures, options and other financial instruments if these are to serve as hedge against price and interest rate risks in connection with existing assets or future purchases of securities or if any additional return is to be generated on existing securities, without performance of delivery obligations causing a shortfall of the restricted assets." [397]

However, banks are allowed to sell insurance issued by licensed insurance companies and are allowed to own insurance companies.[398]

A second limitation is the so called "ring-fencing" of banking and certain investment activities. The "Act on Ring-Fencing and Recovery and Resolution Planning for Credit Institutions and Financial Groups" of 7 August 2013 (Bank Separation Act) includes certain prohibitions in section 3 (2) of the German Banking Act as of 1 July 2015. The purpose of the Bank Separation act is to ring-fence the deposit and lending business of large institutions preventing them from engaging in risky transactions.[399] The subjects of this prohibition are "CRR [Capital Requirements Regulation] credit institutions and of groups of institutions, financial holding groups, mixed financial holding groups or FCs which include a CRR credit institution" where their balance-sheet positions exceed EUR 100 billion (absolute threshold) in financial assets available for trading purposes and available for sale, trading portfolio and liquidity reserves. The same applies if they "amount to at least €90 billion as at the reporting date in each of the three preceding financial years, if they exceed 20% of the total assets from the preceding financial year" (relative threshold). [400]

Section 3 (3) of the German Banking Act states a group exceeding one of the thresholds specified above shall, "no later than six months after exceeding one of the thresholds, identify by means of a risk analysis which of its business activities are prohibited", and, within 12 months after exceeding one of the thresholds, "discontinue such prohibited business" or "transfer it to a financial trading institution".[401] The financial trading

[396] T. Baum and M. Gruson above note 243 ps 101-129, and M. Gruson and R. Reisner Regulation of Foreign Banks, United States and International, Second Edition, 1995, p. 15-19.
[397] Act on the Supervision of Insurance Undertakings (Versicherungsaufsichtsgesetz – VAG). Section 15 (1)
[398] Ibid.
[399] Section 3 (2) of the German Banking Act.
[400]EBA "EBA publishes an Opinion on the perimeter of credit institutions" (2014) available at <https://www.eba.europa.eu/-/eba-publishes-an-opinion-on-the-perimeter-of-credit-institutions>, accessed 24 August 2018.
[401] Section 3(3) of the German Banking Act.

institution must be economically, organizationally and legally independent.[402] Finally, the engagement in prohibited activity is subject to an imprisonment or a fine.[403]

2. Permissible investments and owners

German banks are allowed to invest in other banks, commercial and industrial company shares, and insurance companies.[404] However, anyone who wants to acquire a significant holding in a credit institution must notify BaFin and the Deutsche Bundesbank.[405] A significant holding is a qualifying holding pursuant to Article 4 (1), number 36 of CRR as last amended, which defines it as a "direct or indirect holding in an undertaking which represents 10 % or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of that undertaking". In the Single Supervisory Mechanism (SSM) the European Central Bank is the one that would approve such an acquisition. Also,

> "Anyone who intends to dispose of a significant holding in an institution or to reduce the amount of his/her significant holding below the thresholds of 20%, 30% or 50% of the voting rights or the capital held, or to change the holding in such a way that the institution ceases to be a controlled undertaking, shall report this in writing to BaFin and the Deutsche Bundesbank without delay."[406]

In the case of intra-group transactions with mixed-activity holding companies, a

> "CRR (Capital Requirements Regulation) institution which is a subsidiary of a mixed-activity holding company is to notify BaFin and the Deutsche Bundesbank of any significant intra-group transactions with mixed-activity holding companies or other subsidiaries of such mixed-activity holding companies."[407]

There are also reporting obligations for certain credit institutions to report those "borrowers whose credit volume amounts to €1,000,000 or more (threshold for loans of €1 million or more)" to the Deutsche Bundesbank on a quarterly basis (observation period).[408] Additionally, Section 18 of the Banking Act states

> "A credit institution may grant a loan amounting in the aggregate to more than €750,000 or 10% of the institution's liable capital pursuant only if it requires the borrower to disclose his or her financial situation, in particular by submitting the annual accounts. The credit institution may waive this requirement if, in the light of the collateral provided or of the co-obligors, there is evidently no reason to require such disclosure."[409]

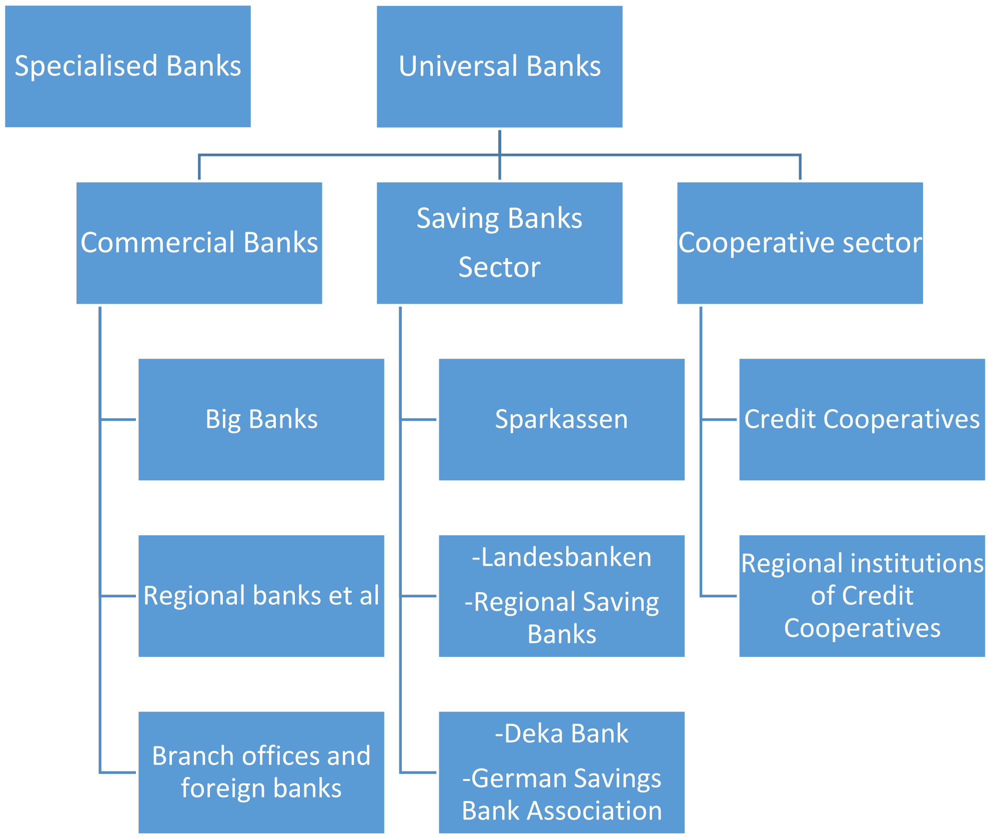
3.1.6.1 The Three Pillar Structure

[402] Section 25f of the German Banking Act.
[403] Section 54 (1) of the German Banking Act.
[404] T. Baum and M. Gruson above note 243 ps 101-129; Section 2c of the Banking Act.
[405] Section 2c of the Banking Act.
[406] Section 2c (3) of the Banking Act.
[407] Section 13 c of the Banking Act.
[408] Section 14 of the Banking Act.
[409] Section 19 include "asset items" in the concept of loans regading sections 13, 14 and 18 of the Banking Act.

As stated above, the German banking system is universal. The “three pillar structure” of the German System is formed by: 1) Commercial banks (private banks); 2) Savings banks; 3) Cooperative banks.

Commercial banks are part of the private sector and comprise the big or major banks (*Grossbanken*), regional banks and branch offices, foreign banks and banks owned by individuals. The savings banks public sector encompasses the savings banks (*Sparkassen*), the *Landesbanken* or giro central banks (*Landesbanken-Girozentralen*) and other state owned banks (*Landesbanken*). The savings banks and *Landesbanken* are owned by government entities such as municipalities, states or other public entities. The third pillar comprises the cooperative banks and the cooperative central banks.[410] Figure 6 shows the structure of the Three Pillar System, while Table 3 describes the number of financial institutions as 2020.

Figure 6. Three Pillar Structure as of 2020



Source: Bundesbank[411]

Table 3. Number of financial institutions in Germany

[410] R. Faltermeier above note 234 p. 15; M. Gruson and R. Reisner above note 396 p 15-21.
[411] Bundesbank, 2020, <https://www.bundesbank.de/resource/blob/829942/0900bba6177ef6e98725475ebda0fc7e/mL/bankstellenstatistik-2019-data.pdf > Accessed 8 April, 2021.

Institution	Year 2019
Big Banks	4
Regional and securities trading banks and other commercial banks	185
Branches of foreign banks and securities trading banks	185
Landesbanken	6
Savings banks	380
Regional institutions of credit cooperatives	1
Credit cooperatives	830
Other credit institutions affiliated with the BVR	14
Mortgage banks	10
Special purpose banks	19
Private building and loan associations	11
Public building and loan associations	8
Housing enterprises with savings facilities	47
Central securities depositories	1
Guarantee banks and other banks	16
Total	**1.717**

Source: Bundesbank, 2020[412]

As an EU member state, the German banking framework is based on EU directives and regulations, primarily on CRR. The main German Banking regulation is the Banking Act (*Kreditwesengesetz*, or KWG) which comprises licensing requirements, ownership control and supervision. Other laws deal with specialized institutions such as building societies (*Bausparkassen*) and investment funds (*Kapitalverwaltungsgesselschaften*).[413]

A. The First Pillar

The financial institutions that form the first pillar are subject to private law and organized generally as limited partnerships with share capital (*Kommanditgesellschaften auf Aktien*) or joint stock corporations (*Aktiengessellschaften*). Some smaller private banks are limited partnerships or even general partnerships, which are not protected by limited liability. Since the 19th century, these banks have been offering retail, wholesale and investment banking services.[414] As licensed banks, they need to comply with the German banking regulation and banking supervision by the BaFin in cooperation with the Bundesbank.

The first group of commercial banks are the big banks. There are four *Grossbanken* in Germany: 1) Deutsche Bank Aktiengesellschaft; 2) Commerzbank Aktiengesellschaft; 3) Hypo Vereinsbank and 4) Deutsche Post (which was acquired by Deutsche Bank). In terms of assets, the four major banks account for almost 65%.[415] The big banks have traditionally acted as house banks to Germany´s industrial firms, providing long-term finance, sitting on the supervisory boards, owning its shares and exercising proxy votes

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412 Ibid.

413 H. Haag, J.L. Steffen and H. Mueller "Banking regulations in Germany: overview" in <https://uk.practicallaw.thomsonreuters.com/w-007-4084?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1> accessed 7 August 2018.

414 D. Dietrich and U. Vollmer, above note 233, p. 127.

415 R. Faltermeier, above note 234, p. 16.

of other shareholders.[416] An empirical study from Elsas and Krahnen concludes that relationship lending is common "among mid-sized firms" and that it is not a "myth" but a fact, with real economic effects on the financing of corporations.[417] They also conclude that "contrary to the common presumption in the literature, evidence does not suggest that banks use proxy-voting rights as a systemic way to influence management decisions".[418] In a similar way "Studies concerned with the impact of a firm's bank dependence on performance consistently find a positive impact of direct equity holdings by banks. In contrast, proxy-voting rights and supervisory board representation by banks appear to be irrelevant for management control". The argument implies that the main advantages of house bank relationship derive from the equity holdings and not directly by proxy rights and supervisory control.[419] A 2018 study by the Deutsche Bundesbank affirms that after the German Government abolished the capital gains tax on the divestitures of equity stakes in 2010, the German banks sold most of their equity shares in non-bank firms (75% of banks' equity was divested in the 6 years after the tax reform), but the relationship lending did not reduce as a consequence of such divestitures.[420]

However, lending by big banks to non-banks has declined from 75% of big bank assets in the 1960s to 25% in 2011. In order to turn this situation around, big banks tried to lend to small and medium size firms, but this was unsuccessful due to the strong bond between savings banks and local firms. In the interim, big banks started developing investment banking. Deutsche Bank bought the English investment bank Morgan Grenfell (1990) and in turn, Dresdner bought Kleinwort Benson (1995).[421]

The second group of commercial banks comprises smaller joint stock banks which operate on a local level. Two foreign banks are included in this group: ING and Santander Consumer Bank. Also, it comprises banks set up by industrial firms like Volkswagen Bank and Mercedes-Benz Bank.[422]

The last group comprises branches of foreign banks, which encompasses almost half of the total balance sheet assets of regional banks and almost one quarter of big bank assets.[423]

B. The Second Pillar

The second pillar comprises savings banks (or *Sparkassen*), the *Landesbanken* and DekaBank,[424] and a parallel structure of associations which comprises regional savings bank associations and the German Savings Bank Association (Deutscher Sparkassen-und

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[416] D. Detzer, N Dodig, T. Evans and H Herr, above note 304 p.33; M. Gruson and R. Reisner, above note 396, p 15-19.
[417] R. Elsas and J.P.Krahnen "Universal Banks and Relationships with Firms" above note 330 p. 211.
[418] Ibid.
[419] Ibid.
[420] B. von Beschwitz and D. Foos "Banks´ equity stakes and lending: evidence from a tax reform" [2018], Discussion paper Deutsche Bundesbank No 06 p.3.
[421] D. Detzer, N Dodig, T. Evans and H Herr above note 304, p 79.
[422] Ibid. See <https://www.vwfsag.de/en/home/unternehmen/Volkswagen_Bank_GmbH.html accessed 13 August 2018; https://www.mercedes-benz-bank.de/de.html >accessed 18 August 2018.
[423] Deutsche Bundesbank Monthly Report as of July 30, 2018 <https://www.bundesbank.de/Redaktion/EN/Downloads/Statistics/Banks_Financial_Institutions/Banks/Tables_Monthly_Reports/ime2425.pdf?__blob=publicationFile >accessed 18 August 2018.
[424] D. Detzer, N Dodig, T. Evans and H Herr above note 304, p 79.

Giroverband – DSGV).[425] The first savings bank was founded in 1778 in Hamburg with the aim to "help the poor".[426] At the beginning the savings banks were established in towns, but later on, rural counties also founded savings banks. The aim was to give the poor the opportunity to earn interest on deposits of their savings, even though they were small. It was only in 1840 that savings banks started to provide credit to small local firms. One main feature of the savings bank from the beginning was they were not profit-motivated or shareholder-value oriented, since it was a public function of the local governments to encourage deposit taking and providing credit to "middle classes". One reason why the savings banks developed regionally was Germany did not have a central government until 1871.[427]

The legal basis of savings banks' establishment and organization are the relevant Savings Banks Act (*Sparkassengesetz*) in each state and its articles of incorporation. As credit institutions they are subject to German Banking Law (mainly the German Banking Act and Securities Trading Act).[428] As licensed banks, they are subject to bank supervision by the Federal Financial Services Authority (BaFin), in cooperation with the Bundesbank. Savings banks are generally organized as independent instrumentalities under public law, which need to fulfill a public function. However, after 1997, a few, so called "free savings banks" have been formed. These are self-controlled and controlled by foundations. [429] Savings banks need to comply with the territorial principle, by which the activities and powers to create branches are restricted into an area of a county or municipality that "establishes and sponsors" the savings bank.[430]

The designation "*Sparkasse*" is protected by law. The Banking Act, section 40 states:

> "(1) The term "savings bank" ("Sparkasse") or a term in which the words "savings bank" appear may be used in the corporate name, as an addendum to the corporate name, to describe the business purpose or for advertising purposes only by: 1 public savings banks with authorization pursuant to section 32; 2 other undertakings which, upon this Act coming into force, were legitimately using such a term pursuant to previous provisions; 3 undertakings which are newly established by restructuring the undertakings specified in number 2 as long as they, by virtue of their articles of association or articles of incorporation, exhibit specific features (in particular, tasks geared towards public welfare and a restriction of their principal business operations to the economic area in which the undertaking is domiciled) to the same extent as before restructuring."

The wording of the disposition may be interpreted as forbidding foreign savings banks that are organized under private law, such as Spanish *cajas*, to establish themselves as *Sparkassen* in Germany. In 2006 the EC and Germany made an agreement (Agreement on Sparkasse) confirming the need to comply with European freedom of establishment (Art. 43) and free movement of capital (Art. 56). "The solution confirms the principle of

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425 R. Ayadi, R. H. Schmidt and S. Carbó Valverde "Investigating Diversity in the Banking Sector in Europe: The Performance and Role of Savings Banks" [2009] CEPS, p.122.
426 T. Guinnane above note 248, p. 84.
427 M. Gruson and U. Schneider, above note 237 p. 345.
428 P. Scherer, S. Zeller *Banking regulation in Germany* (German Law Publishers, 2009), p.23.
429R. Ayadi, et al, above note 425 p. 122.
430 Ibid.

neutrality of Community law as regards the decision to privatize a public enterprise (Article 295 of the Treaty). It recognizes that in the application of national law, Community law has to be respected." [431] Such agreement was incorporated in section 41 of the Banking Act."[432]

Historically, regional regulation of savings banks tended to protect the small depositors by imposing restrictions on lending. For instance, like Bavaria in 1811, savings banks were forbidden to grant loans without real estate guarantees.[433] Nowadays, some legal acts limit the activities of its savings banks in various ways: upper limits for lending activities, limits for the acquisitions of shares and participations, restriction on risky business. The doctrine of *ultra vires* additionally restricts activities that violate the purpose of the public law institution, in that "any legal action not covered by its purpose is declared null and void".[434] While savings banks are not obliged by law to apply the regional principle, they generally observe it, by lending and operating with customers within a delimited territory.[435]

Many of the *Sparkassen* are municipal savings banks. As public law institutions *Sparkassen* have "no owner in the legal sense" but responsible institutions or "*Trager*". The *Trager* remain similar to a private owner, but present more restrictions, such as that they are not allowed to sell the bank, or that the right to take out profits is weak, since articles of association rely strongly on self-financing.[436]

The second level of savings bank sector are the regional *Landesbanken*. They are in general owned by regional associations of *Sparkassen* and the regional states. Originally the *Landesbanken* acted as bankers for the state and as central bank for the *Sparkassen* of the region.[437] Later, they added other financial activities that were difficult for local saving banks to offer due to their smaller size.[438] Nowadays, as stated above, the *Landesbanken* conduct universal banking: commercial, investment and other financial activities, as well as finance public and private projects, and "perform certain treasury functions for the states". The business of the *Landesbank* may overlap those of the *Sparkassen*. The main differences are *Sparkassen* are smaller and need to follow the territorial principle, something that is not applicable to *Landesbanken*.[439] Another feature of *Landesbanken* (together with the *Sparkassen*) were the statutory guarantee for the bank liabilities known as *Anstaltslast* (maintenance guarantee) and the *Gewahrtragerhaftung* (Guarantee obligation). *Anstaltslast* means the owners are responsible for "securing the economic basis of the institution and its function during its existence." *Gewahrtragerhaftung* means the guarantor will "meet all liabilities of the bank which cannot be satisfied from its assets". Both guarantees were not limited, and the banks did not pay any remuneration for them.[440] In the 1990s private banks challenged the system stating that it violated European competition and State Aid rules. In December 1999 the

[431] EC "Agreement on 'Sparkasse'" <http:europa.eu/rapid/press-release_IP-06-1692_en.pdf> accessed 15 August 2018.
[432] German Banking Act, Section 41.
[433] T. Guinnane, above note 248, p. 86.
[434] M. Benzler in P. Scherer, S. Zeller, above note 428 p.26.
[435] R. Ayadi et al, above note 425, p 119.
[436] Ibid p 119.
[437] D. Detzer, N Dodig, T. Evans and H Herr above note 304, p 79.
[438] R. Ayadi et al, above note 425, p 1195.
[439] M. Gruson and U. Schneider, above note 237 p. 353.
[440] EC "Commission requests Germany to bring State guarantees for public banks into line with EC Law" 8 May 2001, <http://europa.eu/rapid/press-releaseIP-01-665en.pdf>accessed 13 August 2018.

European Banking Federation filed a complaint before the Directorate General of Competition of the European Commission. In May 2001, the EC proposed the German Government "appropriate measures" to render the guarantee system compatible with the State Aid European rules. By letter of 11 April 2002, the German government accepted a commission's proposal, where: 1) *Gewährträgerhaftung* were abolished; 2) "*Anstaltslast*, as it exists now, shall be replaced in order to comply with the certain principles in order to comply with State Aid Rules".[441]

The third level of the savings bank sector is the DekaBank, owned by the German Bank Savings Association (DSGV) and the *Landesbanken*, and the DSGV itself. "DekaBank's roots date back to the year 1918, when Deutsche Girozentrale (DGZ) was founded. Deka as an investment company was founded in 1956; DGZ and Deka joined forces to create DekaBank in 1999." DekaBank acts as central asset manager for the savings bank sector. According to its webpage "DekaBank is the *Wertpapierhaus* of the German savings banks and, together with its subsidiaries, forms the Deka Group. With total customer assets totaling approximately €283 billion as at December 2017 and around four and a half million managed securities accounts, the Deka Group ranks among Germany's major securities service providers. It ensures access to a wide range of investment products and services for retail and institutional investors."[442] The DSGV is the "umbrella organization" of the Sparkassen-Finanzgruppe, which is a network of savings banks and *Landesbanken*."[443]

C. Third Pillar

The third pillar comprises the largest number of institutions in the German banking system (830 in 2019). The International Cooperative Alliance defines a cooperative bank as follows: "An autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise"[444] Cooperatives are owned by their members, who receive a "profit-dependent" benefit. Their main function is to support the business of their members. As with *Landesbanken* in Pillar 2, there are central institutions which provide several services to individual cooperatives.[445] Originally, cooperatives were a response to financial constraints as a result of lack of interest in other financial institutions in small craftsmen and farmers. Private bankers were focused on trade finance, commercial banks focused on manufacturers and transport, and savings banks requested collateral.[446] The cooperative societies were first founded by Frank Hermann and Friedrich Raiffeisen in 1865. The "Raiffeisen cooperatives" were a network of agricultural credit institutions that allowed their members to borrow money to pay bills before the harvest. The beginning of the cooperative business lied in the savings and short

[441] EC Commission "Germany agrees on the implementation of the understanding with the Commission on State guarantees for Landesbanken and Savings Banks" <http://europa.eu/rapid/press-release_IP-02-343_en.htm?locale=en.> accessed 13 August 2018
[442] Deka Bank: <https://www.deka.de/deka-group/about-us/profile > accessed 15 August 2018.
[443] DSKV "Missions and Objectives":< https://www.dsgv.de/en/about-us/index.html >accessed 15 August 2018.
[444] ICA (2007), "Statement on the Co-operative Identity", International Cooperative Alliance website, 26 May 2007, <http://www.ica.coop/coop/principles.html.> Accessed 15 August 2018.
[445] F. Hüfner, "The German Banking System: Lessons from the Financial Crisis", [2010] OECD Economics Department Working Papers, p. 92.
[446] A. Hackethal "German Banks and Banking Structure" in Krahnen and R. Schmidt above note 302 p. 83.

term lending business, but it evolved into a truly universal banking system.[447] A Second type of cooperative were the "*Volksbanken*" (people´s banks) that mainly functioned in cities. According to Section 39 of the Banking Act, "The term 'people's bank' ("*Volksbank*") or a term in which the words 'people's bank' appear may be newly taken up only by credit institutions operating in the legal form of a registered cooperative society and belonging to an audit association."[448] The founder of *Volksbanken* was Hermann Schulze, a former mayor of Delitzsch, Saxony.[449] The most important difference between *Volksbanken* and *Raiffeisen* cooperatives were that the former often switched to limited liability (after the 1899 Act), paid dividends, had more staff and were larger than the latter. The *Raiffeisein* cooperatives had small shares and provided long loans, which made them less liquid, and at the same time relied on strong enforcement mechanisms, since in rural areas members knew each other and could impose economic and extra-economic sanctions on each other.[450]

The legal form of the cooperatives in general is a "registered cooperative society" (*Eingetragene Genossenschaft*) according to the German Cooperative Act. The cooperative aim is the promotion of its members by collective business operations.[451] As licensed banks, cooperative banks need to comply with the German banking regulation and banking supervision by the BaFin in cooperation with the Bundesbank.

Several principles guide credit cooperatives' organization.[452] The "principle of self-help" means cooperatives are self-governed private organizations.[453] Members contribute their savings, which are at the same time the lending facilities for the local business. For the first 50 years of existence of cooperatives, these same members were active in monitoring borrowers, who were motivated by the fact that members were "jointly liable" for all debts of the cooperative. The principle of "identity" indicates members are their own clients. This principle was relaxed in recent years, obscuring the principle by the "so-called non-member business" which permitted cooperatives to conduct business with non-members.[454]The "democratic principle" means that, unlike corporations, cooperative members usually only have one vote, irrespective of their investment in the institution. Additionally, members cannot sell their share. The exit strategy available to members is to redeem their share at nominal value plus accumulated profits.[455] Solidarity shapes cooperatives in the sense that "by law and statute cooperative banks do not have the objective to make as large a profit as possible but rather to serve the economic interests of their members and clients".[456] From 1899 cooperatives were subject to external compulsory auditing, mainly as a request from cooperatives, which understood the need

[447] E. Owen Smith *The German Economy* (Taylor & Francis Group 2002), p 330.
[448] Section 39 of the Banking Act.
[449] R. Ayadi, D. T. Llewellyn, R. H. Schmidt, E. Arbak, W.P. De Groen "Investigating diversity in the banking sector in Europe: key developments, performance and role of cooperative banks" [2010] CEPS, p. 27-29.
[450] T. Guinnane, above note 248, p. 90-91.
[451] M. Benzler in P. Scherer, S. Zeller, above note 428 p. 31.
[452] International Cooperative Alliance "Co-operative Principles" available at <https://www.ica.coop/en/whats-co-op/co-operative-identity-values-principles >accessed 22 August 2018.
[453] P. Behr and R. Schmidt "The German banking System: Characteristics and Challenges" [2015] White paper No.32 p.13.
[454] R. Ayadi, et al, above note 449 p.15.
[455] P. Behr and R. Schmidt above note 453 p.13.
[456] R. Ayadi et al, above note 449, p. 28.

to control management in order to avoid failures and reputational risk, but at the same time preventing government interference.[457]

Many of the main characteristics of the credit cooperative today are: i) the democratic principle; ii) the fact members are not allowed to sell their share, and iii) the limitation of liability, may weaken the incentives for a strong monitoring of management by members. From the manager´s perspective, the incentives for increasing the cooperative's value are also weak, and he will not have to worry for a hostile takeover. The positive side of the system, especially the democratic principle, is that the manager may focus on helping its members, and powerful members will not be able to make managers exploit weaker members – e.g by lowering interest rates on deposits.[458] The negative side is that managers may lack incentives to do their work.[459] The main explanations that compensate for this governance problem are twofold. First, cooperatives compete with other financial institutions; bad managers would not be able to simply underperform, since customers and staff may leave the cooperative. Second, as stated above, cooperatives are subject to a regular auditing process, which is not only an accounting procedure but a more comprehensive one, because it also audits the managerial competence. The audit process acts not only on its own behalf but on that of the institutional protection scheme, which makes the governance system even more effective.[460]

As local cooperatives had an inherent inability to diversify because of the restriction of the regional principle, they developed regional institutions that would operate with local cooperatives, accepting deposits and lending. This was the origin of central cooperatives.[461] Nowadays, local cooperative banks own the central bank, DZ BANK (Deutsche Zentral-Genossenschaftsbank – German Central Co-operative Bank). DZ Bank is a central bank, and at the same time an investment, corporate and investment bank. Additionally, the National Association of German Cooperative Banks (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken – BVR) is in charge of risk monitoring and strategic coordination, and the administration of the sector's mutual protection scheme, "whose goal is to protect the solvency of its member banks".[462]

Table 4. Three Pillar system

	Commercial banks	Savings banks	Credit cooperatives
Main German legal regulation	Banking Act	Savings Banks Act Banking Act	German Cooperative Act Banking Act
Typical legal form	Joint stock corporations Limited partnership with share capital	Independent instrumentalities under Public Law	Registered cooperative society

[457] T. Guinnane, above note 248, p. 92-93.
[458] P. Behr and R. Schmidt above note 453, p 13.
[459] R. Ayadi et al, above note 449, p. 33.
[460] P. Behr and R. Schmidt above note 453, p 13 and R. Ayadi et al, above note 449, p. 33.
[461] Ibid.
[462] S&P Report "Cooperative Banking Sector Germany" (2018) <https://www.dzbank.de/content/dam/dzbank_de/de/home/profil/investor_relations/Ratingreports/SP_CFN_01022018.~a7954890a70df17b5c2503fd0a60cd5b.pdf >Accessed 14 August 2018. Other important cooperatives are the "Cooperative Housing Bank (Bausparkasse Schwäbisch-Hall)", one of Germany's largest building societies, and R+V-Versicherung (one of the largest insurance firms in Germany).

Ownership	Shareholders	*Trager*	Members or non-members
Territorial scope	National and/or international	*Sparkassen*: regional principle *Landesbanken*: national or international	Cooperatives: regional principle
Aim	Profit maximization	Serve public interest Profit optimization	Promotion of members Profit optimization
Exit strategy	Sale of shares	Consolidation	Redemption of shares
Way of earning profits	Dividends	Mostly self- financing	Self-financing or redemption of shares plus accumulated profits Dividends in some cases

Source: Own compilation based on various authors[463]

3.2 Concluding remarks

The definition of universal banking is based on the "activities list" approach which includes commercial, insurance and securities business under the same umbrella. Universal banking is not only a way of organizing a financial group but also defines certain type of capitalism: a capitalism based on long term relations, insider dealing and industry development. Capitalism in Germany evolved from "spoliation and devastation" due to several wars, to the rise of *Kreditbanken*, which accompanied the development of railways, mining and machine industries. Under the influence of Saint Simon, the Pereire Brothers founded Credit Mobilier, the prototype of universal banking and model of further *Grossbanken* in Germany. The main force of the newly universal banks was to favour industry development. According to several economists such as Gerschenkron, universal banks had a leading role in the development of the industry in Germany. As the saying went, the German bank accompanied the industrial firm from "cradle to the grave". This special relationship was anchored in four elements: i) providing all kinds of financial services; ii) owning shares in commercial and industrial firms; iii) taking positions in supervisory bodies; iv) controlling commercial and industrial firms via proxy rights. As it will be analysed in chapters four and five, the German model differ in many ways from the British and US Models, not only in its philosphical and historical foundations, but on the the type of capitalism they founded and the organization of its banking system.

Section 3.1.5 analysed the benefits and costs of universal banking. While there are many benefits and costs, it can be concluded there is no "one fits all" type of bank for all jurisdictions alike. A universal banking system relies on long term relationships, taking advantage of economies of scope and scale, reduction of economic risk due to

[463] R. Faltermeier, above note 234, p. 18; M. Benzler in P. Scherer, S. Zeller, above note 428 ps 23-31; R. Ayadi et al, above note 449, p 119.

diversification, and the gains of one-stop shopping. On the other hand, a natural consequence of providing all three services under one roof is the peril of creating "mammoth entities" which are difficult to manage, supervise and resolve. While universal banking is not a synonym of "systemic", the German model *per se* encourages the formation of entities that are bigger than their specialised counterparts. This poses additional focus on anticompetitive behaviour, abuse of information and benefiting of conflicts of interest. While banning or discouraging universal banking because of the latter may be misleading, special care need to be taken by regulators to encourage competition and ethical behaviour.

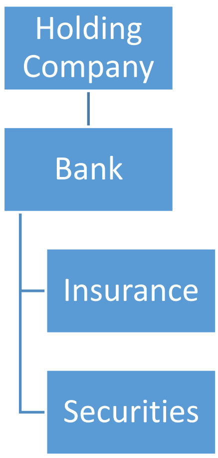
Section 3.1.6 makes a compilation of the "three pillar Structure" of the German universal banking system: i) *Grossbanken* or big banks, ii) savings banks, and iii) cooperative banks. Historically, the three groups have focused on serving different customers, and hence, underpin different business models. The big banks are organised under joint stock corporations of limited partnerships with share capital with shareholders as "owners" of the banks. Their territorial scope is national or international and their aim is profit maximization. Savings banks (the second pillar) are formed of independent instrumentalities by public law, since their responsible institutions are the *Trager*, municipalities or local governments. Their aim is to serve the public interest, while they must also look for profit optimization. They organize themselves under the regional principle (*Sparkassen*) or under a national or international scope (*Landesbanken*). Finally, cooperative banks – the third pillar – are formed under the registered cooperative society, with members or non-members as owners. Their territorial scope is regional and the principal aim is the promotion of members and profit optimization. From a systemic importance view, only one member of the first pillar falls under the G-SIB category: DB. The rest are not systemically important. From a size perspective, the regional territorial scope would segregate cooperatives and *Sparkassen* from the inclusion in the G-SIB list because they would not face cross border issues and they would maintain a size proportional to that of the region

CHAPTER 4. BRITISH MODEL

Following Herring and Santomero's classification, the British model comprises a parent-bank company with non-banking insurance and securities subsidiaries. For this reason, some authors name it the "bank-parent model".[464] However, nowadays most UK banking groups do not encompass a bank-parent company, but a holding company, which is typically a listed company holding shares of a bank. Nevertheless, many UK banking groups resemble the British model's typical structure in that the non-banking activities depend on the bank company and not on the holding company directly, as in the case of the US. This new corporate structure may be called the British Modified model. For this reason, this chapter will analyse the UK banking system and compare the main differences with the German model. The UK also implemented a structural reform, which transformed banking groups' structure operating in the UK. Annex 4 will analyse the corporate structure of Barclays, since it is a UK G-SIB and its corporate structure resembles in part the original British model.

This chapter will examine the nature of the British banking system, a short overview of the history of banking system in the UK, and the alleged lack of links between banks and industry. Sections 4.2-4.4 will survey the types of UK banking groups and structural reform.

Figure 7. British Modified model



Source: own compilation

4.1 British system

Historically, the British banking system (used in the broad sense to include banking – in the narrow sense as deposit-taking activity – and investment banking), has been characterised by four main elements. The first is that the UK has separated the activities of the banking system into merchant banking (investment banking) and commercial banking (clearing banking). The second is that until recently, the industry was self-regulated and authorities used "moral suasion" over explicit regulation. The third is that the industry relied heavily on other sources of funding rather than using banking, like

[464] J. Santos, above note 112, p. 16.

Germany does. Finally, UK banking system is shaped by the City of London. As such, it attracted foreign banks because of London's importance as a banking hub, as well as because London is the Euromarkets capital.[465]

4.1.1. A specialised system that evolved into universal banking

The British financial system separated merchant banking, brokerage and commercial services, though not legally.[466] The British system or specialised system is often compared with the German "Universal Banking" system. Most scholars agree that the British banking system evolved from a specialised system to a universal system after a period of deregulation during the last decades of the twentieth century.[467] Offer believes that after the Competition and Credit Control (CCC) deregulation package, a process began "that led to universal banking..."[468] Others estimate that the UE Second Banking Directive was responsible for the shift to universal banking in the UK.[469] Before this shift, the British financial system comprised a "functional specialisation" system, whereby each function was undertaken by a "different set of institutions."[470]

Although there was no regulation prohibiting banks from undertaking different finance services under the same roof, some policies helped the system to remain specialised. For instance, the Bank of England was not keen to approve certain mergers, such as the merger of the merchant bank Montagu Trust and the clearing bank Midland Bank since it feared the merged bank would be able to evade controls.[471] Also, the London Stock Exchange "restricted membership to partnerships and to those whose sole business was the buying and selling of securities." Therefore, *de facto*, UK banks could not expand into the investment business.[472]

4.1.2 A self-regulated industry

The first domestic act that regulated the conduct of banking in the UK was in 1979. Before that, the Bank of England operated through a system of moral suasion that constituted an informal supervisory body.[473] The Banking Act 1979 required that the acceptance of

[465] A. Saunders and I. Walter, above note 112, p. 113.
[466] C. Folhlin, 'Banking Systems and Economic Growth: Lessons from Britain and Germany in the Pre-World War I Era' [1998] Review, Federal Reserve Bank of Saint Louis p. 39; A. Saunders and I. Walter, above note 112; D. Verdier, above note 237 p. 104; G. Jones, *British Multinational Banking, 1830-1990* (OUP 1995) p. 325.
[467] A. Saunders and I Walter, above note 112; C. Calomiris and S. Haber, *Fragile by Design*: *The Political Origins of Banking Crisis and Scarce Credit* (Princeton University Press 2014) p. 147.
[468] A. Offer, "Narrow Banking, Real Estate and Financial Stability in the UK c.1870-2010" in N. Dimsdale and A. Hotson, *British Financial Crisis since 1825* (2014 OUP) p. 158.
[469] F. Fiordelisi and O. Ricci, above note 232, p. 7; M. Gruson and W. Nikowitz, above note 232, p. 215; N. B. Murphy, above note 232, p. 4; J. Manvell Jeannot, above note 232, p. 1734; G. S. Zavvos, above note 232, p.480; R. Vander Vennet, above note 112, p. 255; A. Dixon, above note 232, p. 19.
[470] A. Offer, above note 468.
[471] F. Capie, *The Bank of England: 1950s to 1979* (CUP 2010) p. 330.
[472] R. Michie, *British Banking: Continuity and Change from 1694 to the Present* (OUP 2016) p.167; R. Michie and S. Mollan, 'British and American Banking in Historical Perspective: Beware of False Precedents' [2011] History and Policy <www.historyandpolicy.org/policy-papers/british-and-american-banking-in-historical-perspective-beware-of-false-prec> accessed 16 July 2019.
[473] S. Konzemannn, M. Fovargue-Davies and G. Schnyder, "The Faces of Liberal Capitalism: Anglo-Saxon Banking in Crisis?" [2012] Cambridge Journal of Economics p. 508; C. Goodhart, "The Bank of England 1970-2000" in R. Michie and P. Williamson (eds) *The British Government and the City of London in the*

deposits from the public needed prior authorization by the Bank of England. This Act was a response to the First Banking Directive, which required formal authorization and supervision of the banking system.[474]

The Bank of England was founded in 1694 after the Glorious Revolution of 1689. As the government needed funds, it chartered three corporations, the Bank of England, the New India Company (1698) and the South Sea Company (1711). The chartered companies lent funds to the government, which in return received a promise of an annual payment secured by a source of revenue. The government granted a charter that gave a monopoly in certain commercial activity. As Grossman affirms, the Bank of England was born due to the government need for war funding, and not on "any desire to foster the growth of banking or to promote monetary stability."[475]

It was only in 1946 that the parliament passed the Bank of England Act, which nationalised the bank. Section 4 of this Act states, "the Bank, if they think it necessary in the public interest, may request information from and make recommendations to bankers, and may, if so authorised by the Treasury, issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation."[476] Although Section 4 gave the Bank of England such supervisory role, it generally relied "on its considerable influence in the banking sector to achieve its goals through informal discussion and persuasion."[477] According to Morton, this practice stemmed from three sources: 1) the Bank of England was the highest authority over UK money markets, hence all banks wanted to have good relations with it; 2) there were certain statutes that allowed some benefits for banks if included in certain lists. The Bank of England was the body that maintained the lists or gave input to those in charge of maintaining those lists; and, 3) the Bank of England had a moral authority as the banker and adviser of the Government.[478]

Michie affirms that this self-regulated system proved to be stable: "by the late nineteenth century there was an implicit belief that the British banking system that had emerged by then was as close to perfection as it was possible to achieve…combining the virtue of stability with the ability to meet the needs of both savers and borrowers."[479] This statement was reinforced by the fact that there were no significant banking crises in the UK from 1878 to 1991.[480] Cassis suggests the last significant crisis in the UK prior to the GFC was that of Baring in 1890.[481] Grossman concurs with Cassis, stating, "The most famous English bailout of the nineteenth or twentieth century was that of Baring Brothers in 1890, although there were others. More extreme measures, in the form of a government takeover, bank moratorium, or bank holiday were never employed in England for the

Twentieth Century (CUP 2009) p. 340; C. Proctor, *The Law and Practice of International Banking* (OUP 2015) p. 4.

474 C. Proctor, above note 473, p. 4.

475 R. Grossman, *Unsettled Account: The Evolution of Banking in the Industrialised World since 1800* (Princeton university press 2010) p. 171.

476 Bank of England Act 1946, s 4.

477 G. Morton, 'Banking Regulation and Treatment of Foreign Banks in the United Kingdom' in M. Gruson and R. Reisner *Regulation of Foreign Banks: United States and International* (1995) ps 22-25.

478 Ibid.

479 R. Michie, above note 472, p. 16.

480 Ibid. According to Grossman, the UK suffered banking crises in 1720 (South Sea Bubble), 1763, 1772, 1783, 1788, 1793, 1797, 1810, 1825, 1836, 1847, 1857, 1866 and 1890, before the 2007/8 crisis. Above note 475, p. 189.

481 Y. Cassis, *Crises and Opportunities* (OUP 2011) p.4.

simple reason that such extreme measures were primarily a product of the first third of the twentieth century, and English Banking was remarkably stable during the fifty years following the Baring crisis".[482] Capie also reminds us that "from 1866 onwards there were essentially a hundred years of financial stability without any financial crises."[483]

However, some authors complain about the role British banking has played on financing the long-term needs of the industry. Others understand that the British banks were London-oriented and underestimated the needs of the provinces. Further, they claim the British banks were over-conservative in their lending, which stymied economic growth.[484] Given this opinion, it is necessary to analyse the role of the British system in the development of industry in the UK.

4.1.3 Banks and industrial finance

It is widely believed, both in economic and popular literature, that banks failed the industry in the UK. There are periods where this line of thinking arose with force: during the end of nineteenth century, before World War I, during the interwar period and after World War II. [485] Collins states,

> "in Britain…it is widely accepted throughout most of the past century-and-a-half the main financial institutions- the deposit banks, the discount houses and the merchant banks-have concentrated on short-term credit provision and/or on holding their longer term assets in the form of government and public utility securities. They seem to have shied away from long-term loans and investments to domestic industry and it is this, which is said to have been in the detriment of the industry. It is in this sense that banks are alleged to 'have failed' the industry."[486]

Some commentators show that Germany outperformed the UK in this field. Clapham, Gerschenkron, Jeffreys and Kennedy believe the German system accounted for German economic development.[487] Kennedy states, "With all their documented imperfections, by making resources available to a large group of technologically progressive industries on a scale unequalled in Britain, account for much of the difference in the economic growth performance between (Germany) and Britain in the half century after 1865."[488]

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[482] R. Grossman, above note 475, p. 191.
[483] F. Capie, "British Financial Crisis in the Nineteenth and Twentieth Centuries" in N. Dimsdale and A. Hotson (eds), *British Financial Crises since 1825* (2014 OUP) p. 13.
[484] R. Michie, above note 472, p. 17; M. Collins, 'Banks and Industrial Finance in Britain 1800-1939' above 480 p. 1; H. S. Foxwell, "The Financing of Industry and Trade" (1917) The Economic Journal, Vol 27 505 p. 27; A. Gerschenkron, above note 272 ps 1-15.
[485] M. Collins, *Banks and Industrial Finance in Britain*, above note 484, p. 1.
[486] ibid 3.
[487] J. Clapham, *The Economic Development of France and Germany 1815-1914* (CUP 1936) p. 390; A.Gerschenkron, above note 272 ps 1-15; J. Jeffreys, *Trends in Business Organisations in Great Britain since 1856, with Special Reference to the Financial Structure of Companies, the Mechanism of Investment and the Relations between the Shareholder and the Company* (University of London 1938); Kennedy, *Industrial Structure, Capital Markets and the Origins of British Decline* (CUP 1987) p. 120.
[488] W. Kennedy, above note 487, p. 120; W. Carlin and C. Mayer, 'How Do Financial Systems Affect Economic Performance?' [1999] University College London and Said Business School, University of Oxford p. 4.

As referred to in Chapter 3, Gerschenkron showed that England was the first country to industrialise. According to him, industrialisation was gradual, and the capital needs for the industry were obtained by retained earnings of agriculture, commercial and, at the end, industrial enterprises. This was not the case of continental countries with economic backwardness, where there was urgency to fund new industries and to create institutional vehicles to obtain such capital.[489] German banks were the institutional vehicles that permitted the strategic planning of industrial development. England had the appropriate banking system for the needs of the Industrial Revolution, but it did not accompany the evolution of a maturing economy.

Elbaun and Lazonick are called "institutionalists" since they allege the UK has not generated during the nineteenth century institutions able to suit twentieth century corporate capitalism.[490] Specifically, they suggest UK financial institutions have concentrated on short-term financing, restricting long-term finance for the industry; the City has preferred financing international trade and not domestic industry finance; and that city institutions have lobbied to use exchange rate and monetary policy to their advantage.[491]

Others believe an explanation of the British industry decline is due to a "City-land fusion against industry." Daunton describes this historical interpretation:

> "The financial sector which contributed to the reshaping of the industry in Germany and America was not involved with British industry, so that financial leverage was not available. On the contrary, the concentration of financial power in the City, and integration with the elite, produced a more coherent influence over policy than was possible for industrialists divided by sector or region; industrial problems were therefore aggravated by measures designed to benefit the City".[492]

According to them, the Industrial Revolution created two capitalisms: 1) Industrial Capitalism (economy of the provinces, "producer's England of the North, loyal to free trade and hostile to the House of Lords and "land") and; 2) Commercial Capitalism (economy of the metropolis, England of the South, dominated by "ostentatious leisure" and "conspicuous waste", supporting the House of Lords and "land").[493]

Although these theoretical assumptions try to explain the reasons why the British banking system has failed the industry, it is not possible to give general explanations without understanding the historical, economic and legislative facets of the different periods during and following the Industrial Revolution. The first period runs from 1750 to 1830, the second runs from 1870 to 1914, the third is the interwar period, and the last is post WWII.

It is important to note that England's industrialization levels from 1750 to 1830, taking into account manufacturing output, were outstanding. During that period, the

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[489] A. Gerschenkron above note 272 ps 1-15.

[490] B. Elbaum and W. Lazonick (eds), *The Decline of the British Economy* (OUP 1986); F. Capie and M. Collins, *Have the Banks Failed British Industry?* (IEA 1991) p. 23; M. Collins, above note 484, p. 8.

[491] M. Collins, above note 484, p. 10.

[492] M. Daunton, *"Gentlemanly Capitalism" and British Industry 1820-1914. Past and Present* (OUP 1989) ps 126-127; E.H. Green, 'Rentiers versus Producers the Political Economy of the Bimetallic Controversy' [1998] English Historical Review p. 611; G. Inham, *Capitalism Divided: The City and Industry in British Social Development* (Macmillan 1984) p. 9; M. Collins, above note 484 p. 13.

[493] Ibid.

manufacturing output rose by a factor of seven. Taking aside the population expansion, Bairoch estimates the UK was responsible for two thirds of Europe's industrial growth of output during the period.[494] While the authors who believe banking failed industry during the Industrial Revolution do not deny this figure, they focus on the lack of banking lending and its probable negative impact on industrial development. During the Industrial Revolution (1760-1830) industrialists generally used their own funds – undistributed funds – and family and friends' money to fund their enterprises. "As a result the demands on banks for long-term industrial funds were not great."[495] At that time, banks were small enterprises circumscribed to their local communities. This phenomenon is known as "country banking".[496]

Calomiris explains the laws enacted by the government in order to finance its operations "constrain the amount of credit that could be mobilised for industry."[497] First, the Bank of England was a monopoly set up to fund government spending. From 1694 to 1825 it was the "only bank in England that was able to take the form of a Joint Stock Company", while other banks could not raise capital from the public and needed to take the form of partnerships that were limited in size.[498] Second, in 1708 during the War of Spanish Succession, the English Parliament enacted a law that prohibited associations of more than six individuals from conducting banking business (issuing bank notes). Again, the act was a consequence of a Bank of England loan to the government.[499] Michie suggests this restriction on banking may have affected the development of insurance companies in the period, and that the cap "could have prevented similar companies being formed to undertake banking business."[500] Third, the Bank of England was given a monopoly over the issue of bank notes in London.[501] Additionally, the country banks were restricted from issuing small denomination notes. From 1804, they had to pay stamp duty on notes, and from 1808, they had to pay a licence fee of £30 in order to issue notes.[502]

Further, English banks were subject to usury laws,[503] which narrowed the number of clients they could obtain. If banks could not increase interest rates for new clients they

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494 P. Bairoch, above note 278, p. 294.
495 M. Collins, above note 484, p. 16; A. Gerschenkron, above note 272, p. 11; C. Calomiris and S. Haber, above note 467, p. 84; R. Michie, above note 472, p. 57-58.
496 R. Cameron, 'Banking in the Early Stages of Industrialization. A Preliminary Survey' [1963] Scandinavian Economic History Review, p.127.
497 C. Calomiris and S. Haber, above note 467, p. 95.
498 ibid; R. Michie, above note 472, p, 51; M. Collins, above note 484, p. 16.
499 K. Alexander, "Regulating the Structure of the EU Banking Sector" [2015] European Business Law Review p. 232; R. Grossman, above note 475, p. 172; C. Calomiris and S. Haber, above note 467, p. 89; P. Temin and H.J. Voth, *Prometheus Shackled: Goldsmith Banks and England's Financial Revolution after 1700* (OUP 2013) p. 181; R. Cameron, above note 496, p. 127; R. Davies and P. Richardson "Evolution of the UK Banking System" (2010) Q4 Bank of England Quarterly Bulletin p. 326; J. Clapham, *The Bank of England – A History, vol I 1694-1797* (CUP 1944) ps 79-86; M. Collins, above note 484, p. 16.
500 R. Michie, above note 472, p. 51.
501 C. Calomiris and S. Haber, above note 467, p. 95; R. Grossman, above note 475, p. 172; P. Temin and H.J. Voth, above note 499, p. 182.
502 R. Grossman, above note 475, p. 174. Another regulatory constraint of this period was the Bubble Act, 1720, passed as a request of the South Sea Company. The Act chartered two new companies and prohibited companies from issuing transferable shares. The Bubble Act was repealed in 1825. *See* C. Calomiris and S. Haber, above note 467, p. 98.
503 H. Rockoff, 'Prodigals and Projecture: An Economic History of Usury Laws in the United States from Colonial Times to 1900' (2003) NBER Working Paper 9742 p.16; P. Temin and H.J. Voth, above note 499, p. 73; S. Campbell, 'Usury and Annuities of the Eighteenth Century' (1928) 44 L. Q. Rev. p. 473.

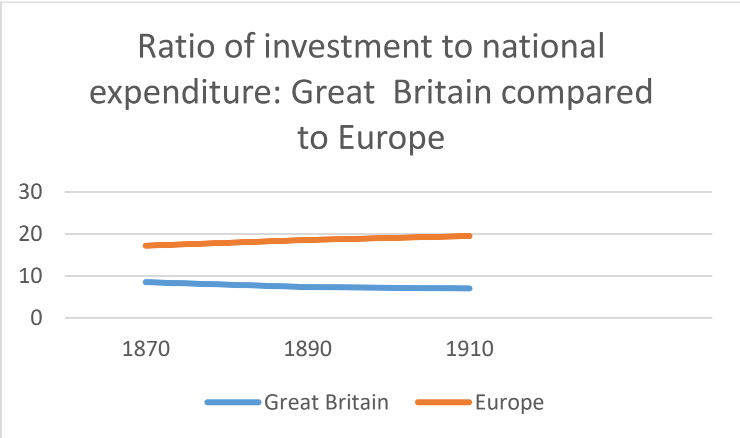
did not know well, then they would limit lending.[504]As usury laws did not apply to the government, it channelled credit to itself.[505]

Another important fact was that England was in constant war with France from 1689 until 1815. War was the principal reason for the demand for new money from the Government. As stated by Temin and Voth, "War increased the government's borrowing demands, crowding out private investment on a vast scale…The British 'warfare state' passed regulations that made it impossible for private finance to compete with state borrowing."[506] They conclude the increasing borrowing needs of the government reduced private lending and "industrial growth slowed markedly whenever public debt grew rapidly."[507]

During 1870-1914 there is agreement that clearing banks did not provide "long-term industrial finance in any large degree."[508] Nor did the capital markets: "There is general agreement that the formal market institutions normally handled little of the business of the British Industry."[509] According to Bairoch's index, between 1860 and 1913 the total volume of world manufacturing output increased more than fourfold (from 226 to 933). The UK during the same period increased the absolute manufacturing output less than threefold (from 45 to 127), and hence it decreased the percentage of total manufacturing output from 19% to 13%.[510]

Have banks failed the industry, stymieing the country's industrial development during this period? According to Goodhart, in 1890 English clearing banks believed a 15% ratio of cash to deposits was recommendable.[511] This shows bankers in the period were concerned about liquidity and short-term lending. This concern was strengthened by several crises in 1847, 1857, 1866 and 1878, which made bankers become even more cautious.[512]

Figure 8.



[504] C. Calomiris and S. Haber, above note 467 p. 84; P. Temin and H.J. Voth, above note 499, p. 73.
[505] P. Temin and H.J, Voth, above note 499, p. 84. Contrary, Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations* (1982 [1776]).
[506] P. Temin and H.J, Voth, above note 499, p. 158.
[507] ibid 173.
[508] M. Collins, above note 484, p. 28.
[509] F. Capie and M. Collins, above note 490, p. 34.
[510] P. Bairoch, above note 278, p. 275.
[511] C. A. E. Goodhart, *The Business of Banking, 1891-1914* (Hillary House Publishers 1972) p. 167-91.
[512] M. Collins, above note 484, p. 35.

Source: N.F.R Crafts, British Economic Growth during the Industrial Revolution;[513] *F. Capie and M. Collins*[514]

The period 1914-1945 witnessed three "devastating global shocks": WWI, the Great Depression and WWII. However, Britain did not suffer a "full-fledged" banking crisis.[515] At the beginning of the war, Keynes praised the British banking system: "I believe our banking system, and indeed the whole intricate organism of the city, to be one of the best and most characteristic creations of that part of the genius and virtue of our nation which has found its outlet in business."[516] This stability, nevertheless, attracted criticism from commentators that believed that the British banks reduced lending to industry.[517] In 1931, the "Macmillan Report", named after Lord Macmillan, chair of the Committee, concluded:

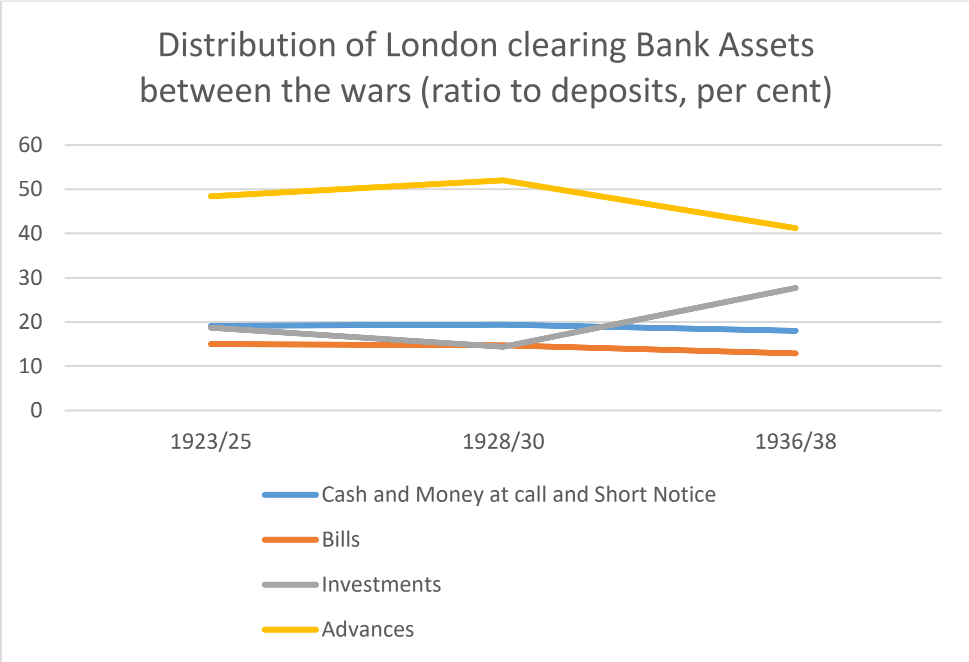
> "Coming back now to the more general question of the relations between finance and industry, and in particular to the provision of long-dated capital, we believe that there is substance in the view that the British financial organization concentrated in the City of London might with advantage be more closely co-ordinated with British industry, particularly large-scale industry, than is now the case; and that in some respects the City is more highly organized to provide capital to foreign countries than to British industry."[518]

From this report came the term "Macmillan Gap" which referred to the lack of provision of funding to small and mid-sized enterprises and in words of Michie represented "the gulf between banking and industry in Britain."[519]

Capie and Collins show (see Figure 9) the distribution of London clearing bank assets between the wars, which confirms the "emphasis on liquidity". Cash and money at call, and on short notice, bills and "advances" were very short-term assets.[520] Investments were "holding of British Government securities", which shows how bank assets were "diverted to finance the public sector."[521]

[513] (Oxford 1985) 63.
[514] Above note 10, p. 29.
[515] C. Calomiris and S. Haber, above note 467, p. 135; R. Michie, above note 472, p. 125.
[516] J. M. Keynes, 'The Prospectus of Money, November 1914' (1914) 24 Economic Journal p. 633.
[517] C. Calomiris and S. Haber, above note 467, p. 136; H. Park, *The Conservatism of British Banks in the Interwar Period, Re-Examined* (Mineo 2012); R. Michie, above note, 472, p. 125.
[518] Committee on Finance and Industry (1931) ps 161–75; R. Michie, above note 472, p. 125.
[519] R. Michie, above note 472, p. 132.
[520] F. Capie and M. Collins, above note 490, p. 51.
[521] Ibid.

Figure 9.



Source: F. Capie and M. Collins[522]

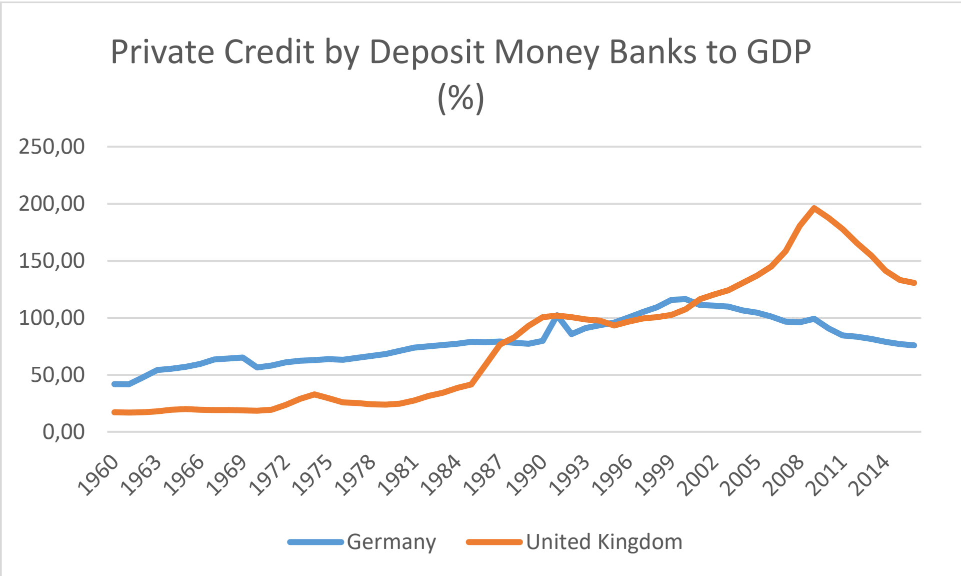
After WWII, there was a period of "constrained banking" from 1945 to 1970. The Labour government nationalised the Bank of England (1945), coalmines, civil aviation, transport, electricity generation and distribution, gas distribution and the iron and steel industry.[523] Banks were not nationalised, though. In response to the "Macmillan Gap", banks and the Bank of England formed the Industrial and Commercial Finance Corporation (ICFC). Its main aim was to provide credit to industrial and commercial business when banks or stock exchanges were not "available".[524] A World Bank dataset, which calculates private credit from deposit money banks as a percentage of GDP shows the UK was close to the worst performer in the OECD with only 19% of GDP. Germany, on the contrary was among the best performers with almost 55%.[525] During this period, the main policy to combat inflation was to constrain private credit. During the 1950s and 60s, the Bank of England "rarely employed interest rate increases", since doing so impaired the ability to finance its expenses. The Bank of England's main instruments to control inflation were "quantity controls" over bank credits and bank "liquidity-ratio requirements".[526] In 1971, the Bolton Committee established that credit controls affected small firms and recommended the end of such policy: "Since we believe that small firms have suffered differentially

[522] F. Capie and M. Collins *The Interwar British Economy: A Statistical Abstract* (Manchester University Press 1983) p. 92-99.
[523] C. Calomiris and S. Haber, above note 467, p. 138; see also N. Chester, *The Nationalization of the British Industry 1945-51* (London: HMSO 1975).
[524] F. Capie and M. Collins, above note 490 p. 66.
[525] T. Beck, A. Demirgüç-Kunt and R. Levine, "A New Database on Financial Development and Structure" (2000) 14 World Bank Economic Review ps 597–605; T. Beck, A. Demirgüç-Kunt and R. Levine, 'Financial Institutions and Markets across Countries and over Time: Data and Analysis' (2009) World Bank Policy Research Working Paper 4943; M. Čihák, A. Demirgüç-Kunt, E. Feyen and R. Levine, 'Benchmarking Financial Development around the World' (2012) World Bank Policy Research Working Paper 6175' Financial Development and Structure Dataset (updated July 2018).
[526] C. Calomiris and S. Haber, above note 467, p. 141; F. Capie, *Bank of England 1950s to 1979*, above note 609, p. 271-282.

from ceilings on lending, their disappearance is to be welcomed."[527] In 1971, the newly elected Conservative government implemented a new regime on competition and credit control (CCC), which removed quantity constraints on bank lending and promoted interest rate targeting as the main instrument of monetary policy.[528] In the words of the governor of the Bank of England, "we have taken a major new initiative. We have put proposals to all the banks for a new approach to credit control, which…will enable us to abandon ceiling controls altogether…What we are therefore adopting is a new approach to credit control designed to permit the price mechanism to function efficiently in the allocation of credit, and to free the banks from rigidities and restraints which have for 'far too long inhibited them from efficiently fulfilling their intermediary role in the financial system.'"[529] However, this new policy did not improve the Private Credit by Deposit Money Banks to GDP index, as shown by Figure 10.

Margaret Thatcher's government imposed a shift in its main policies: it eliminated controls on deposit interest rates and foreign exchange transactions, and "permitted and encouraged the growth of universal banks."[530] After these policies were implemented, there was a rise in the private credit by deposit money banks to GDP, which increased steadily surpassing Germany for the first time in 1988 (see Figure 10). After 2002 and until 2016, the UK lead the ranking against Germany. In 2009, the results were 99 Germany and 196 UK, while in 2016, it was 75 Germany, and 130 UK.

Figure 10.



Source: T. Beck et al.[531]

[527] J.E. Bolton, *Small Firms: Report of the Committee of Inquiry on Small Firms* (London Her Majesty's Stationery Office 1978) p.158.
[528] C. Calomiris and S. Haber, above note 467, p. 143-144; F. Capie and M. Collins, above note 490, p. 68.
[529] Sir L. O'Brien, 'Key Issues in Monetary and Credit Policy. Text of an Address by the Governor to the International Banking Conference in Munich on 28th May 1971' (1971) Bank of England Quarterly Bulletin ps. 195-198.
[530] C. Calomiris and S. Haber, above note 467, p. 147.
[531] See T. Beck et al, above note 525.

4.1.4 A Banking system shaped by the City of London

The UK banking sector is perceived as the "most successful" industry in the twenty first century. "In particular, the component of the Financial Services Sector located in the City of London was judged to be one of the most competitive in the world."[532]

According to Rhodes, "In 2017, the financial services sector contributed £119 billion to the UK economy, 6.5% of total economic output. The sector was largest in London, where 50% of the sector's output was generated."[533] Some commentators believe the City of London will continue to lead as the major European financial centre even after Brexit. "Even if the UK loses a quarter of its international financial sector as a result of Brexit, it will still be double the size of any other European business centre, according to new research which highlights the extent to which the City's dominance gives Britain a point of strength in negotiations over its future relationship with the EU."[534] According to the Global Financial Centres Index (GFCI 24) issued in 2018, London ranked as the second leading financial centre in the world, at just two points below New York.[535]

By 1850 London was the principal financial centre in the world, as Britain was the first economy to face the Industrial Revolution and because of the stability of the country. By this time, London served the interests of the country and was not a global financial centre.[536] From 1850 to 1914, London emerged as a global financial centre. British banks not only served national interests but serviced the world economy, primarily by the use of the telegraph. Britain was by then the largest trading nation and foreign banks could use the existing network through a London-based bank.[537] After WWII New York took London's place as the most important global financial centre because it was located in the wealthiest nation, with a larger economy and most important currency.[538] During the 1950s and 60s, London recovered and became competitive again.[539] This occurred for four reasons. First, the US imposed enforced regulations limiting interest rates on deposits (Regulation Q) and taxing interests on overseas loans (Interest Equalization Tax).[540] Second, there was an emergence and growth of the wholesale money markets, which allowed British domestic banks and merchant banks to act as principals.[541] Third, London developed the Eurocurrency market, which allowed banks to trade dollar deposits located

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532 R. Michie, "The Emergence and Survival of a Financial Cluster in Britain" in 'Learning from Some of Britain's Successful Sectors: An Historical Analysis of the Role of Government' (2010) 6 BIS Economics Paper, Department of Business Innovation and Skills p. 87.

533 C. Rhodes, 'Financial Services: Contribution to the UK Economy' (2018) Briefing Paper, Number 6193, House of Commons Library.

534 K. Allen, 'UK Finance Industry Dominates European Scene' *Financial Times* (London, 5 September 2018) <https://www.ft.com/content/88cdec40-b03c-11e8-8d14-6f049d06439c> accessed 21 February 2019.

535 Z/Yen Group, 'The Global Financial Services Index' (Corporation of London 2018) <https://www.longfinance.net/media/documents/GFCI_24_final_Report_7kGxEKS.pdf> accessed February 2019.

536 R. Michie, above note 532, p. 91.

537 Ibid.

538 Ibid 97.

539 M. Baker and M. Collins, "London as an International Banking Center, 1950-1980" in Y. Cassis and E. Bussiere *London and Paris as International Financial Centres in the Twentieth Century* (OUP 2007) p. 247.

540 Ibid 251.

541 P. Cottrell, "Established Connections and New Opportunities. London as an International Financial Centre 1914-1958" in Y. Cassis and E. Bussiere *London and Paris as International Financial Centres in the Twentieth Century* (OUP 2007) ps.175-176; M. Baker and M. Collins, above note 539, p. 253.

in the city. .[542] Banks did not want to trade in pounds and intended to prevent controls and interest rate caps imposed in the USA.[543] Fourth, London developed the Eurobond market. Eurobonds are bearer bonds in US dollars, issued outside the US and tax-free.[544] Cottrel explains the reasons for the rise of Eurodollar markets in London: "It offered an existing agglomeration of financial services, a reputation for stability and honesty, and freedom from tight regulation—an essential requirement, for the new markets were above all driven by the desire to escape from regulatory controls. Foreign banks were welcome to establish London branches, which did not require separate capitalization, and the Bank of England followed a flexible approach to foreign currency operations with non-residents. There were no reserve requirements or maturity constraints. There was no Glass-Steagall Act, as in the United States, to separate commercial and investment banking."[545] After the Big Bang, London has consolidated as a global financial centre. Some commentators, as stated above, believe the development of the city was to the detriment of the growth of industry.

After the GFC, the "too much finance" doctrine, which was first developed by Arcand, Berkes and Panizza in 2012, showed that the "the marginal effect of financial depth on output growth becomes negative when credit to private sector reaches 80-100%."[546] The doctrine's authors believe two possible reasons are responsible for this; first, large financial systems may lead to "large economic crashes", as predicted by Minsky; and, second the finance sector may misallocate resources from other parts of the economy, as showed by Tobin.[547] Panizza also considers there might be another explanations. He believes a "moral hazard fuelled bad finance", which is based in excessive housing lending and speculative risk taking activities, may have been more important than the "good finance" as the financial sector grew. Additionally, he states there might be "political capture" by finance lobbyists who push for deregulation.[548] Sandbu, from Financial Times, on a paper on Brexit published in 2019 – before the March deadline – suggests, "The rise of finance is plausibly (though partially) to blame for both small manufacturing sector and the reliance on mortgage-fuelled consumption for demand growth. There is also evidence suggesting the overgrown finance sector misallocates

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542 D.K. Sheppard, *The Growth and Role of UK Financial Institutions 1880-1962* (Routledge 2005) p. 12; G. Jones, note 466, p. 320; P. Cottrel, above note 541, p. 176; M. Baker and M. Collins, above note 539, p. 249.

543 R. Michie, above note 532, p. 101.

544 ibid, p. 101; G. Jones, above note 466, p. 320.

545 P. Cottrel, above note 541, p. 176; see also M. Baker and M. Collins, above note 539, p. 251.

546 J.L. Arcand, E. Berkes and U. Painzza, 'Too Much Finance?' (2012) IMF Working paper WP/12/161 p. 6.

547 Ibid; H.P. Minsky, "The modelling of Financial Instability. An Introduction" in *modelling and Simulation Vol 5. Proceedings of the Fifth Annual Pittsburgh Conference, Instruments Society of America* (1974) ps. 267-72; J. Tobin, "On the Efficiency of the Financial System" (1984) 153 Lloyds Bank Review ps. 1-15. See also S. Cecchetti and E. Kharroubi, "Why Does Financial Sector Growth Crowd Out Real Economic Growth?" (2015) BIS Working papers No 490; S. Cecchetti and E. Kharroubi, 'Reassessing the Impact of Finance and Growth' (2012) BIS Working Papers No 381; S. Law, A. Kutan and N. Naseem, 'The Role of Institutions in Finance Curse: Evidence from International Data' [2018] Journal of Comparative Economics; B. Cournede and O. Denk, 'Finance and Economic Growth in OECD and G20 countries' (2015) OECD Economics Department Working Papers No. 1223. Against see W. Cline, 'Too Much Finance or Statistical Illusion?' (2015) Policy Brief PB 15-9 Peterson Institute for International Economies and W. Cline, 'Further Statistical Debate "Too Much Finance"' Working paper series WP 15-16 Peterson Institute for International Economies.

548 U. Panizza, 'Non-linearities in the Relationship between Finance and Growth' [2017] The Graduate Institute Geneva and CEPR p.9.

resources away from business investment. The tilt of the economy's centre of gravity from manufacturing to financial and professional services, moreover, has reinforced both the polarisation in the labour market and regional inequality."[549]

What is clear is the City of London has shaped the UK banking system from 1850 onwards. London's position as the leading financial centre in the world has led many academics and politicians to pose questions as to whether the City has failed industry and if too much finance has stymied economic growth. While some indicators may suggest the City may not have been active in providing long-term financing for industry in the nineteenth and most of the twentieth century, the same credit to GDP ratios show that from 1960 the UK banking system has surpassed German levels. Others focus on the long stability of the UK system during a very long period (1878-1991), something Germany lacked. Today, the City of London is the second leading financial centre in the world, and has proved resilient in reinventing itself and attracting foreign banks, creating vigorous money markets, taking advantage of new opportunities such as the Eurocurrency and Eurobonds markets and maintaining a pro-market financial regulation, which fostered prosperity in the City.

4.2 UK Banking system

As stated above, until 1979 the Bank of England operated an informal supervision system that relied upon moral suasion. In 1979, the parliament passed the Banking Act, which required that prior authorization was necessary to accept deposit business by the Bank of England. As stated by Lord Steyn, "Prior to the enactment of the Banking Act 1979 banking in the United Kingdom was not subject to any formalised system of regulation. Control was exercised in an informal way by the Bank of England and in an indirect manner by means of various statutory provisions which gave privileges to banks which were recognised by the Board of Trade and by the Bank."[550] The Banking Act was passed in order to comply with the First European Community (EC) Banking Directive.[551] In 1987 a new Banking Act was approved. It regulated who was able to carry out banking activity but it lacked rules about the conduct of business.[552] In 1992, the UK implemented the Banking Coordination (Second Council Directive) Regulations,[553] following the Second Council Directive of the coordination of laws, regulations and administrative provisions relating to the pursuit of the business of credit institutions.[554]

The most important feature of this new regulation was the "passporting" scheme, whereby an institution based on the EU should not request authorization from each country that operates through branches, it being enough to ask for authorization in the home state. During the 1980s, the UK implemented different EU directives, which internalised Basel soft law into European law, and others such as the Own Funds Directive[555] and the Solvency Ratio Directive.[556] Proctor emphasises that the early 1990s "saw a significant

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[549] M. Sandbu, 'Brexit and the Future of UK Capitalism' (2019) the Political Quarterly p. 2.
[550] *Three Rivers District Council v Governor and Company of The Bank of England* (2001) 2 All ER 513 (HL).
[551] 77/780/EEC, OJ L 194, 16/7/1973.
[552] C. Proctor, above note 473, p. 5.
[553] See <https://www.legislation.gov.uk/uksi/1992/3218/contents/made> accessed 25 February 2019.
[554] 89/646/EEC, OJ 386 30/12/1989.
[555] 89/229/EEC, OJ L 124, 5/5/1989.
[556] 89/647/EEC, OJ 386, 30/12/1989.

'Europeanization of banking law, mainly as a harmonization measure with a view to completing the EC's single market."[557]

In 1997, the Labour government determined that central bank functions should be separated from market regulator functions and it transferred supervisory regulation to the Financial Services Authority (FSA). In 2010, the regulatory structure was changed whereby the FSA was dismantled and transformed into two different regulators: the Prudential Regulation Authority (PRA), as a subsidiary of the Bank of England, and the Financial Conduct Authority (FCA).[558] The next section will analyse banks and types of financial institutions that form the banking system in the UK.

Although substantive regulation under the FSMA does not explicitly distinguish between forms of banks,[559] the different credit institutions and investment banks in the UK may be classified as:

- Banks
- Credit unions
- Building societies
- Investment banks or merchant banks.

This section will examine those institutions regulated by the PRA, both credit institutions and investment firms, because of the PRA's prudential impact on the whole UK financial system.

4.2.1 Banks

4.2.1.1 What is a bank?

According to the PRA Rulebook, a bank is "1) a *firm* with a *Part 4A Permission* to carry on the *regulated activity* of *accepting deposits* and is a *credit institution*, but is not a *credit union*, *friendly society*[560]or a *building society*; or (2) an *EEA bank*." A "firm" means a *PRA-authorised person* within the meaning of section 2B (5) of the FSMA. A "PRA-authorised person" according to the FSMA means an authorised person who has permission (a) given under Part 4A, or (b) resulting from any other provision of this Act, to carry on regulated activities that consist of or include one or more PRA-regulated activities (see section 22(a)). Part 4A relates to the permission to carry on regulated activities.

Section 19 imposes the general prohibition clause: "No person may carry on a regulated activity in the United Kingdom, or purport to do so, unless he is— (a) an authorised person; or (b) an exempt person. (2) The prohibition is referred to in this Act as the general prohibition". At the same time Section 22 states "an activity is a regulated activity for the

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[557] C. Proctor, above note 473, p. 6.
[558] Financial Services and Markets Act 2000ch 2, 2b.
[559] B. Penn, 'Banking Regulation in the UK: Overview' (*Practical Law, Thomson Reuters*, 2018) <https://uk.practicallaw.thomsonreuters.com/w-008-0211?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1> accessed 25 February 2019.
[560] The FSMA section 417 defines an "incorporated friendly society" as a "society incorporated under the Friendly Societies Act 1992. Regulated Friendly societies engage generally in insurance and provision of non-discretionary benefits."

purposes of this Act if it is an activity of a specified kind which is carried on by way of business and—(a) relates to an investment of a specified kind; or (b) in the case of an activity of a kind which is also specified for the purposes of this paragraph, is carried on in relation to property of any kind." FSMA refers to *accepting deposits* in Schedule 2, paragraph 1, without defining it. It is in the Regulated Activities Order,[561] article 5, that"accepting deposits" is defined:

> "(1)… (a) money received by way of deposit is lent to others; or
>
> (b) any other activity of the person accepting the deposit is financed wholly, or to a material extent, out of the capital of or interest on money received by way of deposit.
>
> (2) In paragraph (1), "deposit" means a sum of money…
>
> (a) under which it will be repaid, with or without interest or premium, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it; and
>
> (b) which are not referable to the provision of property (other than currency) or services or the giving of security."

It is important to test whether the deposits are accepted by way of of "business", as stated by Section 22 FSMA. In *Financial Services v Anderson* the judgement states "At its broadest it (business) may mean anything that is not done for pleasure (Rolls vs. Miller (1884) L.R. 27, Ch D, 71." Without defining the term, the judgement refers to the following elements to respond to the business activity question. First, the aim was to make money. Second, the defendants took deposits over extended terms; third, the number of deposits were substantial; fourth, the amounts were large; fifth, the deposits were paid into "business bank accounts"; and sixth, the defendants described their activities as their "business".[562]

According to the PRA Rulebook, credit institution has the meaning given in point (1) of Article 4(1) of the CRR: "'Credit institution' means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account."

4.2.1.2 Clearing banks: The big four

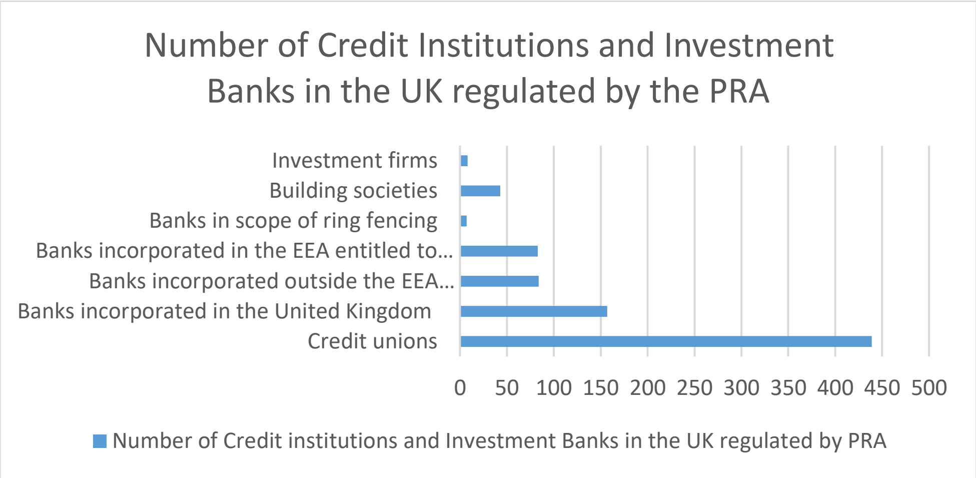
Commentators indicate that "clearing banks", sometimes called "high street" or "retail banks", are those banks with extended networks or those participating directly in the clearing system.[563] Until 1970, the five largest UK clearing banks, known as the "big five" banks, were: 1) Barclays Bank (now part of Barclays); 2) Midland Bank (now HSBC Bank and part of HSBC); 3) Lloyds Bank (now part of Lloyds banking group); 4) National Provincial Bank; and 5) Westminster Bank. In 1970, National Provincial and Westminster merged into NatWest, so the term "big four" was used after that.[564] Today, HSBC is the biggest banking group with more than $2984 billion in assets, followed by Barclays

561 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 <http://www.legislation.gov.uk/uksi/2001/544/article/5/made> accessed 8 April 2021.
562 [2010] EWHC 599 (Ch) points 51 and 52; C. Proctor, above note 473, p. 10
563 A. Saunders and I. Walter, above note 112, p. 113; G. Morton, above note 615, p. 22-27.
564 R. Michie, above note 472, p. 78; P. Cottrel, above note 541, p. 155.

($1605 billion), Lloyds ($1193 billion) and NatWest (former RBS) ($1094 billion). See Figure 12.

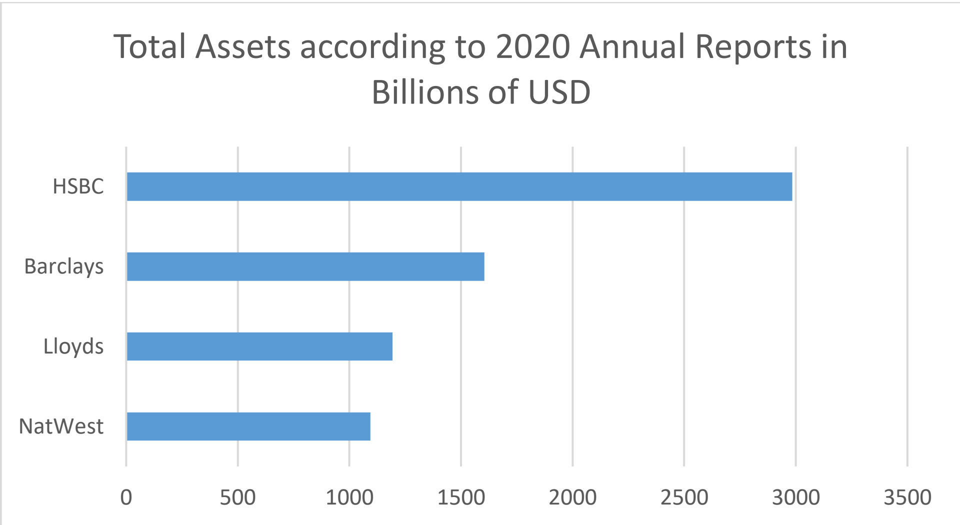
The PRA releases lists of regulated entities every year. In 2021, they were separated as follows: 1) banks incorporated in the UK (157); 2) banks incorporated outside the EEA authorised to accept deposits through a branch in the UK (84); 3) banks incorporated in the EEA entitled to accept deposits through a branch in the UK while in a Temporary Permissions regime (83); 4) building societies (43); 5) credit unions (439); 6) investment firms (8); 7) insurers (369); 8) banks in scope of ring-fencing as at 1 January 2020 (7). See Figure 11.

Figure 11.



Source: PRA[565]

Figure 12.



Source: 2020 Annual Reports[566]

565 PRA, 'Which Firms Do We Regulate?' <https://www.bankofengland.co.uk/prudential-regulation/authorisations/which-firms-does-the-pra-regulate>.

566 HSBC Holdings plc's Annual Report and Accounts 2020 <https://www.hsbc.com/investors/results-and-announcements/annual-report/>; Barclays PLC Annual Report 2020 <https://home.barclays/investor-

4.2.1.3. Foreign banks

Historically, foreign banks have been attracted to London, as explained above. During the nineteenth century, many foreign banks started to operate in London, such as Allied Irish (1825), Alemagne Bank Netherland (1858), and others with British connections such as the Bank of New South Wales (1853) and the Bank of New Zealand (1862). French banks arrived during the 1870s: Comptoir National d`Edspargne, Societé Générale and Crédit Lyonnais (1871). German banks arrived around the same time: Deutsche Bank (1873), Dresdner Bank (1895) and Disconto-Gellschaft (1900). By 1914, Russian, Japanese, Belgian, Chinese, Swiss and Italian banks started to operate in London too. In the 1920s, US banks arrived: Bankers Trust Company, First National City and Manufacturers Hanover Trust. During WWI, German banks abandoned London, while Italian and Japanese banks did the same during WWII. During the 1950s, foreign banks felt attracted to London again.[567]After the Second Banking Directive, passporting was granted and a new type of firm, the "EEA bank", was formed.

According to the PRA Rulebook, an EEA bank means an incoming EEA firm that is a CRD credit institution. An incoming EEA firm "means an EEA firm which is exercising, or has exercised, its right to carry on a regulated activity in the UK in accordance with Schedule 3 of FSMA." Schedule 3 refers to EEA passport rights. A CRD credit institution means a credit institution that has its registered office (or, if it has no registered office, its head office) in an EEA state, excluding an institution to which the CRD does not apply under Article 2 of the CRD.[568] As stated above, these EEA firms are not part of the definition of a bank for the PRA.

Foreign banks regulated by the PRA are those that establish a subsidiary in the UK by way of incorporation or operate in the UK via a branch. According to the PRA, a branch "means (1) (a) a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions; (b) for the purposes of the CRD and in accordance with Article 38 of the CRD, any number of places of business set up in the same EEA State by a credit institution with headquarters in another EEA State are to be regarded as a single branch".[569]

4.2.1.4. British multinational or overseas banking

This panorama was not always like this. Beginning in 1830 the British banks established overseas branch networks, which focused on a "triad" consisting of Australasia, Latin America and Asia. This phenomenon was called "British multinational banking".[570] British clearers avoided international banking until the late nineteenth century and multinational banking until the twentieth. The British multinational banks of the

relations/reports-and-events/annual-reports>; Lloyds Banking group Annual Report and Accounts 2020 </ https://www.lloydsbankinggroup.com/assets/pdfs/investors/annual-report/2020/2020-lbg-annual-report.pdf >; NatWest <https://investors.natwestgroup.com/~/media/Files/R/RBS-IR-V2/results-center/19022021/natwest-group-annual-report-accounts-2020-v1.pdf> accessed 8 April 2021.

[567] M. Baker and M. Collins, above note 539, p. 248.

[568] CRD, above note 88.

[569] PRA Rulebook Glossary: Bank <http://www.prarulebook.co.uk/rulebook/Glossary/Rulebook/0/03-09-2015/B> accessed 28 February 2019.

[570] G. Jones, above note 466, p. 372.

nineteenth century did not undertake domestic business in the UK, but the London-based directors and executives took all major decisions.[571] During the 1860s, certain entrepreneurs "promoted a series of banks, including the London and River Plate Bank, the London and Brazilian Bank, the English Bank of Rio de Janeiro, and the London Bank of Mexico and South America. They established branches at the ports and in a few major inland trading centres, especially in the fast-growing River Plate region, where British mercantile interests were active in the export of wool, hides, and skins, and the import of British-manufactured textiles and other commodities.…Throughout the nineteenth century and beyond, British banking activity in Latin America was confined to four countries, Argentina, Uruguay, Brazil, and Chile."[572] Many of these multinational banks consolidated, and others exist nowadays, although multinational British banking lost its prominence in the 1960s. One example of consolidation is the acquisition by Lloyds of London and River Plate Bank in 1918. In 1923, it was merged with London and Brazilian Bank, creating the new Bank of London and South America (BOLSA) in 1923. In 1971, Lloyds merged its European and South American subsidiaries under Lloyds International Bank. On the other hand, two examples of British multinational banks that still operate are Hong Kong Bank and Standard Chartered, which survived the decline of the British Empire and two world wars. Today HSBC is the UK's largest bank in total assets, and Standard Charter the fifth, with £688 billion in total assets as of 2018.[573]

The second form of credit institution regulated by the PRA are the credit unions.

4.2.2 Credit unions

According to the PRA Rulebook, a credit union means a credit union as defined by: (1) the Credit Unions Act 1979; or (2) the Credit Unions (Northern Ireland) Order 1985, "which is an authorised person."[574] The Credit Unions Act 1979 states: "a society may be registered under the Co-operative and Community Benefit Societies Act 2014" (the 2014 Act) as a credit union if: i) the society has at least 21 members; ii) it has a registered office in Great Britain; and iii) it is regulated by the FCA.

Edmonds define credit unions as "non-profit making financial institutions based on cooperative values. A credit union is a group of people who save together and lend to each other at a favourable rate of interest. Each union is separate and autonomous although there are some national organisations which act as promoters and supply expertise, training and model rules."[575]

Credit unions are ruled by internal regulation and specific legislation. In general, trade associations prepare the internal regulation. In the UK the Irish League of Credit Unions (ILCU), the Association of British Credit Unions Limited (ABCUL), the Scottish League

[571] Ibid, p. 11
[572] Ibid, p. 24.
[573] Standard Chartered Annual Report and Account <https://www.sc.com/en/> accessed 26 February 2018.
[574] PRA Rulebook. Glossary: Credit Union <http://www.prarulebook.co.uk/rulebook/Glossary/FullDefinition/52110/25-02-2019> accessed 13 April 2019.
[575] T. Edmonds, "Credit Unions" (2015) Briefing paper Number 01034 p.4.

of Credit Unions (SLCU), the Association of Independent Credit Unions (AICU) and the Ulster Federation of Credit Unions (UFCU) assist and support their members.[576]

Credit unions are "self-help cooperative financial organizations geared to attaining the economic and social goals of members and wider local communities."[577] The main characteristics of credit unions are: 1) voting is on a one-member, one-vote basis, which gives every member the same voice; 2) permitted activities are limited to membership, which is based on the common bond (e.g., belonging to a geographical place, having the same employer or following a particular occupation); 3) shareholder profit is not the principal aim of the credit union. Instead, they seek to attain the economic and social goals of their members; 4) directors are often unpaid volunteers;[578] 5) shares, other than "deferred shares", are not tradable;[579] however, members can withdraw shares;[580]6) there are special rules for dividends: "The dividend payable on any shares of a credit union shall—(a) on its dissolution, not exceed a rate of 8 per cent per annum or such other rate as may be specified by order made by the Treasury; and (b) at any other time, not exceed that rate except to the extent that the rules of the credit union provide otherwise."[581]

According to Section 1(c) of the Credit Unions Act 1979:

> "The objects of a credit union are—(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."[582]

Credit unions require that membership "must be restricted to persons who fall within one or more common bonds appropriate to a credit union… the common bonds appropriate to a credit union are—

> (a) following a particular occupation;
>
> (b) being employed by a particular employer;
>
> (c) residing or being employed in a particular locality;
>
> (d) being a member of a bona fide organisation or being otherwise associated with other members of the society for a purpose other than that of forming a society to be registered as a credit union;
>
> (e) any other common bond for the time being approved by the Authority.[583]

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[576] A. Ward and D. McKillop, "An Investigation into the Link between UK Credit Union Characteristics, Location and their Success" (2005) 76(3) Annals of Public and Cooperative Economics p. 463.
[577] D.G. McKillop, A-M Ward & J. O. S. Wilson "The Development of Credit Unions and Their Role in Tackling Financial Exclusion" Public Money & Management, 27:1, ps 37-44.
[578] Ibid, p. 463; A. Ward, D. McKillop and J. Wilson, "The Development of Credit Unions and Their Role in Tackling Financial Exclusion" (2007) 27(1) Public Money & Management ps. 37-44.
[579] Credit Unions Act 1979, s 7(2).
[580] Credit Unions Act 1979, s 7(4).
[581] Credit Unions Act 1979, s 14(4).
[582] Credit Unions Act 1979 <https://www.legislation.gov.uk/ukpga/1979/34> accessed 25 February 2019.
[583] Credit Unions Act 1979 s 1B, amended by The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 <http://www.legislation.gov.uk/uksi/2011/2687/part/4/made> accessed 25 February 2019.

The Legislative Reform (Industrial and Provident Societies and Credit Unions) Order 2011 broadened the common bonds in order to increase the scope of permitted activities of credit unions. It also permitted corporate members if they do not surpass 10% of total members.

According to the Bank of England, as of 2020 the total assets of all the credit unions together amount to £3.8 billion. The total members surpass 2 million people.[584] The next group of credit institutions are building societies.

4.2.3 Building societies

According to the PRA Rulebook, a building society has the meaning given in section 119 of the Building Societies Act 1986 (BSA).[585] Section 5 of this act establishes that "A society may be established under this Act if (and only if) it complies with the following requirements, namely— (a) its purpose or principal purpose is that of making loans which are secured on residential property and are funded substantially by its members; and (b) its principal office is in the United Kingdom." …Residential property" means land at least 40% of which (a) is normally used as, or in connection with, one or more dwellings; or (b) has been, is being or is to be developed or adapted for such use."[586]

Building societies have several limitations. There are: 1) lending limits;[587] 2) funding limits;[588] and 3) restrictions to act as a market maker in securities, commodities or currencies, or to trade in commodities or currencies and enter into any transaction involving derivative investments.[589] According to Rex, "The 1997 Act gave building societies the freedom to pursue any activities set out in their memorandum, subject only to compliance with the revised principal purpose introduced by that Act, the lending and funding limits, the restrictions on powers and appropriate prudential requirements,.... In essence, it is the principal purpose, the 'nature' limits and restrictions, together with the fact that most of a building society's customers are its members, which retain a building society's fundamental character, and differentiate it from other financial institutions."[590]

Schedule 2 of the BSA states that "no person shall be a member of the society unless he is a shareholding member or a borrowing member or both. 'Borrowing member' means an individual who is indebted to the society in respect of a loan which is fully secured on land; or if the rules of the society so provide, in respect of a loan which is (within the meaning of the rules) substantially secured on land." "Shareholding member" means a

584 Bank of England Credit Union Quarterly Statistics - 2020 Q2 <https://www.bankofengland.co.uk/statistics/credit-union/2020/2020-q2#:~:text=Total%20liquid%20assets%20increased%20by,in%20arrears%20rose%20by%205.0%25>.

585 The Building Societies Act 1997, the Financial Services and Markets Act 2000 and the Financial Services Act 2012 have subsequently amended the 1986 Act.

586 BSA, s 5. <https://www.legislation.gov.uk/ukpga/1986/53/section/5> accessed 25 February 2019.

587 BSA, s 6; R.K. Shiwakoti, A. Iqbal and W. Funnell, 'Organizational Form, Business Strategies and the Demise of Demutualized Building Societies in the UK' (2018) 94 Journal of Banking and Finance 339: "At least 75% of building society assets must be loans fully secured on residential property and 50% of the funds must be raised from the individual members (retail depositors) of the society."

588 BSA, s 7.

589 BSA, s 9A(1).

590 S. Rex, 'The Building Societies Act 1986 - A BSA Summary Sixth Edition' [2013] Building Society Association <https://www.bsa.org.uk/information/consumer-factsheets/general/the-building-societies-act-1986-a-bsa-summary-fift> accessed 28 February 2019.

person who holds a share in the society.[591] Schedule 2 gives the freedom to establish whether any preferential or deferred shares are to be issued and, if so, within what limits; and whose membership ceases.[592]

During the 1980s housing finance was opened, and council houses were permitted to be sold to their tenants, which extended the housing finance. Banks were permitted to engage in mortgage lending.[593] The BSA permitted mutual building societies to "demutualise" and transform into stock banks. Ten of the largest building societies abandoned the mutual form between 1989 and 2000 "transferring about 80% of the industry's assets to the banking sector."[594] Banks and building societies started competing for the same market, which drove up housing prices.[595] Households started using their properties as collateral for borrowing and "the society as a whole was becoming increasingly leveraged prior to the financial crisis."[596]

According to the Director of UK Banks & Building Societies of the Bank of England, demutualised building societies' business models proved to fail: "As I have said on other occasions, the crisis revealed deep flaws in the business model of demutualised building societies. Not one of them survives today as an independent entity."[597] Not surprisingly, it was Northern Rock, a demutualised building society that was responsible for a bank run of unprecedented dimensions in the UK in 2007.

As Lastra explains, "Northern Rock was not a victim of the subprime crisis but of its own funding structure. The credit squeeze in August 2007 following the sub-prime mortgage crisis in the United States, caused serious liquidity problems in many banks that had come to rely on wholesale capital markets (markets for securitized assets) for their funding needs. Northern Rock suffered more than others because it was heavily reliant on such markets at a time when they were drying out."[598]

By 2021, building societies' total assets summed £451 billion.[599]

4.2.4 Investment banks

In addition to credit institutions, the FSMA also regulates investment firms. Some major investment firms are supervised by the PRA. Under the PRA-regulated Activities Order,

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[591] BSA, sch 2, s 5.
[592] BSA 1986, sch 2, s 3.
[593] A. Offer, above note 468, n.7, p. 163.
[594] R.K. Shiwakoti, A. Iqbal and W. Funnell, above note 587, p. 337. These were Abbey National, Cheltenham & Gloucester, National & Provincial, Alliance & Leicester, Halifax, Woolwich, Northern Rock, Bristol & West, Birmingham & Midshires and Bradford.
[595] A. Offer, above note 468, p. 167.
[596] R. Michie, above note 472, p. 223.
[597] A. Bailey, 'Promoting a Prudent and Stable Financial System' at the Future of the Retail Banking Conference, London (Bank of England 2011) <https://www.bankofengland.co.uk/-/media/boe/files/speech/2011/promoting-a-prudent-and-stable-financial-system-speech-by-andrew-bailey.pdf?la=en&hash=7C82B9E6BEC8EEA655F1AAB4629755FEABFB5B13> accessed 28 February 2019.
[598] R. Lastra, 'Northern Rock and Banking Law Reform in the UK in F. Bruni and D.T. Llewellyn, *The Failure of Northern Rock: A Multi-Dimensional Case Study* (SUERF – The European Money and Finance Forum 2009) p. 147.
[599] Building Societies Association: Building Society Assets <https://www.bsa.org.uk/information/consumer-factsheets/general/building-society-assets-(1)> accessed 28 February 2019.

the PRA may designate investment firms for prudential supervision by the PRA. These are,

> "[b]roadly speaking, that the person: (a) has, or has applied for, permission to deal in investments as principal; and (b) has, or would have if it were authorised, a minimum capital of €730,000, or is a broadly analogous European Economic Area (EEA) passporting firm or non-EEA firm. Under PRA Statement of policy, a person meeting the conditions in article 3(2) and (3) is referred to as an "Eligible Investment Firm". "The PRA will have regard to each of the following factors in determining whether an Eligible Investment Firm should be designated: a) whether the firm's balance sheet exceeds an average of £15 billion total gross assets over four quarters, as reported on regulatory returns; and/or b) whether the sum of the balance sheets of all Eligible Investment Firms in a group exceeds an average of £15 billion total gross assets over four quarters; and/or c) where the firm is part of a PRA group, whether the firm's revenues, balance sheet and risk-taking is significant relative to the group's revenues, balance sheet and risk-taking."[600]

As of 2020, the investment firms regulated by the PRA are:[601]

- Barclays Capital Securities Limited
- Citigroup Global Markets Limited
- Credit Suisse Securities (Europe) Limited
- Goldman Sachs International
- Merrill Lynch International
- MUFG Securities EMEA Plc
- Morgan Stanley & Co. International Plc
- Nomura International Plc.

According to the PRA Rulebook, an investment firm means "any person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis." Investment services and investment activities mean "any of the services and activities listed in Section A of Annex I to MiFID."[602] Section A, Annex I of the MiFID states, "(1) Reception and transmission of orders in relation to one or more financial instruments. (2) Execution of orders on behalf of clients. (3) Dealing on own account. (4) Portfolio management. (5) Investment advice. (6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis. (7) Placing of financial

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[600] PRA 'Statement of Policy Designation of Investment Firms for Prudential Supervision by the Prudential Regulation Authority' March 2013 (PRA 2013) <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2013/designation-of-investment-firms-for-prudential-supervision-by-the-pra.pdf?la=en&hash=570F23B585B77326C308B8B45CEB157BD1ADC03D> accessed 25 February 2019.

[601] List of Designated Firms compiled by The Bank of England January 2021 <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/authorisations/which-firms-does-the-pra-regulate/2019/designated-firms-list-december-2018.pdf?la=en&hash=9802C6C9CE2C77126FEF15208A2C518806EA49A2> accessed 25 February 2019.

[602] European Parliament and Council Directive on Markets in Financial Instruments (No. 2004/39/EC).

instruments without a firm commitment basis (8) Operation of Multilateral Trading Facilities."[603]

The origin of merchant banks was international trade. Barings (1763) started as wool merchants; Rothschilds (1808) as cotton merchants; Schroeders (1818) and Kleinworts (1855) as sugar merchants; and Morgan Grenfell (1838) as dry goods merchants. Those merchants endorsed bills of exchange of lesser-known merchants, which was known as "acceptance". Over the years, they mixed commerce and "accepting" but at the end, they concentrated on the financial activity. The name of the institution varied over time: they were called "merchants", "merchant bankers", "accepting houses", "issuing houses", "industrial bankers" and "investment bankers". Nowadays, the most common terms are merchant banks and investment banks.[604]

While trade finance was also developed by clearing banks, it gave merchant banks the opportunity to use their experience in placing securities: investment management, underwriting, mergers and acquisitions services, financial advisory, trading of securities and bullion and personal banking.[605] In terms of a business model, Michie explains investment banks use the "Originate and Distribute model", meaning they issued stocks and bonds "on behalf of borrowers and then sold to investors. In the interval between the issue and sale of these securities, investment banks could use the stocks and bonds they held as collateral for short-term loans from retail banks, and so meet the immediate need of borrowers. Once the securities had been sold the funds borrowed from the banks could be repaid."[606]

Following the Big Bang in 1986, two of the protagonists of the financial sector in the nineteenth and twentieth centuries disappeared: multinational banking and merchant banking. Two multinational or overseas banks survive. One of them, HSBC, is the leading bank in the UK. The merchant banks "were to be taken over, one after the other, during the closing of the twentieth century, though by American and European banks rather than British."[607] One reason for this might have been the removal of exchange controls, since UK investors trusted foreign brokerage firms.[608] According to Roberts, 77 of the 225 stock firms were bought: 16 by UK merchant banks, 27 by UK clearing banks, 14 by US banks and 20 by foreign banks.[609] After the GFC, Barclays took the opportunity to buy the investment banking business of Lehman Brothers,[610] and now it is the only British investment firm regulated by the PRA.

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[603] Ibid, s A, Annex 1.
[604] R. Roberts, "What's in a Name? Merchants, Merchant Bankers, Accepting Houses, Issuing Houses, Industrial Bankers and Investment Bankers" [1993] 35(3) Business History p. 22.
[605] A. Saunders and I. Walter, above note 112, p. 115.
[606] R. Michie, above note 472, p. 216.
[607] Y. Cassis, above note 481, p. 116.
[608] R. Roberts, "London as an International Financial Centre, 1980-2000: Global Powerhouse or Wimbledon EC2?" in Y. Cassis and E. Bussiere, above note 541, p. 302.
[609] Ibid.
[610] R. Michie, above note 472, p. 216; B. White and E. Dash, 'Barclays Reaches $1.75 Billion Deal for a Lehman Unit' *New York Times* (New York, 17 September 2008) <https://www.nytimes.com/2008/09/18/business/worldbusiness/18barclays.html> accessed 28 February 2019; Helen Avery, 'The Numbers that Prove Lehman was Deal of the Century for Barclays' *EuroMoney* (18 September 2013) <https://www.euromoney.com/article/b12kjsf0lgb850/the-numbers-that-prove-lehman-was-deal-of-the-century-for-barclays?copyrightInfo=true> accessed 28 February 2019.

After the GFC the focus was centred again on the risks of providing retail and non-retail banking under the same roof. The next section will examine the structural reform in the UK.

4.3 Ring-fencing

In response to the GFC, several developed economies adopted structural reform measures. The main feature of the three structural reform incentives, the "Volcker Rule" in the US, the Vickers Commission in the UK and the Liikanen Report in the European Commission, was a mandatory separation of "commercial banking and certain securities market activities."[611] According to Gambacorta there was a reassessment of the costs and benefits of universal banking's involvement in proprietary trading and other securities market activities. "Many large universal banks shifted too many resources to trading books, supported by cheap funding. The complexity of many banks weakened market discipline, while their interconnectedness increased systemic risk, contributing to contagion within across firms."[612] Binder defines ring-fencing as "[a] generic concept that involves the segregation of assets, liabilities and or/business activities from specific risks with a view to protecting markets and counterparties either directly or indirectly."[613]

The ring-fence approach in the UK is centred on a list of activities called "core activities". Only ring-fenced banks will be able to achieve core activities. The Vickers Report is achieved by section 4 of the Financial Services (Banking Reform) Act 2013, which inserts a new Part 9B to the FSMA. "Core activities" include i) the regulated activity of accepting deposits (whether carried out in the UK or elsewhere) and ii) other activities designated by the Treasury when "an interruption of the provision of services provided in the UK…could adversely affect the stability of the UK financial system or of a significant part of that system, and (b) that the continuity of the provision of those services can more effectively be protected by treating the activity as a core activity."[614] The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 (2014 Order), states that the following institutions are exempted from the definition of

> "ring-fenced body provisions of the FSMA:
>
> - insurance companies
> - societies registered under s. 1 of the Co-operative and Community Benefit Societies Act 2014 (which include credit unions and industrial and provident societies)

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[611] L. Gambacorta and A. van Rixtel, "Structural Bank Regulation Initiatives: Approaches and Implications" [2013] BIS; European Commission, *Proposal for the Regulation of the European Parliament and the Council on Structural Measures Improving the Resilience of EU Credit Institutions* (2014) (Liikanen Report); FSOC, *Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds* (2011) (Volcker Rule) available at <https://www.treasury.gov/initiatives/documents/volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf> accessed 6 March 2019; Independent Commission on Banking, *Final Report Recommendations* (2011) <https://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmtsanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf> accessed 6 March 2019.

[612] L. Gambacorta and A. van Rixtel, above note 611.

[613] J.H. Binder, 'Ring-Fencing: An integrated Approach with Many Unknowns' [2015] European Business Organization Law Review p. 115.

[614] FSMA, s 142 B.

- Northern Ireland credit unions
- Northern Ireland industrial and provident societies
- banks which hold less than £25 billion core deposits
- bodies which would only have become ring-fenced bodies as a result of action being taken under the Banking Act 2009 to stabilise a bank in financial difficulty where not more than four years has passed since the date of that action”.[615]

Article 2 of the 2014 Order establishes if a deposit is not a core deposit, then the activity of accepting it is not a “core activity”. A deposit is a core deposit “if it is held in an EEA account unless one or more of account holders is a relevant financial institution;; a qualifying organisation; a member of a qualifying group, or an eligible individual.” A qualifying organisation is one the has a turnover of not less than £6.5 million; its balance sheet total is not less than £3.26 million; and it employs not less than 50 people. An eligible individual is the one that held “not less than £250,000 in assets” in a period of one year. [616][617]

After defining core activities and core services, the FSMA lists the excluded activities, which are prohibited activities for ring-fenced bodies.[618]

Goodhart believes the UK ring-fence solution is less than optimal since “[r]ing-fencing UK banks into two, or three, parts will add to transactional and operational costs for both banks and their larger clients. The ring-fenced UK retail banks will concentrate even more on financing UK property, and became even more subject to the vagaries of the UK property cycle. The investment bank, i.e. the non-ring-fenced part, will face more expensive and difficult funding conditions. The idea that retail banks must be saved from liquidation, but investment banks can and should be left to fail, is dubious. A better approach would have been to require banks to hold much more equity, and to intervene earlier to stop their downward spiral, rather than to impose such a separation.”[619] Binder suggests that irrespective of legal barriers the reputational risk will still be in place if similar brands and logos and marketing channels remain after modifying the banking group’s structure.[620]

The UK banking system is in continuous evolution. While it first evolved as a specialised banking system, after the deregulation period of Margaret Thatcher and the Big Bang the system turned into a universal banking system. After the GFC, universal banks were found in part responsible for the increase of risks and interconnection, and now as Sir Vickers affirms, “(ring-fence) would end universal banking.”[621] While this is part true, ring-fencing in the UK will not mandate a complete separation,[622] and permits banking groups to maintain the different activities under the same banking group and name.

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[615] The Financial Services and Markets Act 2000 (Ring-Fenced Bodies and Core Activities) Order 2014.
[616] The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions) Order 2014, s 2.
[617] Ibid. Core activities are listed in FSMA s 142 C.
[618] FSMA, s 142 D; C. Proctor, above note 473, p. 17.
[619] C. Goodhart, “The Vickers Report: An Assessment” [2012] Law and Financial Markets Review p. 32.
[620] J. H. Binder, above note 613, p. 108.
[621] Independent Commission on Banking, Interim Report, April 2010
[622] C. Goodhart, above note 619, p. 36.

4.4 Concluding remarks

This chapter has addressed the British model banking groups. The original British model comprises a bank-parent company, which owns insurance and securities subsidiaries. Today, most British banking groups comprise a holding company at the apex of the group. Therefore, the corporate group that is composed of a holding company, which holds a Bank, which in turn owns the securities and insurance subsidiaries, may be labelled as the British Modified model.

Section 4.1 analysed the distinctive characters of the British banking system.

1. Unlike the German system, the UK system has historically been characterised by the separation of investment and retail banking. The deregulation movement that some locate in the CCC and others on the EU Second Banking Directive, led the UK banking system to universal banking. After the GFC, structural reform separated retail banking from investment banking, again. This time the change was regulatory.
2. The UK banking system has relied heavily on self-regulation, a unique characteristic that is absent in the German and US models It was only in 1979 that the Bank of England had to authorise the acceptance of deposits from the public. This self-regulated system proved to be very stable, since there was a long period of more than 100 years without a significant banking crisis (1878-1991).
3. The relationship between bankers and industrialists has proven to be problematic in the different stages of history in the UK. There is acceptance that the UK banking approach was indeed different from the German system. While UK bankers provided short-term credit to the industry, their German counterparts provided long-term finance, owned the companies and were part of the boards of directors of such companies. Gerschenkron believes the main issue was that the UK faced the Industrial Revolution first, which could not accompany the evolution of a maturing economy. Germany and other backward economies had to face the Industrial Revolution via new vehicles, the *Grossbanks*. Others believe the UK institutions are to blame for the lack of long-term financing and others explain the "industry decline" due to a coalition of the City and the land against the industry. While there was no formal regulation until 1979, the Bank of England had a monopoly to fund the government and to take the form of a joint stock company, which was to the detriment of the other banking institutions. Usury laws also restrict the number of customers banks could get and increased collateral lending. Facts indicate from 1860 to 1913 the UK manufacturing output decreased from 19 to 13% of the total manufacturing output. Additionally, there is evidence that banks before WWI were concerned with liquidity and short-term lending, and that UK foreign investment was huge. The sum of these factors might have stymied industry development in the UK. Things changed after the Big Bang. In 1988, the UK surpassed Germany for the first time in the private credit by deposit money banks to GDP, and after 2002 Germany could not lead again against the UK As it is analysed in chapter five, the UK system resembles in some way the US System in that banks did not provide sufficient financing to the industry as in Germany.
4. The UK banking system is shaped by the City, something the German model lacked. London is the second ranked financial centre in the world, below New York. Data suggest the City of London will continue to be the major financial centre in Europe after Brexit. The history of the City of London showed how

> London championed the financial world, first by being the imperial city. After WWII, when New York emerged as the major financial centre because it was located in the major economy, and had the major currency, London demonstrated it had resilience in that it developed both the Eurocurrency market and the Eurobond Market to compete again. Some posed questions as to whether the City has failed industry in the UK, or even if the City has failed the British economy as a whole. After 2012 the "too much finance" doctrine has emerged to question if concentration of one industry may have unintended consequences such as inducing large crises and misallocating resources from other parts of the economy. Brexit has raised these questions again.

Section 4.2 makes a compilation of the UK banking system in its broad sense, including both credit institutions and investment banks. The UK banking system is comprised by: 1) banks, 2) credit unions, 3) building societies and 4) investment banks. This section defines a bank and analyses the "big four", "multinational" or "overseas" banking and foreign banks. Credit unions are non-profit financial institutions based on cooperative values. All credit unions together comprise total assets of £3.3 billion. Building societies are financial institutions with the principal purpose of making loans, which are secured on residential property and are funded by its members. During the 1980s housing finance was opened and banks were permitted to engage in mortgage lending, while at the same time building societies were permitted to demutualise. Northern Rock was one of them. These instructions were said to have deep flaws in in building societies' business models. Investment banks or merchant banks are the last category. Historically, merchant banks had a specialised banking business, which derived from international trade. Some major investment firms are regulated by the PRA. Only Barclays stands as a British PRA regulated investment firm. Similar to Germany, the UK system includes commercial banks and institutions with a primary aim that differ from profit maximizations: Credit unions (UK) and Saving Banks and Coorperatives (Germany).

Section 4.3 examines the structural reform in the UK, which tried to break universal banking. While the aim was to separate retail banking from investment banking, the result of the ring-fencing regulation permits, under certain limits, the holding of both retail and investment banking companies under the same holding company, and under the same banking name. What the ring-fencing provisions in the UK prohibited is a German model banking group, since retail and investment banking cannot be provided under the same roof. The ring-fence provisions are centred on a list of core activities and core services that are permitted only to the ring-fenced entity.

Annex 3 analyses insurance regulation in the UK. It examines the definition of an insurance contract, the limits of the insurance activity under both Solvency II and internal regulation. As of the last published G-SII list (2016), Aviva plc and Prudential plc are the only two British institutions that are not part of a BBFC.

CHAPTER 5. US MODEL

5.1 The US model

Unlike the German banking system, that has always been essentially universal, the features of the US banking system have evolved over the last two centuries leading to a complex dual system (federal – state) in which banking has co-existed with capital markets and insurance businesses, and the legal form has changed often in response to crises. When Herring and Santomero classified FCs according to their legal and operational separateness, they correctly identified the US model as a holding model. From the 1950's, the US Congress introduced the holding banking system and this structural legal form still prevails in most of the US BBFCs. The US financial system permitted universal banking from its inception as an independent nation in 1776 until the GSA in 1933. The GSA separated commercial banking from investment banking. This lasted until the deregulation period in the 1990s when Congress permitted banking groups to perform the three types of financial activities (banking, securities and insurance) under the same group, *de facto* permitting FCs to operate in the US market again, as in the pre- GSA period. In 1999, the Financial Services Modernization Act, also known as the Gramm-Leach-Bliley Act (GLBA), repealed provisions of the GSA that had prevented banks, securities firms and insurance companies from entering each other's markets.

5.1.1 Historical and philosophical foundations of the US banking system

The US banking system was shaped by its federal system and has evolved into different phases throughout history. Following the British experience, the first phase was the adoption of the charter banking system (1780-1837), which gave Congress or state legislatures the power to authorise and define permitted activities, capital and other requisites, and the period it would operate in certain territory. A second phase was the "free banking" period (1837-1865), where banks were free to engage in banking activities as long as they collaterised note issuance. A third phase comprised the "National Banking System" (1865-1913). Unlike the free banking system, where no national charters were permitted, the new system allowed banks to choose between a national and a state charter. The last phase comprises the period starting in 1913 up to the present.

After the creation of the Federal Reserve System in 1913 and its consecutive "foundings" in the words of Conti-Brown,[623] the system changed in that: i) the new central bank was a public entity; ii) it was given authority over the nation's payment system; and iii) it was designed as a decentralised bank in order to prevent power concentration, and it was designed as independent from political power.[624] The Roosevelt administration responded

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[623] P. Conti Brown, *The Power and Independence of the Federal Reserve* (Princeton University Press 2016) ps. 16-39. According to Conti Brown, the Federal Reserve System had three "foundings", one in 1913 by the Federal Reserve Act of 1913, a second founding by the Banking Act of 1935 and a third founding by the Fed-Treasury Accord of 1951.

[624] Federal Reserve Bank of Minneapolis, "A History of Central Banking in the United States" <https://www.minneapolisfed.org/about/more-about-the-fed/history-of-the-fed/history-of-central-banking> accessed 5 June 2019; See generally: R. Lastra, *Central Banking And Banking Regulation* (Financial Markets Group of the London School of Economics and Political Science 1996); C. Goodhart, *The Evolution of Central Banks* (MIT Press 1988); A.F. Burns, "The Independence of the Federal Reserve System" [1976] Challenge; P. Conti-Brown, "The Institution of Federal Reserve Independence" [2015]

to the Great Depression with the "New Deal Legislation". The Banking Act of June 16, 1933 (GSA) established the Federal Deposit Insurance Corporation (FDIC) to insure all accounts for depositary institutions and separated investment banking from insurance and commercial banking. Finally, the GSA prohibited the payment of interest on demand deposits.[625] In the securities front, new federal securities regulations imposed improved transparency requirements.[626]

In 1956, the US Congress passed the BHCA which introduced the "Bank Holding Company" structure.[627] At that time there were only 47 BHCs registered with 7.6% of the country's bank deposits. Fifty years later, almost 6,320 BHCs were registered, holding 94% of all bank assets.[628] The bank holding model was developed by most US BBFCs, and has defined, in the words of Herring and Santomero and many others,[629] the US model.

From April 1951 until 1965, economic growth and stable inflation was the norm in the US. After 1965, it started a period called "the great inflation", which characterised the US economy until 1982.[630] In the following years, the US banking sector was subject to interest rate controls, and later removal, and the advent of the Eurodollar market. The Eurodollar market consisted of deposits and loans issued outside of the US denominated in US dollars. They were attractive to US investors since they were outside the scope of interest rate ceilings and reserve requirements.[631]

The most important banking bills of this period were: i) the Financial Institutions Supervisory Act of 1966[632] that expanded enforcement powers of federal banking agencies against unsafe and unsound banking practices and allowed them to remove directors who breach fiduciary duties;[633] ii) the International Banking Act of 1978;[634] iii) the Financial Institutions Regulatory and Interest Rate Control Act of 1978[635], which created the Federal Financial Institutions Examination Council that imposed limits and reporting requirements for insiders; iv) the Depository Institutions Deregulation and

32(2) Yale Journal on Regulation; E. Balls, J. Howat and A. Stansbury, "Central Bank Independence Revisited: After the Financial Crisis, What Should a model Central Bank Look Like?" [2016] M-RCBG Associate Working Paper Series, No. 67, Mossavar-Rahmani Center for Business & Government of Harvard University; M. Barr, H. Jackson, and M. Tahyar, *Financial Regulation: Law and Policy* (Foundation Press 2018).

625 Pub. L. No. 73-66, 48 Stat. 162.

626 W. Lovett and M. Mallow, *Banking and Financial Institutions Law in a Nutshell* (West Academic Publishing, 8th edn 2014) ps. 16-17; E. A. Keller, "Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934" (1988) 49 Ohio State Law Journal ps. 329-352; L. Lowenstein, "Financial Transparency and Corporate Governance: You Manage What You Measure" [1996] Columbia Law Review 1335; US Securities and Exchange Commission <https://www.sec.gov/Article/whatwedo.html> accessed 6 August 2019.

627 Bank Holding Company Act of 1956 (12 USC § 1841, et seq).

628 W. Lovett et al., above note 626, p. 221.

629 See Chapter 2.

630 Federal Reserve History <https://www.federalreservehistory.org/essays/great_inflation?WT.si_n=Search&WT.si_x=3>, accessed 2 December 2019.

631 R. Grossman, above note 475, p. 264.

632 Financial Institutions Supervisory Act of 1966 (P.L. 89-695, 80 STAT. 1028).

633 Federal Deposit Insurance Corporation <https://www.fdic.gov/regulations/laws/important/>accessed 2 December 2019.

634 International Banking Act of 1978 (P.L. 95-369, 92 STAT. 607).

635 Financial Institutions Regulatory and Interest Rate Control Act of 1978 (P.L. 95-630, 92 STAT. 3641).

Monetary Control Act of 1980,[636] which created "NOW Accounts" and "began the phase-out of interest rate ceilings on deposits",[637] while establishing the Depository Institutions Deregulation Committee; v) the Garn-St Germain Depository Institutions Act of 1982, which strengthened the FDIC in order to help troubled banks and thrifts via the Net Worth Certificate (NWC) program that provided funds to banks that suffered from interest rate shocks;[638] and vi) the Competitive Equality Banking Act of 1987 (CEBA).[639]

In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act,[640] also known as FIRREA. FIRREA was a response to the savings and loan crisis, which involved the failure in 1981-1983 of more than 100 savings and loan associations (S&L).[641] FIRREA tried to restore confidence in the S&L. It eliminated the Federal Savings & Loan Insurance Corporation (FSLIC), while the FDIC started insuring deposits of thrift institutions.[642]

Two years later, the Federal Deposit Insurance Corporation Improvement Act (FDICIA)[643] was passed in order to strengthen the power of the FDIC. The FDICIA's main goals were "to recapitalize the Bank Insurance Fund of the FDIC" and 2) to reform the "deposit insurance and bank regulatory system so that taxpayer losses would be minimized."[644]

The US banking system has some distinctive features. Historically the US government constrained the growth of banks and bank holding companies via branching restrictions, holding company activity restrictions and merger regulations. These restrictions reflect a strong tradition of federalism and decentralised banking as well as prevention of undue concentration of financial resources (a classic antitrust concern).[645] While universal banking may trace its philosophical foundations to Saint Simon's ideas, which were implemented by the Pereire brothers; in America, there is no such philosophical or religious body of ideas concerning banking. While not philosophical in nature, but similar in its power to move economic agents, it can be said that federalism was the nerve which moved and shaped the US banking system from its inception, and for most of its history.[646] The fear of concentration and abuse of power which is essential to federalism was always present in the idea of decentralised "unit banks" (with no branches) which were designed to serve the needs of the communities and were not managed in a centralised way.[647]

Due to deregulation and technological advances, the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 modified the "unit bank" model. It allowed BHCs to:

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[636] Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221, 94 STAT. 132).
[637] FDIC <https://www.fdic.gov/regulations/laws/important/> accessed 2 December 2019.
[638] Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320, 96 STAT. 1469).
[639] Competitive Equality Banking Act of 1987 (P.L. 100-86, 101 STAT. 552). See s 5.1.6.2.
[640] P.L. 101-73, 103 STAT. 183.
[641] National Commission on Financial Institution Reform, Recovery and Enforcement, *Origins and Causes of the S&L Debacle a Blueprint for Reform* (1993) p. 32.
[642] FDIC <https://www.fdic.gov/regulations/laws/important/> accessed 2 December 2019.
[643] Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA, Pub. L. 102–242).
[644] F. Mishkin, "Evaluating FDICIA" [1996] Federal Reserve Bank of New York Graduate School of Business, Columbia University and National Bureau of Economic Research, p.1.
[645] W. Lovett et al., above note 626, p. 8.
[646] Ibid, 8.
[647] B. Abrams and R. Settle, 'Pressure-Group Influence and Institutional Change: Branch-Banking Legislation During the Great Depression' [1993] Public Choice p. 689; D. Morentz Markeley, "The Impact of Financial Deregulation on Rural Capital Markets in Virginia: An Analysis of Bank Decision Making" [1984] Virginia Polytechnic Institute and State University p. 165.

i) acquire banks after 1995; ii) merge banks into a single branch network with locations in different states. It also limited the restriction of interstate branching when the national deposit market share exceeded 10%..[648] In 1999, the US Congress passed the GLBA, which repealed the GSA "granting broad-based securities and insurance powers to commercial banking companies."[649] It also allowed BHCs to take the form of financial holding companies (FHC) that are permitted to engage in securities underwriting, insurance agency and merchant banking activities.[650] The GLBA authorises national banks to underwrite and deal in municipal revenue bonds and to own or control a financial subsidiary that may perform activities that are not permitted for national banks directly.[651] These financial subsidiaries may not engage as principal in underwriting insurance, real estate development or real estate investment activities or merchant banking activities.[652]

While not a banking fraud *per se*, the Enron scandal led to the Sarbanes-Oxley Act of 2002.[653] It regulated public accounting firms that audit publicly traded companies.[654] Scandals and lack of regulation were breeding grounds for the GFC.

While a multitude of causes led to the GFC, Lastra and Wood have shown the build-up to the crisis was based in part in failures of regulation and supervision. "There were plenty of regulatory and supervisory failures (as well as a degree of regulatory capture or, at the very least, excessive group-think). Rules regarding capital proved inadequate; accounting rules exacerbated problems; and the absence of rules on liquidity was unfortunate. Indeed, capital and accounting regulations actually made things worse by being procyclical, with

648 P. Mulloy and C. Lasker, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition" (1995) 21 J. Legis. p.255; R. Deyoug, "Banking in the United States" in A. Berger, P. Molyneux and J. Wilson *The Oxford Handbook of Banking* (OUP 2012) p. 785; S. Stritzel, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation" [1995] 46 Syracuse Law Review p. 165. C. Tart, "Expansion of the Banking Industry under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Is the Banking Industry Headed in the Right Direction?" [1995] Wake Forest Law Review p. 915; G. Buerstetta, "Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994" ([1995] Annual Review of Banking Law p. 2; R. Zarutskie, "Evidence on the Effects of Bank Competition on Firm Borrowing and Investment" [2006] 81(3) Journal of Financial Economics ps. 503-537; G. Giedeman, "The Riegle-Neal Act and Local Banking Market Concentration" [2004] 10 International Advances in Economic Research p. 245, 328; S. Nippania and K.W. Green Jr., "The Banking Industry after the Riegle–Neal Act: Re-Structure and Overall Performance" [2002] The Quarterly Review of Economics and Finance ps. 901-909.

649 R. Deyoug, above note 648, p. 786; R. Cebula, "Bank Failures in Light of the Gramm-Leach-Bliley Act" [2010] Atlantic Economic Journal p. 455; T. Jeng-Yan, "The Gramm-Leach-Bliley Act: Optimal Interest Margin Effects of Commercial Bank Expansion into Insurance Underwriting" [2012] Applied Economics Letters p. 1459; J. Cuaresma, "The Gramm-Leach-Bliley Act" [2002] Berkeley Technology Law Journal p. 497; F. Neale and P. Peterson, "The Effect of the Gramm-Leach-Bliley Act on the Insurance Industry" (2005) 57(4) Journal of Economics and Business ps. 317-338; A. Al Mamun, M. Kabir Hassan and S. Van Lai, "The Impact of the Gramm-Leach-Bliley Act on the Financial Services Industry" (2004) 28(3) Journal of Economics and Finance ps. 333–347; M. Restreppo, "The Convergence of Commercial and Investment Banking under the Gramm-Leach-Bliley Act: Revisiting Old Risks and Facing New Problems" [2005] Law and Business Review of the Americas p. 269; B. Shull, "Banking, Commerce and Competition under the Gramm-Leach-Bliley Act" [2002] Antitrust Bulletin p. 25.

650 GLB 103 (a), 12 USC 1843 (K) (4); R. Effros, *Addendum to Central Banks in an Age of Standardization* (Effros 2004) p. 2.

651 12 USC § 24a.

652 12 USC § 24a (2)(B).

653 Sarbanes-Oxley Act of 2002 (P.L. 107-204).

654 FDIC <https://www.fdic.gov/regulations/laws/important/> accessed 2 December 2019.

rules on risk-weighting capital combining with mark-to-market accounting to reduce requirements in good times and raise them sharply in bad."[655]

After the deregulation period, and the following GFC, the US Congress validated the Volcker Rule and prohibited proprietary trading via the Dodd Frank Act (DFA). As Lastra and Wood contend, "one of the major 'breakthroughs' in the response to the crisis is that a distinction is now made between macro-prudential supervision and microprudential supervision." Macro-prudential supervision analyses the "trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy."[656] In the US, the macro-prudential policy response,[657] and the last chapter of financial regulation of bank-based FCs led to the creation of the Financial Stability Oversight Council (FSOC) which has the responsibility of identifying risks to the financial stability of the US of large interconnected bank or non-bank holding companies. FSOC's main power is to designate the "SIFI label" to nonbank financial institutions and to financial market utilities (FMU). According to the DFA there are three different "systemic importance" categories: i) banking SIFIs: those whose assets are beyond $50 billion; ii) non-banking SIFIs: those non-banking financial institutions whose material financial distress – or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities – could pose a threat to US financial stability; and iii) FMU.[658]

The following sections will examine federalism in America, the evolution of banking and capital markets in the US, and some special features of the US banking system: i) branching restrictions; and ii) a BHC's permitted activities. Further sections will analyse the US banking structure.

5.1.1.1 Federalism in America

Federalism has shaped the banking system in the US from its inception. "The term 'federal' is derived from the Latin *foedus*, which, like the Hebrew term brit, means covenant. In essence, a federal arrangement is one of partnership, established and regulated by a covenant, whose internal relationships reflect the special kind of sharing that must prevail among the partners, based on a mutual recognition of the integrity of each partner and the attempt to foster a special unity among them."[659] A federal political system is one that constitutionally recognises that political authority is divided between a

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[655] R. Lastra and G. Wood, 'The Crisis of 2007–09: Nature, Causes, And Reactions' (2010) 13(3) Journal of International Economic Law ps. 531–550. See also See generally J. Crotty, 'Structural Causes of the Global Financial Crisis: A Critical Assessment of the "New Financial Architecture"' [2009] 33 Cambridge Journal of Economics ps. 563–580; Ö. Orhangazi, "Financial Deregulation and the 2007-08 US Financial Crisis" [2014] FESSUD, Working Paper Series No 49; S. Roy and D. M. Kemmeb, "The Run-Up to the Global Financial Crisis: A Longer Historical View of Financial Liberalization, Capital Inflows, and Asset Bubbles" [2019] International Review of Financial Analysis; H. Anheier, S. Kauffman and S. Ziaja, "Ten Years after the Global Financial and Economic Crisis" [2018] The Governance Report 2018, Hertie School of Governance.

[656] ibid.

[657] B. Bernanke, "Implementing a Macroprudential Approach to Supervision and Regulation" speech at the 47th Annual Conference on Bank Structure and Competition, Chicago, Illinois, 5 May 2011.

[658] See Chapter 2, s 2.3.3.

[659] D. Elazar, *Exploring Federalism* (University of Alabama Press 1991) p.5.

central government and state governments, where people are subject to both governments at the same time, each government acting within its own sphere.[660]

Federalism refers to "a means of governing a polity that grants partial autonomy to geographical defined subdivisions of the polity."[661] The late Supreme Court Justice Antonin Scalia imagines federalism as a "midway between two extremes." At the one extreme, he poses autonomy, disunity and conflict between states; at the other, uniformity, inflexibility and monotony of a centralised government. "Federalism is meant to be a compromise between the two."[662]

John Jay explained in Federalist paper No. 2 that "[i]t is well worthy of consideration…, whether it would conduce more to the interest of the people of America that they should, to all general purposes, be one nation, under one federal government, or that they should divide themselves into separate confederacies, and give to the head of each the same kind of powers which they are advised to place in one national government...Providence has been pleased to give this one connected country to one united people…This country and this people seem to have been made for each other, and it appears as if it was the design of Providence, that an inheritance so proper and convenient for a band of brethren, united to each other by the strongest ties, should never be split into a number of unsocial, jealous, and alien sovereignties."[663] Jay recognised the need for a government and gave reasons why the most suitable form of government for Americans is a united nation and not a series of sovereign confederacies.

The framers of the US Constitution "invented a new type of federalism." Before the US constitution, federal governments were simple allies and people of the states were primarily loyal to the local government and not to the federal one. US federalism created a nation.[664] Since the US Constitution proved to be an effective form of government and helped to shape a nation, constitution makers in major new nations emulated it.[665] For Blumstein federalism has "indeed become *the* pervasive legal/political issue around the world."[666]

Alexis de Tocqueville in his *Democracy in America* described the American political system for French readers. He observed, "[i]t was impossible at the foundation of the states…to establish a central administration in America." For him, Americans were dispersed over an enormous geographical area and "separated by too many natural obstacles" and that "America is therefore pre-eminently the country of provincial and municipal government." Tocqueville believed that "[t]he English settlers in the United States early perceived that they were divided into a great number of small and distinct

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[660] G. Bermann, "Taking Subsidiarity Seriously: Federalism in the European Community and in the United States" [1994] 94 Columbia Law Review 331, p. 404.
[661] M. Feeley and R Rubin, *Federalism: Political Identity and Tragic Compromise* (University of Michigan Press 2008) p. 12.
[662] A. Scalia, "The Two Faces of Federalism" [1982] 6 Harvard Journal of Law and Public Policy p. 19.
[663] J. Jay, *Federalist Paper No 2* (1787) <https://www.congress.gov/resources/display/content/The+Federalist+Papers#TheFederalistPapers-1> accessed 2 December 2019.
[664] W. Riker, "The Senate and American Federalism" [1995] 49(2) The American Political Science Association p. 452.
[665] W. Riker, above note 664. "About half the earth is presently ruled by federal governments-all of them reminiscent in one way or other of the Philadelphia invention."
[666] J. Blumstein, "Federalism and Civil Rights: Complementary and Competing Paradigms" [1994] 47 Vanderbilt Law Review. ps. 1251, 1252; W. Riker, above note 664, p. 452.

communities which belonged to non-common centre; and that it was needful for each of these little communities to take care of its own affairs, since there did not appear to be any central authority which was naturally bound and easily enabled to provide them." He also observed that the sovereignty of the people was an essential concept in the newly formed country. For him:

> [p]rovidence has given to every human being the degree of reason necessary to direct himself in the affairs which interest him exclusively-such is the grand maxim upon which civil and political society rests in the United States. The Father of the family applies to his children; the master to his servants; the township to its officers; the province to its townships; the State to its provinces; the Union to the States; and when extended to the nation, it becomes the sovereignty of the people.[667]

These observations help to explain how and why the Americans saw the federal system as so essential to their own interests. Americans lived in a great geographical space, with no other visible and accountable authority than the local one. They had to organise themselves maintaining sovereignty of the people, via a dual system, one that gave the people the power to maintain local authority while at the same time, one that gave them a sense of "nation" via a federal government. Federalism was necessary at the creation of the US since people's loyalty to their own state was stronger than their loyalty to the union.[668]

Scalia contends the individual possesses, in accordance with the Declaration of Independence, a "God-given freedom" which rejects the idea of governmental constraints. However, according to him, there is no particular governmental unit with a natural right to rule, since the decision of which unit has to rule is a pragmatic one, which would be determined by the "practicalities of the matter." The question of the limits of federal legislative or regulatory authority over a field that may be accomplished also by the State is one that has been subject to the "practicalities of the matter." Weschler argues the restraints of federal interventions flow from "the sheer existence of the states and (from) their political power to influence the action of the national authority."[669] He in turn borrows his argument from Madison's Federalist Paper no. 45 where he states that "each of the principal branches of the federal government will owe its existence more or less to the favour of the State governments" and the Congress "will be disinclined to invade the rights of the individual states or the prerogatives of their governments."[670]

During the first 70 years of the Constitution's existence, article I, Section 8's enumeration of the powers of Congress remained a subject of discussion. The states ratified the Constitution on the understanding that the central government would only act on the powers enumerated in the Constitution.[671] Also, the Tenth Amendment enshrined this view: "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." In early years,

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667 A. de Tocqueville, *Democracy in America*, Vol I and II (The Floating Press 2009) p. 758.

668 E. Rubin, "Puppy Federalism and the Blessings of America" (2001) 574 The Annals of the American Academy of Political and Social Science ps. 37, 43.

669 H. Weschler, "The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government" (1954) 54 Columbia Law Review p. 543.

670 J. Madison, *The Federalist No 45*, (B. Wright ed, 1961) p. 327.

671 P. Zavodnyik, *The Rise of Federal Colossus: The Growth of Federal Power from Lincoln to F.D.R* (Praeger Series on American Political Cultures 1st ed 2011) p. xiii.

two schools of thought disputed the real meaning of the powers of Congress. Hamilton, Marshall, Clay and Webster gave them a broad reading, while Jefferson, Madison and Polk tended to protect the rights of the states, interpreting the powers in a narrow way. The latter prevailed during the antebellum period. After the civil war, however, the broad interpretation prevailed.[672]

The Commerce Clause ("[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes") was used as a way to expand federal power. The SCOTUS stated in 1824 that this power "is complete in itself, may be exercised to its utmost extent, and acknowledges no limitations other that are prescribed by the Constitution."[673] This broad interpretation changed during the first decades of the twentieth century when a body of doctrine forbade the federal government from regulating certain areas.[674]

The second avenue that would limit federal powers would be the Tenth Amendment. In 1976, the SCOTUS ruled in *National League of Cities v Usery* that the commerce clause authority does not extend to shift state power to structure employment relations in areas of "traditional governmental functions." The scope of this limit of federal power was confined to the concept of sovereignty itself.[675] In 1985, the SCOTUS overruled *National League* in *Garcia v San Antonio Metropolitan* since the category "traditional governmental functions" was unworkable.[676] Under *Garcia*, the US Congress has discretion to allocate responsibilities in areas of federal and state concurrent competence.[677] The SCOTUS ruling coincides with Weschler and Madison's views; since for SCOTUS the framers of the constitution chose to rely on a federal system in which restraints on federal power over the states rely on the national government itself "rather than in discrete limitations on the objects of federal authority." For the SCOTUS, procedural safeguards protect better state interests than judicial limitations of federal power. [678] In 1992 in *New York v United States* the SCOTUS condemned "commandeering state regulatory apparatus" to spend their administrative resources to implement federal policies, based on the Tenth Amendment.[679]

While there is no clear doctrine distinguishing federal from state jurisdiction, some commentators believe the US is no longer federalist ("real federalism is gone"), since the reasons behind federalism, that is to say, a country with linguistic, religious and disunity, did not exist or are no longer present in the US.[680] This thesis argues that the US still maintains federalism. The dual banking system and the peculiar mix of state authority in insurance and federal in securities is a peculiarity of the US. While it is true that the US is now a united country and people are more loyal to the union than to the states, federalism is still present in the Constitution and that has not changed. As Scalia contends, federalism is somehow a "virtuous middle" between disunity and centralism. History has

[672] Ibid.
[673] *Gibbons v Ogden* 22 US (9 Wheat.) 1, 196 (1824).
[674] M. Feeley and E. Rubin, above note 661; *United States v E. C. Knight, Co*., 156 U.S. 1 (1895); *Hammer v Dagenhart*, 247 U.S. 251 (1918); *Carter v Carter Coal Co*., 298 U.S. 238 (1936); *United States v Butler*, 297 U.S. 1 (1936).
[675] G. Bermann, above note 660, p. 418.
[676] 469 U.S. 528 (1985).
[677] G. Bermann, above note 660, p. 419.
[678] 469 U.S. 528 (1985).
[679] 112 S. Ct. 2408 (1992).
[680] E. Rubin, above note 668, p. 49; M. Feeley and E. Rubin, above note 661, p.149.

shown the system has auto-regulated the limits of federal and state jurisdiction and that the SCOTUS had a role to play in the interpretation of those limits.[681] The US is a country based on the practicalities of commerce and British Empiricism, following the Lockean school,[682] in which practical wisdom is enhanced. This practical wisdom has created a system, federalism, which is now followed by many countries around the world, and the US is home to one of the most important democracies in the world. This system has shaped banking in the US. An overview of the development of banking in the US will follow.

A. The chartered banking system (1780-1837)

The adoption of the new Constitution signed in 1787 and entering into force in 1789 restricted state power to print fiat paper money, but states did not lose the power to charter state banks that could issue paper money.[683] States chartered banks at a fast pace. By 1790 there were three state banks, by 1800 there were 28, by 1810 there were 102, by 1820 there were 327 and by 1835 there were 584.[684]

During the first half of the nineteenth century, corporate privileges were reserved for non-profit organisations that served the common good, e.g., libraries, schools and bridge companies. The second quarter of the century saw a rise in charters provided to profit organisations, which gave their promoters certain advantages, for instance broad powers and legal personality. However, bank and insurance charters imposed restrictions such as unlimited liability to shareholders in the event of failure or fraud.[685] Early banks were identified with the political party of their founders; "becoming a bank insider required open and dedicated service to the party."[686] Since the number of charters were limited, they became very profitable. Allegations of bribery and wrongdoing were common in the State of New York as early as 1804.[687]

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[681] J. Bednar, W. Eskridge Jr. and J. Ferejohn, "A Political Theory of Federalism" in J. Ferejohn, J. Rakove and J. Riley (eds), Constitutions and Constitutionalism (CUP 2001) p.37.

[682] L. Gerston, *American Federalism: A Concise Introduction* (Routledge 2015) p. 22; L. Hartz, *The Liberal Tradition in America* (Harvest 1991) p. 140: "Locke dominates American political thought, as no other thinker anywhere dominates the political thought of a nation"; C. Becker, *The Declaration of Independence. A Study in the History of Political Ideas* (Harcourt, Brace and Co. 1922) p. 27: "So far as the Fathers were, before 1776, directly influenced by particular writers, the writers were English, and notably Locke"; M. White, *The Philosophy of the American Revolution* (OUP 1978) p. 5; D. Elazar, above note 659, p. 115; C. Wiltse, *The Jeffersonian Tradition in American Democracy* (1960) p. 37; J. Miller, *The Origins of the American Revolution* (Stanford University Press 1943) p. 491; D. Malone, *Jefferson and his Time Vol I.* (Little, Brown & Co. 1948) p. 175; G. Chinard, *Thomas Jefferson, the Apostle of Americanism* (The Floating Press 2011) p. 72.

[683] R. Sylla, "US Securities Markets and the Banking System, 1790-1840" [1998] Federal Reserve Bank of Saint Louis 85.

[684] Ibid, 86.

[685] H. Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York" in E. Glaeser and C. Goldin (eds), *Corruption and Reform: Lessons from America's Economic History* (University of Chicago Press 2006) ps. 233-234.

[686] Ibid; J. Wallis, R. Sylla and J. Legler, "The Interaction of Taxation and Regulation in Nineteenth-Century U.S. Banking" in C. Goldin and G. Libecap, *The Regulated Economy: A Historical Approach to Political Economy* (University of Chicago Press 2001) p. 135; H. Bodenhorn, *State Banking in Early America: A New Economic History* (OUP 2002) p. 123.

[687] J. Knox, *A History of Banking in the United States* (Rhodes 1903) p. 397. H. Bodenhorn, above note 685, p. 233.

At a federal level, the first bank to receive a federal charter was the Bank of North America. It was the first fractional reserve commercial bank in the US and the first private central bank, modelled after the Bank of England.[688] It opened its doors in 1782. Despite its monopoly powers, the market perceived that its notes were inflated compared with specie. After one year of operation, the Bank of North America ended its role as central bank and obtained a bank charter by the state of Pennsylvania. All federal stock was placed in private hands and all federal debt had been repaid.[689]

Hamilton did not give up on his intention of creating a US central bank. In 1791, the First Bank of the United States (BUS or First BUS) was chartered following Hamilton's suggestion to financier Robert Morris in 1779.[690] Hamilton argued the formation of the BUS would contribute to the "augmentation of the active or productive capital of the country" and "thus by contributing to enlarge the mass of industrious and commercial enterprise, banks become nurseries of national wealth."[691] The BUS borrowed some features from the Bank of England, like the prohibition on the trade in goods, merchandise and land, or the provision of a legal monopoly of the national charter for the lifetime of the BUS. However, unlike the Bank of England, the BUS was limited to twenty years.[692] The establishment of the BUS resulted in grave constitutional argument. Jeffersonians argued the Constitution gave the federal government no power to establish a bank, while Hamiltonians argued there were "implied powers" which allowed the Congress to charter the BUS.[693] The SCOTUS took Hamilton's views in *McCulloch v Maryland*.[694] However, the recharter bill was defeated by one vote both in the Senate and in the House of Representatives.[695]

During the War of 1812 (1812-1815) the government had difficulties raising federal loans while state banknotes were seen as unreliable by the market. As Ruthbard contends, "The nation could not continue indefinitely with the issue of fiat money in the hands of discordant sets of individual banks."[696] Because of these factors, the charter of the Second Bank of the US (Second BUS) (1816-1836) was established in 1816.[697] The Second BUS was modelled closely after the First BUS as a private corporation with one-fifth of the shares owned by the federal government. The aim of the Second BUS was to create a national currency, purchase public debt and receive deposits from the Treasury. Its notes were to be redeemable in specie and the federal government accepted them to pay taxes,

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688 M. Rothbard, *A History of Money and Banking in the United States. The Colonial Era to World War II* (Ludwig Von Mises Institute 2002) p. 61.
689 ibid.
690 R. Grossman, above note 475, p. 222.
691 A. Hamilton, "Final Version of the Second Report on the Further Provision Necessary for Establishing Public Credit (Report on a National Bank), 13 December 1790" <https://founders.archives.gov/documents/Hamilton/01-07-02-0229-0003> accessed 1 July 2019.
692 W. Lovett and M. Malloy, above note 626, p. 9; R. Grossman, above note 475, p. 224; M. Rothbard, above note 688, p. 67; E. Symons Jr and J. White, *Banking Law: Teaching Materials* (1991) p. 12; J. Wettereau, "The Branches of the First Bank of the United States" (1942) 2 The Journal of Economic History, Supplement: The Tasks of Economic History p. 66.
693 M. Rothbard, above note 688, p. 69.
694 17 U.S. (4 Wheat.) 316 (1819).
695 M. Rothbard, above note 688, p. 69; F. Allen and D. Gale, *Comparing Financial Systems* (MIT Press 2001) p. 32; R. Grossman, above note 475, p. 225.
696 M. Rothbard, above note 688, p. 82.
697 W. Lovett and M. Malloy, above note 626, p. 9; R. Grossman, above note 475, p. 227; E. Symons Jr and J. White, above note 692, p. 13; B. Hammond, "Jackson, Biddle and the Bank of the United States" [1947] 7(1) The Journal of Economic History p.1.

de facto giving them “quasi-legal tender”.[698] From its inception, the Second BUS had expansionary credit operations, which impelled an inflationary boom around the country. In 1818 the Second BUS contracted credit and purchased millions of dollars of specie from abroad, which led the US into a depression, which led to a series of defaults and liquidations.[699] In the aftermath of the crisis, William Gouge said, “the Bank was saved and the people were ruined.”[700] In 1831, the Second BUS’s President Nicholas Biddle requested the charter to be renewed. President Jackson vetoed the bill and the charter of the Second BUS expired in 1836.[701] The US did not have a central bank until three-quarters of a century later.

B. Free banking period (1837-1865)

From the beginning of the republic, banks in the US had been chartered by special acts of incorporation by state legislatures or by Congress (First and Second BUS).[702] Charters were comprehensive and included all sorts of issues such as value of the shares, dividend policies, the minimum number of directors, etc. Michigan (1837), New York (1837) and Georgia (1838) began to enact “free banking” acts where anyone interested in engaging in banking activities needed to complete a file and deposit the correct amount of government bonds within the corresponding authority, without legislature approval.[703] In essence, free banks were requested to grant a loan to the state government in exchange for the right to function.[704] The deposit of government bonds served as a security for all the circulating notes issued by the bank. If the bank failed to honour its notes, the state would sell the bonds and reimburse the note holders out of the proceeds.[705]

The reasons for the rise of free banking laws may be explained as an “understandable response” to the destruction of the Second BUS and the subsequent importance of state laws in regulating banks.[706] Additionally, economic interests of people living in cities without banks, and popular dislike of the granting of political privileges, elitism and corruption favoured the free banking movement.[707] Finally, “radical free- market or laissez-faire populism” and a general belief that more banking would promote economic

[698] M. Rothbard, above note 688, p. 82.
[699] ibid p. 86.
[700] W. Gouge, *A Short Story of Paper Money and Banking in the United States, Including an Account of Provincial and Continental Paper Money* (T.W. Ustick 1833) p.110.
[701] B. Hammond, above note 697, p. 10; R. Catterall, *Second Bank of the U.S*. (University of Chicago Press 1903) p. 239; E. Symons et al, above note 692, p. 12; J. Knox, above note 687, p. 69; C. Calomiris and Haber, above note 467, p. 169; P. Temin, ‘The Economic Consequences of the Bank War’ (1968) 76 Journal of Political Economy p. 258. On the demise of the Second BUS, see R. Grossman, above note 475, p. 228.
[702] R. Grossman, above note 475, p. 229.
[703] C. Calomiris and S. Haber, above note 467, p. 169; R. Grossman, above note 475, p. 229.
[704] C. Calomiris and S. Haber, above note 467, p. 169.
[705] H. Rockoff, ‘The Free Banking Era. A Re-Examination’ (1974) 6(2) Journal of Money, Credit and Banking p. 144; H. Bodenhorn, ‘Entry, Rivalry and Free Banking in Antebellum America’ (1990) 72 The Review of Economics and Statistics p. 683; K. Ng, ‘Free Banking Laws and Barriers to Entry in Banking, 1838-1860’ (1988) XL VIII (4) The Journal of Economic History p. 878; G. Dwyer Jr., ‘Wildcat Banking, Banking Panics and Free Banking in the United States’ [1996] Economic Review Federal Reserve Bank of Atlanta p. 2; H. Bodenhorn, above note 686, p. 184.
[706] Ibid, p. 142.
[707] C. Calomiris and S. Haber, above note 467, p. 170.

growth were also elements that favoured free banking laws.[708] Free banking ended *de facto* in 1865 when the government imposed a tax on state banknotes.[709]

C. National banking

In the US a dual banking system was established, in which state banks and national banks are chartered and supervised at different levels. Under the dual banking system, national banks are chartered and regulated under federal law and standards are supervised by a federal agency. State banks are chartered and regulated under state laws and standards, which includes supervision by a state supervisor. The dual banking system in the US was born during the Civil War period. President Abraham Lincoln's Treasury Secretary, Salmon Chase, led the effort to create the NBA of 1863, the main objective of which was to raise money for the North to defeat the South. This had to be done via the issuance of a common currency at the national level. Up to that point, state banknotes were in circulation. The 1863 Act created competition with state banks, and the legislators went a step further the next year by passing an amendment to tax the issuance of state banknotes.

During the Civil War, without the interference of eleven southern states, it was possible to enact stronger federal banking legislation.[710] In 1862, the federal government started issuing paper currency called "greenbacks" that held the status of legal tender. The NBA favoured the federal chartering of state banks with weak capitalization requirements, while limiting note issuance. State bank note issuance disappeared because of the 10% federal tax levied on them.[711] However, checkbook transactions replaced most currency transactions by 1880, which led to a revival of state banks.[712]

National banks were "national" in the sense they were chartered by the federal government. However, they could not operate via nationwide branches, *de facto* preserving a system of geographic monopolies since state laws regulated the branching of national banks. The NBA was "free banking" on a national scale.[713] The drafting of the NBA drew heavily on the New York Act.[714] For the first time in US history, national banks would be supervised by a newly created agency, the Comptroller of the Currency, under uniform charters and uniform rules.[715] The aim of the NBA was to develop a national currency, a market for federal bonds and the use of federal banks as federal depositories.[716]

In order to reduce *ex ante* the risk of a banking crisis, federal and state law in this period included capital requirements, double liability, deposit insurance and branching regulations.[717] Minimum capital requirements were introduced both at the federal and state levels, but the minimum amounts fell from an average of USD57,000 in 1865 in small populations to USD 28,000 in 1880, USD 18,800 to just USD 17,000 during WWI.

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708 H. Bodenhorn, above note 686, p.191.
709 G. Dwyer Jr, above note 705, p. 2; H. Bodenhorn above note 686, p. 183.
710 W. Lovett and M. Mallow, above note 626, p. 11.
711 C. Calomiris and S. Haber above note 467, p. 179; R. Grossman above note 475, p. 229.
712 W. Lovett and M. Mallow, above note 626, p. 11.
713 C. Calomiris and S. Haber above note 467, p. 179.
714 E. Symons Jr and J. White above note 692, p. 22.
715 R. Grossman above note 475, p. 229.
716 E. Symons Jr and J. White above note 692, p. 22.
717 R. Grossman above note 475, p. 242.

The decline of minimum capital requirements may be explained by regulatory competition within states and a perception of an increase in safety in the banking system due to double liability, deposit insurance and branching.[718]

"Double liability" was imposed to shareholders of failed banks, which were called to pay not only the initial payment in capital but another amount equal to such amount.[719] For national banks, it was required that "each shareholder shall be liable to the amount of the par value of the shares held by him, in addition to the amount invested in such shares."[720] Six states instituted triple liability, while others imposed unlimited liability.[721] Senator Sherman explained that the reasons for assuring double liability were the protection of creditors and that it "tend(s) to prevent stockholders and directors of a bank from engaging in hazardous operations."[722] By 1930 only four states allowed single liability.[723] The Great Depression hit both single and double liability states and by 1941 there were no double liability or triple regimes in the US. According to Macey and Miller, the reasons for the repeal of double liability rested on the following: i) the bankruptcy of managing shareholders put pressure on politicians to change the regime; ii) the 1929-1933 bank failures proved double liability did not adequately promote stability; and iii) the implementation of federal deposit insurance made it redundant.[724] However, history has proved during the GFC that federal deposit insurance did not prevent the crisis. Double liability is a very interesting idea to make insiders responsible and to stop moral hazard. Recently, Goodhart and Lastra have proposed a two tier liability system, where insiders would be subject to multiple liability depending on their involvement in the disposition of information. The aim of their proposal stems from the fact that it would "shift the costs of failure back towards those who have the responsibility for taking these decisions."[725]

Unfortunately, fragility and periodic panic were the norm until the reforms of the 1930s.[726] Defects in the banking system before that time become patent in the panic of 1907, which led the Congress to enact the Aldrich Vreeland Act of 1908.[727] The aim of this act was to permit "a greater flow" of national currency until there was a consensus for the creation of a central bank.[728]

D. The Federal Reserve System (1913-)

With agrarian objections, the Federal Reserve Act was passed in December 1913. The preamble of the Act stated that its aim was "[t]o provide for the establishment of Federal

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[718] ibid 237.
[719] C.A.E. Goodhart and R. Lastra, 'Equity Finance: Matching Liability to Power' [2020] Journal of Financial Regulation p.3; J. Macey and G. Miller, 'Double Liability of Bank Shareholders: History and Implications' (1992) 27 Wake Forest L. Rev. 31, p. 37; H. Bodenhorn, 'Double Liability at Early American Banks' (2015) NBER Working Paper No. 21494 ps 5-6; R. Grossman, 'Fear and Greed: The Evolution of Double Liability in American Banking, 1865–1930' (2007) 44 Explorations in Economic History ps. 44, 61.
[720] National Banking Act of 1863, ch. 58, 12 Stat. 665.
[721] R. Grossman, above note 719, p. 237.
[722] Cong. Globe, 38th Cong., 1st Sess. Part II 1069 (1864).
[723] R. Grossman, above note 719, p. 238.
[724] J. Macey and G. Miller, above note 719, p. 37; R. Grossman, above note 719, p. 238.
[725] C.A.E. Goodhart and R. Lastra, above note 719, p.1
[726] W. Lovett and M. Mallow, above note 626, p. 13.
[727] 35 Stat. 546. 60th Congress, 1st Session, ch 229.
[728] E. Symons Jr and J. White, above note 692, p. 26.

reserve banks to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States and for other purposes."[729] The Federal Reserve System was conceived as the central bank of the US, which was the first central bank after the demise of the Second BUS, more than 75 years earlier.[730] As Bernanke affirms, "financial stability concerns were a major reason that Congress decided to create a central bank."[731] National banks had to be members of the Federal Reserve System, while state banks were allowed to join. By 1916, only 37 state banks joined the system.[732] The Board of Governors (the former Federal Reserve Board (FRB)), which leads and oversees the entire system, manages the Federal Reserve System.[733]

However, the System is federal in nature, since the law grants authority to twelve Federal Reserve Banks and their branches, which operate in twelve different districts around the country.[734] The federal nature of the bank resulted partly from American "wariness of concentrating too much financial authority within one institution."[735] Actual operations are engaged by the Federal Reserve banks "in concert" with member banks.[736] As Lastra explains, the Federal Reserve System itself does not have legal personality. Instead, the legal entities are the Board of Governors (which is a federal agency) and the twelve Federal Reserve banks, which are privately owned, and perform central banking activities and commercial banking activities.[737]

The Federal Reserve System was designed to be independent from political power.[738] Conti Brown states, "Fed independence is the separation, by statute, of the central bankers (specifically the Fed chair) and the politicians (specifically the president) for purposes of maintaining low inflation."[739]

During the 1920s the US economy flourished. However, in 1929 the US and the world suffered the Great Depression. The US stock market crashed on 29 October 1929. From 1929 to 1932, stock prices fell 85%.[740] US GDP contracted by one third between 1929 and 1932. In 1931 the Creditanstalt collapsed, bringing down other banks in Europe. The depression in the US lasted until 1941.[741] According to some commentators, the Federal

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[729] Federal Reserve Act: Public Law 63-43, 63d Congress, H.R. 7837: An Act to Provide for the Establishment of Federal Reserve Banks, to Furnish an Elastic Currency, to Afford Means of Rediscounting Commercial Paper, to Establish a More Effective Supervision of Banking in the United States, and for Other Purposes.

[730] Federal Reserve <https://www.federalreserveeducation.org/about-the-fed/structure-and-functions> accessed 22 July 2019. Over the years, its role has expanded. Today it has three principal functions: monetary policy, banking supervision and financial services. R. Grossman, above note 719, p. 243.

[731] B. Bernanke, *The Federal Reserve and the Financial Crisis* (Princeton University Press 2013) p. 9.

[732] E. Symons Jr and J. White, above note 692, p. 28.

[733] Federal Reserve above note 730; E. Symons Jr and J. White, above note 692, p. 28.

[734] E. Symons Jr and J. White, above note 692, p. 28.

[735] R. Grossman, above note 475, p. 243.

[736] E. Symons Jr and J. White, above note 692, p. 29.

[737] R. Lastra, above note 27, p. 65.

[738] See generally R. Lastra, above note 624; C. Goodhart, above note 624; P. Conti-Brown, above note 624; E. Balls, J. Howat and A. Stansbury, above note 624; M. Barr, H. Jackson and M. Tahyar, above note 624.

[739] P. Conti-Brown, above note 624, p. 2

[740] B. Bernanke above note 731 p. 19.

[741] Ibid.

Reserve failed both on the monetary side and on the financial stability side.[742] On the monetary side, this occurred since it did not ease money because it wanted to maintain the gold standard and believed in the "liquidationist" theory, which stated that after an expansion the correct result is a period were excesses are "squeezed out".[743] On the financial stability side, this occurred because the Federal Reserve did not fully fulfil the lender of last resort responsibility, responding inadequately to bank runs.[744]

During the early years of 1933, many states declared banking holidays in order to free banks from redeeming deposits. On 4 March 1933, Franklin Delano Roosevelt (FDR) inaugurated his presidency and the following day he declared a national bank holiday.[745] Among a series of emergency actions, the most significant was the GSA.[746] Its most important provisions included: i) the creation of the FDIC[747]; ii) the "Glass-Steagall Wall" which separated investment banking from commercial banking[748]; iii) the limit of interest payments on demand deposits; iv) giving the Federal Reserve credit control authority to prevent speculative excesses; and v) creating the Federal Open Market Committee (FOMC) as the "central body that would make proactive decisions about the purchase of market securities, including government securities."[749] This also led to the publification/agencification of the Federal Reserve System.

Another important measure of FDR administration was the abandonment of the gold standard. Through the Banking Act of 1935, Congress expanded the powers of the FRB in order to better fulfil its functions as a central bank.[750] At the same time, the FDR government perceived the need to restore confidence in the capital markets, damaged by the Great Depression. During the 1920s approximately 20 million Americans "took advantage of post-war prosperity and set out to make their fortunes in the stock

742 B. Bernanke, above note 731 p. 24; B. Bernanke, 'On Milton Friedman's Ninetieth Birthday' Remarks by Governor Ben S. Bernanke at the Conference to Honour Milton Friedman, University of Chicago, Chicago, IL, 8 November 2002; M. Friedman and A. J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton 1965) p. 444; W. Lovett and M. Mallow, above note 626, p. 15; G. Richardson, "The Great Depression" <https://www.federalreservehistory.org/essays/great_depression> accessed 5 August 2019; A. Meltzer, *A History of the Federal Reserve, volume 1 : 1913-1951* (2003) 16; P. Temin, "Lessons for the Present from the Great Depression" [1976] 66(2) The American Economic Review p. 40; C.D. Romer, "The Nation in Depression" The (1993) 7(2) Journal of Economic Perspectives p. 33.

743 Ibid, B. Bernanke p. 24

744 M. Friedman and A. Schwarz above note 742 p 407.

745 R. Grossman, above note 475, p. 224.

746 Act of June 16, 1933, 48 Stat. 162.

747 According to M. Friedman and A. Schwartz, "Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic…and…the structural change most conductive to monetary stability", above note 742, p 434.

748 The relevant Sections are 16, 20, 21 and 32. R. Effros, above note 9; F. Edwards, "Banks and Securities Activities: Legal and Economic Perspectives on the Glass-Steagall Act" in L. G. Goldbergand, L. J. White, *The Deregulation of Banking and Securities Activities* (Lexington Books 1979) ps. 273-94; M. Sherman, "A Short History of Financial Deregulation in the United States" [2009] Center for Economic and Policy Research p.10 ; R. Kroszner and R. Rajan, above note 372, p. 814; G.J. Benston, above note 233, p. 121; R. Carmel, 'Glass-Steagall: Some Critical Reflections' [1980] Banking Law Journal ps. 631-641; B. Shull, "The Separation of Banking and Commerce in the United States an Examination of Principal Issues" [1999] OCC Economics Working Paper p. 12; B. Shull and L. White, "Of Firewalls and Subsidiaries: The Right Stuff for Expanded Bank Activities" [1998] New York University Center for Law and Business Working Paper #CLB-98-017 p. 4.

749 P. Conti-Brown, above note 624, p. 25

750 W. Lovett et al., above note 626, p. 8; G. Richardson, A. Komai and M. Gou, "Banking Act of 1935" (2013) <https://www.federalreservehistory.org/essays/banking_act_of_1935> accessed 5 August 2019.

market."[751] Congress passed the Securities Act of 1933[752] with the aims of monitoring the securities industry by promoting stability in the markets and by protecting investors.[753] Many of the "New Deal" reforms persist as of today. They have shaped the US financial system and they have been essential in the development of the US economy.

Because of its federal nature, one special feature of the US banking system is how it regulated the branching of banks at both the state and federal levels. An overview of these restrictions follows.

5.1.2 Branching and unit banking

The US has a long history of restricting the geographic expansion of banking entities. Its rationale, as with antitrust, stems from preventing abuse of power and undue concentration of financial resources.[754] While the First BUS and Second BUS were permitted to branch,[755] the NBA of 1864 was interpreted by the Comptroller of the Currency to prohibit branching by national banks.[756] State banks that already had branches were allowed to maintain those branches if they obtained federal charter, resulting in some national banks having branches. However, they could not open new branches. Similarly, many state-chartered banks faced comparable limitations. Many states prohibited branching of any kind; some states permitted only intra-city branches, and a few permitted state-wide branching.[757]

The consequence of these restrictions was a system composed mostly of individual unit banks.[758] "No other nation prevented its banks from branching as severely as the United States did, and by the beginning of the twentieth century, branching networks were nearly

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[751] A. L. Nazareth "Speech by SEC Staff: "Come With Me to the SEC" Remarks before the Brown University Commencement Forum" <https://www.sec.gov/news/speech/spch052403aln.htm#:~:text=During%20the%201920s%2C%20approximately%2020,fortunes%20in%20the%20stock%20market.&text=Banks%20also%20lost%20great%20sums,invested%20heavily%20in%20the%20markets .> accessed 12 April 2020.
[752] United States Code: Securities Act of 1933, 15 USC §§ 77a-77mm (1934).
[753] US Securities and Exchange Commission <https://www.sec.gov/Article/whatwedo.html> accessed 5 August 2019.
[754] Bank centralization is "contrary to the spirit of American Independence". Speech by former Governor Stokes of New Jersey before Pennsylvania Bankers Ass'n at Atlantic City. 74 Cong. Rec. 1129, 1130, cited by Harvard Law Review Association, 'Branch, Chain and Group Banking' (1935) 48(4) Harvard Law Review p. 659. M. Nieto and M. Wall, "Breaking Down Geographic Barriers on Banks: U.S. and EU Recent Experiences" [2015] Federal Reserve Bank of Atlanta <https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1507.aspx accessed 20 December 2019>. C. Calomiris and S. Haber, above note 467. On the rational of antitrust, see Federal Trade Commission "Antitrust Laws" <https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/antitrust-laws> accessed 19 March 2021.
[755] J. Wettereau, above note 692; C. Calomiris and C. Ramirez, "The Political Economy of Bank Entry Restrictions: Theory and Evidence from the U.S. in the 1920's" [2004] Working Paper, Columbia University, p.4.
[756] D. Amel and N. Liang, "The Relationship Between Entry into Banking Markets and Changes in Legal Restrictions on Entry" [1992] Antitrust Bulletin p. 633; D. Riefler, "Branch Banking and Chain Banking" (1930) 1 Editorial Research Reports p.1-4; D. Giedeman, "Branch Banking Restrictions and Finance Constrains in Early- Twentieth-Century America" (2005) 65(1) The Journal of Economic History p. 129.
[757] D. Giedeman, above note 756, p. 129.
[758] E. White, "A Reinterpretation of the Banking Crisis of 1930" (1984) 44(1) The Journal of Economic History p. 131.

ubiquitous in every advanced nation except the United States."[759] The McFadden Act of 1927 permitted national banks to establish branches only if state law allowed it. Even then, branching was limited to the city limits.[760] In 1986 the Douglas Amendment[761] provided no BHC might acquire a bank outside the state of its principal banking activities "unless that state specifically authorizes, by statute, such an acquisition."[762]

Calomiris explains an "agrarian Populist-Unit Banker coalition" existed in the US from the colonial era. British America was a society of small farmers that were armed and had the right to vote. The agrarian coalition believed in property rights and easy access to credit. They understood unit banks served local communities better than branches. Because of the federal nature of the American political and legal system and because the US Constitution did not explicitly give banking regulatory authority to the federal government, the "agrarian-unit bank" coalition could more easily win legislative fights at the state level. Until the twentieth century, they did not fight at a national level.[763] When this moment came, branching restrictions ceased with the passing of the Riegle-Nale Interstate Banking and Branching Efficiency Act of 1994, when the whole banking system changed.[764]

5.1.2.1. Benefits and costs of unit banks

The costs and benefits of unit banking have been addressed in different stages of US history. Even before the NBA, Hamilton was distrustful of the idea of a national bank with branches.[765] Unit banks were not only favoured by the agrarian coalition, but, at least in one case, citizens voted for the maintenance of the unit bank system via referenda.[766] The next section analyses the benefits and costs of unit banks from a historical perspective.

A) Benefits of unit banks

1. Because of its unique structure unit banks may not be altered by the mismanagement of a branch

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[759] D. Giedeman, above note 756; see also C. Fohlin, "Economic, Political and Legal Factors in Financial System Development: International Patterns in Historical Perspective" (2000) California Institute of Technology, Social Science Working paper 1098 p. 2.
[760] C. Calomiris and C. Ramirez, "The Political Economy of Bank Entry Restrictions", above note 755, p.5; For other legal restrictions see D. Amel and J. Nellie Liang, above note 756 p. 633.
[761] 12 USC § 1842(d).
[762] C. Falsenfeld, "The Bank Holding Company Act: Has It Lived Its Life" [1993] Villanova Law Review p.121.
[763] C. Calomiris and S. Haber, above note 467, p. 154.
[764] The Riegle-Niele Interstate Banking and Branching Efficiency Act of 1994 allowed the following: i) well-managed and well-capitalized BHC's could acquire banks in any state after 29 September 1995; ii) BHCs could merge banks in different states into a single branch group after 1 June 1997; iii) until 1 June 1997, states could opt-out of branching provisions; and iv) BHCs may not control more than 10% of the US's total deposits, among other requisites. Federal Reserve History, "Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994" <https://www.federalreservehistory.org/essays/riegle_neal_act_of_1994?WT.si_n=Search&WT.si_x=3> accessed 27 September 2019.
[765] J. Wettereau, above note 692, p. 70.
[766] E. White, "Voting for Costly Regulation: Evidence from Banking Referenda in Illinois, 1924" [1985] 51(4) Southern Economic Journal.p. 1084

Hamilton explained that while the situation in the US would inspire the admission of a plurality of branches for the First BUS, "the argument against it is, that each branch must be under a distinct, though subordinate direction, to which a considerable latitude of discretion must of necessity be entrusted. And as the property of the whole institution would be liable for the engagements of each part, that and its credit be at stake, upon the prudence of the directors of every part. The mismanagement of either branch might hazard serious disorder in the whole."[767] While this argument is an essential note of branch banking, it does not prevent the cost effectiveness of branch banking. Moreover, the problem of mismanagement remains in the unit bank and affects all types of financial activity.

2. Small unit banks may have a more personal knowledge of customers which enhances monitoring and control

Sprague finds the most important advantage of small banks is the "extensive local knowledge…and very intimate acquaintance with the individual borrower." This advantage is greater in rural areas where loans are not so liquid and the personal element is crucial. [768]

While true in nature, the same effect of "local knowledge" may be theoretically present in branches of a non-unit bank.

3. Local ownership and control of unit banks focused more on local concerns and interests

Some authors from the 1920s and 1930s explained local customers were keener to be served by local unit banks than by branch banking because they believed unit banks would better attend local interests and concerns.[769] According to Morentz Markeley, "The local nature of the decision making process inherent in the independent banking structure puts the independent bank in a better position to identify the capital needs of the agricultural sector and to design bank policies that can best serve this local sector."[770]

While this subjective argument might have been present in the past in the rural areas of the US, theoretically local branches of a non-unit bank might serve local interests as well as unit banks.

4. Branch banking may lead to capital outflows from nonmetropolitan areas

Morentz Markely explains that since the decision-making process of branch banking is more centralised, "As a result, local capital needs could possibly be left unmet as capital is allocated within the holding company to less risky, higher return ventures in other areas of the state. These events could lead to capital outflows from nonmetropolitan areas, as a result of the decline in independent banks in rural areas."[771]

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[767] M. St. Claire Clarke and D. A. Hall, *Legislative & Documentary History of the Bank of the United States, Reprints of Economic Classics* (Routledge 1996) p. 15.
[768] O.M. Sprague, 'Branch Banking in the United States' (1903) 17 The Quarterly Journal of Economics p. 249.
[769] B. Abrams and R. Settle, above note 647, p. 689.
[770] D. Morentz Markeley, above note 647, p. 165.
[771] D. Morentz Markeley, above note 647.

5. Unlike branch banking, unit banking tends not to be monopolistic in character

Comptroller Dawes raised objections to allowing branch banking before the House Committee of Banking and Currency in 1924. He contended that branch banking is "essentially monopolistic" since it may reduce interest rates until it becomes a monopoly and then reimburse the costs. He also alleged that in other countries branch banking led to bank concentration in a few banks.[772]

The monopoly argument against branch banking has been strong in the US, for the reasons Dawes explains. The development of antitrust law in the US has prevented the kind of predatory pricing-like measures described by Dawes. US law now prefers to trust in regulation to avoid monopolistic measures (predatory pricing among others)[773] and not in "anti-branch" policies as in the past.

6. Branch banking opposes federalism

Comptroller Dawes believed branch banking opposed federalism. "Branch banking is peculiarly inconsistent with the American idea of local self-government and Federal coordination. The banking system of the United States is closely analogous to the governmental structure. Under the Federal reserve system local independent units are coordinated while branch banking proposes that they should be consolidated."[774]

Federalism as a political system is not denaturalised by the branch banking system since the way banks are structured is not an essential note of federalism. The US is and will continue to be a federal country no matter how its FCs are structured.

B) Costs of unit banks

1. Unit banks were inadequate to finance industrial firms

Evidence suggests "links between industrial firms and banks were much weaker in the United States than in other countries (notably, much weaker than in Germany's universal banking system). This reflected primarily the small size of incorporated banks relative to the large needs of industrial borrowers."[775] In 1914 in the US there were 26,000 banks, overall not capable of establishing branches. In general, they were incapable of

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[772] House of Representatives 29 December 1924 <https://www.govinfo.gov/content/pkg/GPO-CRECB-1925-pt1-v66/pdf/GPO-CRECB-1925-pt1-v66-19.pdf> accessed 21 August 2019; D. Riefler, above note 756, p. 1-4.

[773] P. E. Areeda and Herbert Hovenkamp, *Antitrust Law* (2nd Ed 2002) paras 722–49; P. Areeda and D.F. Turner, "Predatory Pricing and Related Practices under Section 2 of the Sherman Act" [1975] 88 Harv. L. Rev. 697, 697; U.S. Dep't of Justice, Competition and Monopoly: Single-Firm Conduct under Section 2 of the Sherman Act (2008).

[774] House of Representatives, above note 123.

[775] C. Calomiris and C. Ramirez, "Financing the American Corporation: The Changing Menu of Financial Relationships" (1996) NBER Working Papers Series on Historical Factors in Long Run Growth 20 p. 144; See also G. Cartinhour, *Branch, Group and Chain Banking* (Macmillan Company 1931) p. 266; H. Preston, "Branch Banking with Special Reference to California Conditions" (1922) 30(4) Journal of Political Economy p. 511.

"financing, monitoring and disciplining large industrial borrowers."[776] On the other hand, this inability of unit banks to finance industrial growth induced innovative means of finance such as the development of commercial paper and investment banking syndicates.[777]

Not only were branching restrictions inadequate to finance large firms but also there is evidence that branch banking "hindered the development of large-scale American enterprises in the early twentieth century."[778] While there is evidence that banks did finance industry in early nineteenth century, their role was less important by the end of the century.[779]

In order to show the differences between the US and Germany in terms of how banks finance industry, it is useful to look at what Goldsmith defines as the "Financial Intermediation Ratio" (FIR), the ratio that "measures the importance of financial institutions in terms of resources within the financial superstructure."[780] The FIR for Germany rose from 20.3 in 1850 to 30.1 in 1929, while the FIR for the US rose from 12.5 to 16.4 over the same period. He also concludes that the participation of financial intermediaries in financing the main sectors of the economy in the US in the first half of the twentieth century "averages approximately 5 per cent for nonfarm households and agriculture, and between 12 and 15 per cent for unincorporated and corporate business and state and local governments."[781] Moreover, the specific link of banks financing industry was greater in Germany than in the US.[782]

Calomiris concludes, "American industrialists could not depend on a single banking relationship to guide them through their growing and changing financial needs over the years. They relied less on banks for credit, especially to finance large-scale projects…the small size of banks limited bank lending to large-scale firms."[783]

2. Unit banks imposed costs on large firms that had to rely on investment banking syndicates

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[776] C. Calomiris and C. Ramirez, "Financing the American Corporation", note 775, p. 144; see also C. Calomiris "The Political Lessons of Depression-Era Banking Reform" [2010] 26 Oxford Overview of Economic Policy p. 542, and C. Calomiris, "Corporate Finance Benefits from Universal Banking: Germany and the United States 1870-1914" (1993) NBER Working Paper No 4408 p. 6. See also T. Hikino and A. Chandler, above note 251, p. 80.
[777] C. Calomiris and C. Ramirez, 'Financing the American Corporation', above note 775, p. 21; D. Giedeman, above note 746, p. 134; J. Armour et al., *Principles of Financial Regulation* (OUP 2016) p. 438.
[778] D. Giedeman, above note 756, p. 148.
[779] C. Calomiris and S. Haber, above note 467, p. 185. See also R. Sylla, "U.S. Securities Markets and the Banking System 1790-1840" [1998] Review, Federal Reserve of Saint Louis ps. 83-84; N. Lamoreaux, *Insider Lending, Banks, Personal Connections, and Economic Development in Industrial New England* (CUP 1994) p. 19; F. Allen et al., "How Important Historically were Financial Systems for Growth in the UK, US and Japan?" [2010] World Bank Project on Financial Structure. M. Jaremski concludes that national banking acts were partially responsible for increasing the number of banks in the manufacturing belt, which "indirectly contributed to the nation's industrialization." M Jaremski, 'National Banking's role in US industrialization, 1850-1900' [2013] Working Paper 18789, National Bureau of Economic Research p. 18.
[780] R. Goldsmith, above note 294 p. 134.
[781] R.W. Goldsmith, *Financial Intermediaries in the American Economy Since 1900* (Princeton University Press 1958) p. 181.
[782] C. Calomiris, above note 328, p. 283.
[783] Ibid 288.

Large firms had to rely on investment banking syndicates to finance their fixed capital investments because unit banks were incapable of borrowing such amounts.[784] According to SEC data on the fees paid to investment bankers in 1930s, external finance through security issuances were on average 20% of the value of the issue. Costs were "unusually high" compared to the fees applied by German universal banks.[785]

3. Unit banks were more associated with bank panics than branch banking

According to some authors, branch banking reduced the incidence of panics.[786] Bordo's survey on panics from 1870 to 1933 explains, "[t]he United States experienced banking panics in a period when they were a historical curiosity in other countries."[787] Calomiris, comparing evidence from English-speaking countries showed unit banks were more prone to panics than branch banking institutions.[788] The reason behind these facts may be explained by the diversification of individual bank assets.[789] "Systems based on large, geographically diversified banks that engage in a variety of activities that have been the least susceptible to panic, have had a lower incidence of bank failure, and have suffered smaller losses when banks failed."[790] Bernanke and James also explain that countries with unit banking "suffered more severe banking panics."[791]

White tested the hypothesis that branch banking was better prepared to survive financial crises by comparing data from banking crises in Canada and the US in the 1920s and 1930s. While in the US in the 1920s there were 6,008 suspensions, in Canada, only one bank failed during that period.[792]

4. Unit banks hindered financial integration and diversification

There is a consensus among American scholars that disparities in regional rates of return in the nineteenth century were due to branching restrictions and "geographical dispersion

[784] C. Calomiris, above note 328 p, 283; J. Armour et al., above note 777 p. 438.
[785] C. Calomiris, "Regulation, Industrial Structure and Instability in U.S. Banking" in M. Klasner and L. White (eds), *Structural Change in Banking* Business (One-Irwin 1993) p. 54.
[786] B. Abrams et al., above note 647 p, 687; M. Carlson and K Mitchener, "Branch Banking as a Device for Discipline: Competition and Bank Survivorship during the Great Depression" (2007) NBER Working Paper Series p. 1.
[787] M. Bordo, "The Impact and International Transmission of Financial Crisis: Some Historical Evidence: 1870-1933" (1985) 2 Revista di Storia Economica ps. 41-78.
[788] C. Calomiris, above note 785, p. 11.
[789] O.M. Sprague, above note 768 p. 243; E. White, above note 758 p. 131.
[790] C. Calomiris, above note 785, p. 3.
[791] B. Bernanke and H. James, "The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison" in R.G. Hubbard, *Financial Markets and Financial Crisis* (Chicago University Press 1991) p. 54.
[792] E. White, above note 758 p. 131.

of economic opportunities." [793] Unit banks hindered interregional capital flows that in general help to equalize rates of return on loans.[794]

In addition, the high cost of gathering and transmitting information over long distances resulted in information asymmetries, which led banks to charge higher premiums on loans to customers located far away from the bank.[795] Unit banks were also less diversified and more exposed to "location-specific" shocks, such as agricultural price volatility.[796]

5. Unit banks were less able to provide services in thinly populated regions

Since the costs of establishing a branch office were much lower than establishing a unit bank, branches could operate in places where unit banks could not, expanding into new areas and diversifying bank portfolios.[797]

6. Unit banks were less efficient than branch banking in the use of capital and reserves

Historical evidence shows branch banking in certain states in the nineteenth century had lower ratios of reserves to assets and lower capital-to-asset ratios than unit banks.[798] Calomiris explains since branch banking reduces banks' risks it also reduces banks' demands for reserves.[799] Additionally, branch banking "lowers both bank and customer costs" since they are able to produce services in "more optimally sized offices."[800]

7. Unit banks prevented competition among banks

Unit banks could only face competition by other unit banks, allowing the existence of less profitable banks which were less prepared for adverse times. Barriers of entry increased the costs of setting unit banks.[801] Furthermore, branching limits restricted the eligible candidates for acquiring or taking over banks to the same locality or state.[802] Moreover,

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[793] C. Calomiris, above note 785, p. 28; See also L. Davis, "The Investment Market 1870-1914; The Evolution of a National Market" [1965] 26 Journal of Economic History; R. Sylla, 'Federal Policy, Banking Market Structure, and Capital Mobilization in the United States, 1863-1913' [1969] 29 Journal of Economic History; K. Snowden, "Mortgage Rates and American Capital Market Development in the Late Nineteenth Century" [1987] Journal of Economic History; J. Binder and A. Brown, 'Bank Rates of Return and Entry Restrictions, 1869-1914' [1991] Journal of Economic History.
[794] C. Calomiris, above note 785, p. 28; O.M. Sprague, above note 768, p. 242.
[795] D. Giedeman, above note 756.
[796] C. Calomiris, "The Political Lessons of Depression-Era Banking Reform", above note 776, p. 542; E. White, above note 758, p. 131.
[797] C. Calomiris, above note 785, p. 38.
[798] Ibid 39.
[799]C. Calomiris, above note 785, p. 38; See also C. Calomaris and L. Schweikart, "Was the South Backward? North-South Differences in Antebellum Banking" [1988] Colombia University working Paper. O.M. Sprague, above note 768.
[800] D. Humphrey, "Why do Estimates of Bank Scale Economies Differ?" [1990] Economic Review, Federal Reserve Bank of Richmond ps. 38-50; See also P. Calem, 'The Impact of Geographic Deregulation on Small Banks' (1994) 17 Federal Reserve Bank of Philadelphia.
[801] C. Calomiris, above note 785 p. 38; A. Berger et al., 'The Transformation of the U.S. Banking Industry: What a Long Strange Trip It's Been' [1995] Brooking Papers on Economic Activity p. 62.
[802]A. Berger et al., above note 801p. 62.

Carlson and Mitchener showed unit banks that competed with branch banking before the Great Depression were better able to survive the crisis than unit banks that did not.[803]

8. Economic growth accelerated in states that allowed interstate branching

Jayaratne and Strahan from the Federal Reserve of New York showed upon empirical evidence that "economic growth accelerated following intrastate branching reform" and that there were no other "concurrent policy changes" to explain such "improvements in growth." They explain that the possible factors of growth improvement are due to "bank monitoring and screening improvements". The result of deregulation on this field was the improvement of the quality of lending.[804]

5.1.2.2. A reaction to unit banks: chain and group banking and bank holding companies

Branching restrictions induced bankers to circumvent them via other instrumentalities such as group and chain banking.[805] Chain banking is a phenomenon of one individual, or one family or small group of persons, controlling stock in a number of banks.[806] Group banking, on the other hand, is defined by Wakefield,

> "Group banking is the name that has come into common usage for this step in the evolution of the American banking system…Group banking is not simply chain banking under another name. Chains of banks under common ownership or common control usually of a single individual, have existed for generations…Group banking on the other hand is the association of a number of corporately independent institutions within a single holding company for mutual advantages, the group being built around one or more large banks of a territorial nature and its management resting in the hands of the banking interests of a territory served."[807]

The FRB characterised the group banking structure by the following features: i) the existence of a holding company which owns the stock of a number of banks; ii) a centralised direction of essential activities of the banks under the holding company; iii) an exchange of stock of the shareholders of the banks for the stock of the holding company; and iv) marketing of the existence of the group and the names of those belonging to it. By 1931, 97 banking groups controlled 978 banks.[808]

As it usually happens, it was a new corporate structure that gave rise to a new regulatory regime. It was not until 1956 that BHCs were regulated in the US. The relationship of the group structure and regulation is a typical chicken and egg situation.[809] The regulator reacts based upon what the private sector structures, and at the same time, the private

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[803] M. Carlson and K Mitchener, above note 786 p.1.
[804] J. Jayaratne and P. Strahan, 'The Finance-Growth Nexus: Evidence from Bank Branch Deregulation' (1996) The Quarterly Journal of Economics p. 667.
[805] D. Riefler, above note 756 ps 1-4; Federal Reserve Board, 'Banking, Groups and Chains' (1930) p. 73; Harvard Law Review Association, above note 950, p. 663; D. Amel and N. Liang, above note 756, p. 634.
[806] Federal Reserve Board, "Banking, Groups and Chains" (1930) p. 73.
[807] United States Congress, 71st, 2nd Session, House Committee on Banking and Currency, Hearings on Branch, Chain and Group Banking, under H. Res. 141, 25 February 1930 p. 26; see also Federal Reserve Board, above note 806.
[808] Federal Reserve Board, above note 806, p. 5.
[809] C. Morris, *The Law of Financial Services Groups* (OUP 2019) p. 31.

sector tries to organise itself in a way that is economically fit and less bureaucratic in nature, which may in turn make the regulator react to impede such innovation if it finds it would harm industry.

The next section will analyse the evolution of capital markets in the US.

5.1.3 The US and the evolution of capital markets. The inability of the unit banking system to finance industry

Unlike Germany, where universal banks were strongly involved in the evolution and the development of industry, in the US, unit banks were unable to finance large-scale industrial firms.[810] However, in part due to branching restrictions, capital markets were key to the US after the Great Depression. As noted by Gordon and Judge, "Central to the US story was a mismatch between growing enterprises and a stunted banking system. Political choices led to a banking system populated primarily by small local banks that were ill suited to provide financing in the amounts, or with the risk, needed to fund the railroads and the follow-on industrial firm expansion. The bond market stepped in, creating national and international channels for debt and then equity finance."[811] The results of these restrictions were the growth of bond markets first and the growth of equities markets second. Gordon and Judge correctly stress, "The role of the law here was largely repressive, facilitating the growth of capital markets by limiting bank capacity."[812] Here we find a convincing explanation of the secondary effects of the law. While the intention of US lawmakers was to restrict bank branches, the unwanted result was that US big firms had to rely on syndicates and other forms of finance to substitute bank loans, which in turn developed the bond market first, and the equity market second.

On the other hand, the depression era "New Deal" laws strengthened these markets via: i) a strong disclosure regime; ii) a strong regulator and enforcer, the SEC; iii) the separation of commercial and investment banking (GSA); iv) the creation of investment banks; and v) weak state intervention on the issuance of debt and equity. Other legal changes further helped the capital market development in the US, such as: i) the Trust Indenture Act of 1939, which protected bondholders from expropriation in restructurings;[813] ii) the 1940 Investment Company Act[814] that regulated the mutual industry fund, which permitted retail investors to invest in a share of a pool of diversified credit portfolios; and iii) the Employee Retirement Security Act of 1974[815] (ERISA) which pooled pension funds out of banks.[816]

One example of the inability of unit banks to finance large enterprises was railroad finance. Railroad finance took place at the beginning of the 1820s. Most of the finance

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[810] N. R. Lamoreaux, 'Banks, Kinship, and Economic Development: The New England Case' (1986) 46(3) Journal of Economic History p. 647. See also H. Bodenhorn, above note 686; V. Carosso, *The Morgans: Private International Bankers, 1854–1913* (1987).
[811] J.N. Gordon and K. Judge, "The Origins of a Capital Market Union in the United States" [2018] Working Paper No. 584, The Center for Law and Economic Studies Columbia University School of Law.
[812] J. N. Gordon and K. Judge, above note 811, p. 2. See also Calomiris, above note 328, p. 287.
[813] 15 USC §§ 77aaa–77bbbb.
[814] 15 USC §§ 80a-1–80a-64.
[815] 29 USC ch 18.
[816] J. N. Gordon and K. Judge, above note 811, p.3.

was in bonds and almost a third was foreign investment.[817] Since railroad finance was risky, rates were high.[818] Gordon and Judge believe the first "junk bonds" were railroad bonds. Moreover, banks were unable to diversify the risk in their loan portfolios and they were subject to bank runs because there was no lender of last resort system at the time.[819] The consequence was that investment banks arranged bond issuance from a national and international "catchment area".[820] Investment banks realised that credit markets were more profitable than equity markets, so they had incentives to develop market-based mechanisms of credit intermediation mainly in the form of underwriting.[821] The separation of investment banking from commercial banking led investment banks to develop a securities market-based alternative to bank-based finance.[822] As European finance has shown, a universal bank with strong commercial lending activity will be "reluctant to cannibalize its existing business through market-finance innovations."[823]

Indeed, securities as a proportion of national assets in both the US and Germany show how the US had a long-lasting superiority in the mentioned ratio, which explains the importance of US capital markets and the underdevelopment of the German counterpart.[824] The mismatch between firm size in the US and US bank fragmentation has contributed to the expansion of the bond market in the US in comparison to Germany. This has also shown a bigger loan market in Germany than in the US. [825] As stated above, bank fragmentation in the US induced firms to find alternative ways of funding since unit banks were unable to fund big firms. They had to rely on bank syndicates and bond issuance to finance their business. That was not the case in Germany, where universal banks were able and eager to finance German industry.

Data from Beck et al. indicates that private credit by deposit money banks to GDP (%) is higher in Germany than in the US. The same data shows that the stock market total value traded to GDP (%) for the US is almost 250 while for Germany it is only 50. These figures show how today the influence of the German financial system continues to be broadly bank-based, whereas the US continues to be a market-based system.[826]

5.1.4 Bank holding company regulation

In part as a reaction to chain and group banking, the BHCA[827] was enacted in 1956. The US Congress endorsed the BHCA "to prevent possible abuses related to the control of

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[817] Ibid p.13.
[818] K. Snowden, "Historical Returns and Security Market Development, 1872-1925" (1990) 27 Explorations in Economic History p. 381.
[819] J. N. Gordon and K. Judge, above note 811, p. 13.
[820] Ibid; A. Morrison et al explain, "The capital required by the railroads, and later by the industrials, was largely raised through bond issues. Capital accumulation in America was insufficient to cover her industrialization, and as a result, America was a substantial importer of capital throughout the nineteenth century. American bond issues were therefore marketed in England and Continental Europe, as well as at home" A. Morrison and W. Wilhelm, *Investment Banking, Institutions, Politics and the Law* (OUP 2008) p. 121.
[821] J. Armour et al., above note 777, p. 438; J. Gordon, "The Empty Call for Benefit-Cost Analysis in Financial Regulation" (2014) 43(S2) The Journal of Legal Studies p. 360.
[822] J.N. Gordon and K. Judge, above note 811, p. 2.
[823] J. Armour et al., above note 777, p. 438.
[824] R. Goldsmith, above note 294, p. 134
[825] J.N. Gordon and K. Judge, above note 811, p. 14.
[826] T. Beck et al, above note 525.
[827] 12 USC § 1841, et seq.

commercial credit"[828] and its underlying philosophy was "that bank holding companies ought to confine their activities to management and control of banks and that such activities should be consistent with the public interest."[829] As the SCOTUS affirms, the BHCA "restrains undue concentration of commercial banking resources and abuses of commercial credit by regulating the activities of bank holding companies."[830] Another aim of the BCHA was to prevent banks from *de facto* interstate banking, since banks have used holding company with different incorporated state banks to circumvent the McFadden Act of 1927.[831]

The BCHA defines BCHs as those that "own or control" one or more banks. Ownership or control of 25% of the voting shares fulfils this purpose, or less, if the FRB believes there is controlling influence.[832] The FRB needs to approve: i) the formation of a BHC; ii) the formation of a subsidiary of a BHC a subsidiary of a BHC; iii) a BHC's acquisition of more than 5% of the shares of a bank; iv) a BHC's acquisition of bank assets and v) the merger of a BHC.[833]

A BHC is "any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter."[834] This definition includes corporations, partnerships, business trusts, associations, trusts in general with certain exceptions and similar organisations.[835] BHCs are regulated by the FRB and are subject to the BHCA and to FRB Regulation Y, which implies reporting and compliance obligations as well as minimum capital requirements.[836] BHCs need to act as a source of managerial and financial strength for their subsidiary banks.[837] The source of financial strength means the 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.[838]

Because of prosperity in the 1960s and the eagerness of bank shareholders for growth and diversification, there was a surge of bank holding companies in 1967-69, which

[828] S. Rep. No. 1084, 91st Cong., 2d Sess. 24, reprinted in 1970 US. CODE Cong. & Ad. News 5519, 5541.
[829] S. Rep. No. 1095, 84th Cong., 1st Sess. 2, reprinted in 1956 US. CODE Cong. & Ad. News 2482, 2483.
[830] United States Supreme Court *Board of Governors, Frs v Dimension Financial* (1986) No. 84-1274.
[831] S. Omarova and M. Tahyar, "That which we Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States" [2011] 31 Review of Banking and Financial Law p. 129; C. A. Sax and M. Sloan III, "The Bank Holding Company Amendments of 1970" [1970] 39 George Washington Law Review ps.1200-1202.
[832] 12 USC § 1841.
[833] W. Lovett and M. Mallow, above note 626, p. 221.
[834] 12 USC § 1841. 12 USC § 1841(b).
[835] 12 USC§ 1841(b) and 12 CFR§ 225.2(d).
[836] Regulation Y. Electronic Code of Federal Regulations <https://www.ecfr.gov/cgi-bin/text-idx?SID=0964d00e9d961703ad24e97c80394fe5&mc=true&node=pt12.3.225&rgn=div5> accessed 2 April 2019.
[837] 12 U.S. Code § 1831o–1.
[838] 12 USC § 1831o-1(f); See also C. M. Bradley and K. D. Jones, "Loss Sharing Rules for Bank Holding Companies: An Assessment of the Federal Reserve's Source-of-Strength Policy and the FDIC's Cross Guarantee Authority" [2008] 17(4) Financial Markets, Institutions & Instruments ps. 249-286; P. Lee, "The Source-Of-Strength Doctrine: Revered and Revisited - Part I" [2012] The Banking Law Journal p. 771; P. Lee, "The Source-Of-Strength Doctrine: Revered and Revisited – Part II" [2012] The Banking Law Journal p. 867; See also A. Ashcraft, "Are Bank Holding Companies a Source of Strength to Their Banking Subsidiaries?" [2008] Journal of Money, Credit and Banking; S. Meyerowitz, "The Source-of-Strength Doctrine" [2012] The Banking Law Journal; S. Meyerowitz, "The Source-of-Strength Doctrine - Part II" [2012] The Banking Law Journal.

augmented the conglomerate merger activity. Congress responded with the Bank Holding Company Amendments of 1970, which limited BHCs and their subsidiaries to activities that are "incident to banking or managing or controlling banks."[839] From the 1980s, the Federal Reserve and the OCC have permitted BHCs to perform different activities such as the underwriting of commercial paper, securitization products and even some kind of insurance underwriting.

BCHA Section 4 and Regulation Y limit BHCs' scope of non-bank permissible activities. Permissible non-bank activities for BHCs include activities "closely related to banking" and other activities permitted by statute. The FRB has established a list of activities that are "closely related to banking." They include: i) extending credit and servicing loans; ii) activities related to extending credit; iii) leasing personal or real property; iv) operating nonbank depository institutions (industrial banking and savings associations); v) trust company functions; vi) financial and investment advisory activities; vii) agency transactional services for customer investments (including securities brokerage); viii) investment transactions as principal such as underwriting and dealing in government obligations and money market instruments; ix) management consulting and counselling activities; x) support services; xi) certain insurance agency and underwriting services (credit insurance and finance company subsidiary); xii) community development activities; xiii) money orders, savings bonds and traveller's checks services; and xiv) data processing services.[840]

For many years, the FRB has excluded land development, real estate intermediation and travel agencies, among others.[841] Finally, in 1999, Congress passed the GLBA that allowed financial holding companies (FHCs) to operate in banking, insurance and securities markets.[842] Today virtually all big groups are registered as FHCs. While FHCs are regulated by the Federal Reserve System, the GLBA provides for functional regulation of an FHC's nonbank financial subsidiaries (i.e., broker-dealer subsidiaries of a FHC are primarily regulated by the SEC, and insurance subsidiaries by state insurance regulators).[843]

As stated above, the GLBA changed the landscape of the US banking industry since it removed many restrictions on the scope of permitted activities of BHCs. An FHC is a bank holding company that meets certain requirements. First, all depository institutions "controlled by the bank holding company must be and remain well capitalized" and well managed. Second, the BHC must have made an effective election to become an FHC.[844]

The main difference between the BHC and the FHC is that the latter may engage in a broader scope of permissible activities. These include all the activities that a BHC may engage in, and activities "financial in nature or incidental to such financial activity" or

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[839] W. Lovett and M. Mallow, above note 626, p 221.
[840] 12 CFR§ 225.28 (b) (1)-(14).
[841] W. Lovett and M. Mallow, above note 626, p. 225.
[842] K.J. Stiroh and A. Rumble, "The Dark Side of Diversification: The Case of US Financial Holding Companies" [2006] 30(8) Journal of Banking & Finance ps. 2131-2161; F. Furlong, "The Gramm–Leach–Bliley Act and Financial Integration" [2000] FRBSF Economic Letter, ps. 2000-2010.
[843] D. Avraham, P. Selvaggi and J. Vickery, "A Structural View of U.S. Bank Holding Companies" [2012] FRBNY Economic Policy Review, p. 67.
[844] 12 CFR § 225.81.

"complementary to a financial activity [that] does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[845]

The advantages of an FHC over a BHC may be summarised as following: an FHC may engage in activities that are banking or closely related to banking; financial in nature or complementary to financial activity while a BHC may not.[846]

According to statue, certain activities are regarded as "financial in nature" such as lending, acting as an agent or broker in life, health, property and casualty insurance, providing advisory services, securities underwriting or dealing, operating a travel agency or organising a mutual fund, among others.[847]

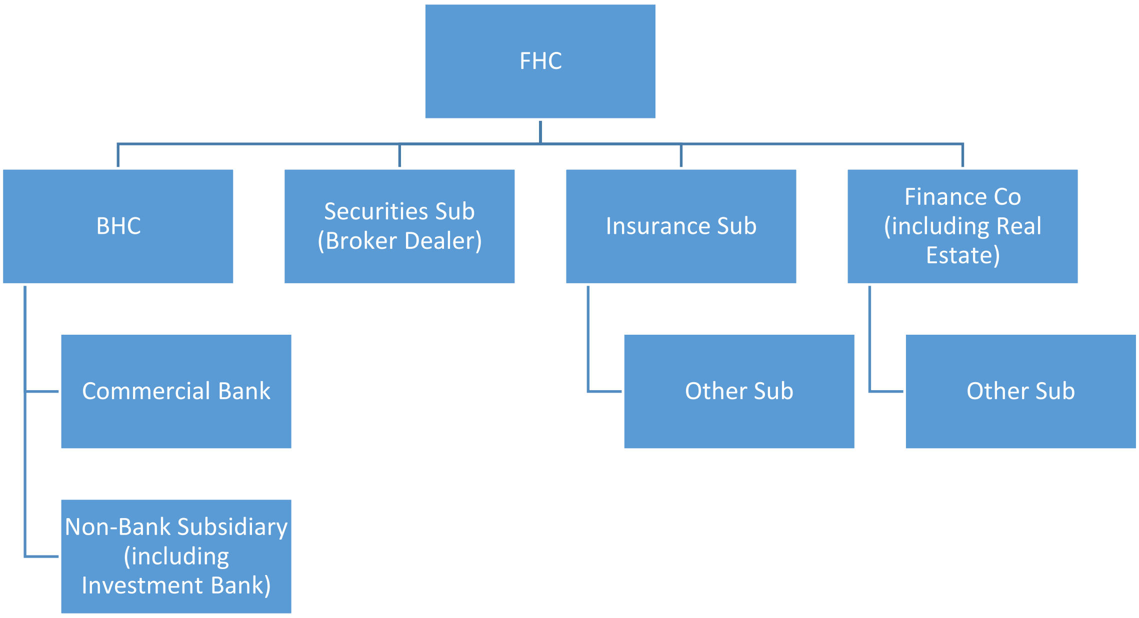
The FRB may approve certain limited commercial activities that are complementary to financial activities only when "[t]he proposal could be expected to produce benefits to the public that outweigh possible adverse effects"[848] and the proposal "does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[849]

One of the main activities that the GLBA permitted to an FHC is merchant banking. The merchant banking rule authorises an FHC to "directly or indirectly and as principal or on behalf of one or more persons, to acquire or control any amount of shares, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company under section 4 of the Bank Holding Company Act."[850] An FHC may invest directly (via portfolio company investments) or indirectly (via private equity funds). The merchant banking authority does not include investing in financial companies, since this is regulated under different sections of the BHCA.[851] When investing directly, FHCs are required to control a broker-dealer registered by the SEC, or control an insurance underwriter and a registered investment adviser.[852] However, an FHC and "any subsidiary (other than a depository institution or subsidiary of a depository institution) may acquire or control merchant banking investments."[853] Pursuant to 12 CFR § 225.170, merchant banking activity is "not permitted unless it is part of a bona fide underwriting or merchant or investment banking activity."[854]

[845] 12 U.S. Code § 1843 (k) (1) (A) (B); *Financial Holding Companies: Business Activities and Regulation ID 1-526-1845* (Practical Law, Thomson Reuters 2019). See also 12 U.S. Code § 1843 (k); *Financial Holding Companies: Business Activities and Regulation*, above note 132. Also, the FHC may engage in finders activities (12 C.F.R. § 225.86(d) (1)).
[846] 12 US Code § 1843 (k) (1); *Finance Fundamentals: Bank Holding Company v Financial Holding Company* (Practical Law Note 7-521-7963, Thomson Reuters 2019).
[847] 12 CFR 225.86(b)
[848] 12 CFR § 225.89 (b) (3).
[849] 12 U.S. Code § 1843 (k) (1) (A) (B); *Financial Holding Companies: Business Activities and Regulation* ID 1-526-1845 (Practical Law, Thomson Reuters, 2019).
[850] 12 CFR § 225.170.
[851] *Private Equity Investments by Banks (Merchant Banking) Other Methods of Making Private Equity Investments* ID 2-506-0525 (Practical Law, Thomson Reuters 2019).
[852] 12 USC § 1843(k); 12 CFR § 225.170 f(1); *Private Equity Investments by Banks (Merchant Banking) Other Methods of Making Private Equity Investments*, ibid.
[853] 12 CFR § 225.170 (d).
[854] Bank Holding Companies and Change in Bank Control. A Rule by the Federal Reserve System and the Treasury Department on 01/31/2001, 66 FR 8465.

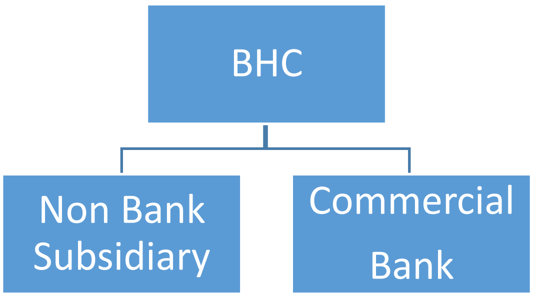
The FHC structure is well suited for FCs because it allows engaging in all three financial activities, but may not be the best suited structure for core banking structures. Indeed, in 2017, Bank of the Ozarks, Inc (a BHC) merged into Bank of the Ozarks (a wholly owned subsidiary) because "the Company currently operates as the bank holding company of the Bank and conducts substantially all of its business through the Bank. The Company believes the reorganization will further improve the combined entity's efficiency by eliminating redundant corporate infrastructure and activities as well as the associated supervision and oversight from the Federal Reserve Board ('FRB') applicable to registered bank holding companies."[855]

Figure 13. Typical FHC structure



Source: Federal Reserve Bank of Dallas[856]

Figure 14. Typical simplified BHC structure



Source: Federal Reserve Annual Report of Holding Companies-FR Y-6 for Merchants and Manufacturers Bank Corporation[857]

[855] SEC SCHEDULE 14A Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934, 5 May 2017.

[856] R. W. Fisher, "Ending 'Too Big to Fail': A Proposal for Reform Before It's Too Late" [2013] Federal Reserve Bank of Dallas.

[857] Chicago Federal Reserve FR Y6 <https://www.chicagofed.org/~/media/others/banking/financial-institution-reports/fr-y-6-pdf-files/2017/m/merchants-and-manufacturers-bank-corporation-2022734-2017.pdf>. Merchants and Manufacturers is a typical example of a simple, one-state BHC structure.

5.1.5 US banking system

Because of the federal nature of the US banking system, the banking institutions in America differ from their counterparts in Germany and most European systems. First, this is because of the dual banking system which comprises national and state banks. Second, this is because throughout US history, the GSA created *de facto* specialised financial institutions, with a universal banking model only arising after the GSA was eliminated in the 1990s. Third, this is because the US comprises a net of different regulators and supervisors which make the US's regulation of banking one of the most complex in the world.

This first section will analyse what a bank is. The second section will examine the structure of the US banking system.

5.1.5.1. What is the "business of banking"?

In order to analyse what a bank is, this thesis will first examine the meaning of the phrase "business of banking". This phrase first appeared in the NYFBA, which provides: Such association shall have power to carry on the *business of banking*, discounting bills, notes, and other evidences of debt, by receiving deposits, by buying and selling the gold and silver bullion, foreign coins and bills of exchange, in the manner specified in their articles of association for the purposes authorised by this act; by loaning money on real and personal security; and by exercising such incidental powers as shall be necessary to carry on such business.[858]

The NBA copies the text of the NYBA but adds the phrase "by obtaining and issuing circulating notes in accordance with the provisions of this Act."[859] This change did not alter substantially the NYFBA. The aim of the NBA was to persuade state banks to turn into national banks to create a national currency, to finance war via the placement of federal bonds and the use of national banks as depositories.[860] In 1995 the SCOTUS in *Nations Bank of North Carolina, N.A. v Variable Annuity Life Ins. Co* (VALIC) held the "'business of banking' is not limited to the enumerated powers in § 24 Seventh and that the [OCC] therefore has discretion to authorize activities beyond those specifically enumerated," provided that the OCC's discretion is exercised "within reasonable bounds."[861] After VALIC the OCC proposed the following test:

> "Judicial cases affirming OCC interpretations establish that an activity is within the scope of this authority [12 U.S.C. § 24(Seventh)] if the activity: (1) is functionally equivalent to or a logical outgrowth of a traditional banking activity; (2) would respond to customer needs or otherwise benefit the bank or its customers; and (3) involve risks similar to those already assumed by banks."[862]

The OCC believes, "The business of banking is an evolving concept and the permissible activities of national banks similarly evolve over time. The same holds true concerning the permissible activities of federal savings associations, subject to the applicable

858 Ch 260 § 18, 1838 N.Y Laws 245-249.
859 Act of June 20, 1874, ch 343, §1, 18 Stat 123.
860 E. Symons et al., above note 683; B. Hammond, above note 697, p. 724.
861 *Nations Bank of North Carolina, N.A. v Variable Annuity Life Ins. Co*., 513 U.S. 251, 258 n.2 (1995).
862 OCC Interpretive Letter No. 684 (4 August 1995).

statutory limitations."[863] However, the SCOTUS did not address "whether the 'business of banking' includes certain essential functions, such as deposit taking, the performance of which is fundamental to the statute's purpose."[864] According to Alter, as the NBA is based on the NYFBA, it "adopted the cluster of ideas that were attached to each borrowed word in the body of learning from which it was taken."[865] Therefore, in order to examine whether there are essential functions that define the *business of banking*, the interpreter must find help in New York case law from before 1838. Several cases demonstrate how essential deposit taking was to the *business of banking.*[866] Symons concludes "the definition of the business of banking" as deposit taking, credit granting and credit exchange, though analytically simple, is a key-stone in any principled elaboration of permissible banking activities."[867]

At a federal level, several cases show the centrality of deposit taking. The *McGough v Jamison* judgement stated that "[t]he very nature of the business of banking is to invite the deposits."[868] In *Commonwealth v Bilotta*, the judgement understood that "receiving deposits is...manifestly germane to and...universally associated with the business of banking."[869] The SCOTUS in *Oulton v. German Savings & Loan Society* held that "[s]trictly speaking the word bank implies a place for deposit of money, as that is the most obvious purpose of such an institution. Originally the business of banking consisted only in receiving deposits…"[870] These cases show the importance of the deposit taking function in the US, so that colloquially banks are denominated "depository institutions" whereas in the EU the common term for banks is "credit institution".[871]

As stated in Chapter One, banking business was defined by the SCOTUS in *Austen v United States Bank of New York* as a list approach.[872]

5.1.5.2 What is a bank?

After 1956 many statutory definitions have emerged, starting with the BHCA and ending with the Competitive Equality Banking Act of 1987 (CEBA). The evolution of the statutory definition of a bank for BHCA purposes starts with the original BHCA of 1956

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[863] OCC, "Activities Permissible for National Banks and Federal Savings Associations, Cumulative" (2017).
[864] D. Alter, "The 'Business of Banking'in New York – An Historical Impediment To the OCC's Proposed National 'Fintech Charter"' (2017) 36 Yale J. on Reg.: Notice & Comment <http://yalejreg.com/nc/the-business-of-banking-in-new-york-an-historical-impediment-to-the-occs-proposed-national-fintech-charter-by-daniel-s-alter/> accessed 22 March 2019.
[865] *Sekhar v United States*, 570 U.S., 133 S. Ct. 2720, 2724 (2013).
[866] See for example *People ex rel. Attorney General v Utica Insurance Co*., 15 Johns. 358, 390 (Sup. Ct. 1818); *People v Manhattan Co.*, 9 Wend. 351, 383 (Sup. Ct. 1832).
[867] E. Symons et al. above note 692, p. 726.
[868] *McGough v Jamison*, 107 Pa. 336, 339 (1884).
[869] *Commonwealth v Bilotta*, 61 Pa. Super. 264, 267 (1915).
[870] *Oulton v German Savings & Loan Society*, 84 U.S. 109, 118 (1872).
[871] Under US federal law, "Depository Institution" is defined under 12 USC § 1813, and "Credit Institution" is defined in point (1) of Article 4(1) of the CRR.
[872] See note 12.

and follows this path:[873] 1) the original BHCA of 1956; 2) the 1966 BHCA Amendments;[874] the 1970 BHCA Amendments;[875] and 4) the CEBA of 1987.[876]

The original BHCA defined a bank "simply on the formal charter."[877] A bank is "[a]ny national banking association or any State bank, savings bank or trust company."[878] It expressly excluded Edge Act and Agreement Corporations[879] from the definition. Initially the BHCA regulated holding companies that hold two or more banks.[880] Congress enacted the BHCA "to prevent possible abuses related to the control of commercial credit"[881] and its underlying philosophy was "that bank holding companies ought to confine their activities to management and control of banks and that such activities should be consistent with the public interest."[882] As the SCOTUS affirms, the BHCA "restrains undue concentration of commercial banking resources and abuses of commercial credit by regulating the activities of bank holding companies."[883] Another aim of the BCHA was to prevent banks from *de facto* interstate banking, since banks have used the holding company with different incorporated state banks to circumvent the McFadden Act of 1927.[884]

The 1966 BHCA amendments changed the definition to include a *formula approach*. A bank "means any institution that accepts deposits that the depositor has a legal right to withdraw on demand."[885] This time the amendment excluded foreign branches and banking corporations authorised to do foreign banking business by the Federal Reserve System. The aim of the 1966 amendments was to exclude "institutions like industrial banks and nondeposit trust companies."[886] Instead of excluding explicitly industrial banks and non-deposit trust companies from the definition of a bank, the US Congress changed the entire definition to include a new test. This new test permitted certain subsidiaries to perform commercial and *de facto* banking activities as long as they do not accept deposits that may be withdraw on demand.

The main factor that drove the 1970 amendments was the desire to regulate the one-bank holding company, which was not included in the original BHCA.[887] The one-bank holding company combined not only a bank under the holding company but also other commercial or non-financial banks, in what was called "congenerics" or groups centred around a bank

[873] S. Omarova and M. Tahyar, above note 831, p. 115.
[874] Act of July 1, 1966, Pub, L. No. 89-485§ 3 (c), 80 Stat. 236, 236 (1966) Codified at 12 USC § 1841 (c) 2010.
[875] BHCA Amendments of 1970, Pub. L- No 91-607, § 101 (a) 84 Stat. 1760 236 (1970).
[876] Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 101 Stat. 552, 554 (1987).
[877] S. Omarova and M. Tahyar, above note 831, 115-116.
[878] Bank Holding Company Act of 1956, Pub. L. No 84-511 §§ 1-12, 70 Stat 143, 135 (1956).
[879] An Edge Act and Agreement Corporation is a subsidiary of a bank or financial holding company that is authorized by the Federal Reserve to conduct foreign banking activities. (Section 25A of the Federal Reserve Act).
[880] C. L. McIntyre, "The Nonbank Bank Loophole to the Bank Holding Company Act of 1956--The Need for Congressional Action" (1986) 37 Alabama Law Review p. 713.
[881] S. Rep. No. 1084, 91st Cong., 2d Sess. 24, reprinted in 1970 US. CODE Cong. & Ad. News 5519, 5541.
[882] S. Rep. No. 1095, 84th Cong., 1st Sess. 2, reprinted in 1956 US. CODE Cong. & Ad. News 2482,2483.
[883] United States Supreme Court, *Board of Governors, Frs v Dimension Financial* (1986) No. 84-1274.
[884] S. Omarova and M. Tahyar, above note 831, p. 129; C. A. Sax and M. Sloan III, "The Bank Holding Company Amendments of 1970" (1970) 39 George Washington Law Review ps. 1200-1202.
[885] S. Rep. 89-1179, 89th Cong., 2d Sess. 7 (1966).
[886] Ibid.
[887] P. Nadler, *"The One-Bank Holding Company" Banking* (1968) p.804; F. Edwards, "The One-Bank Holding Company Conglomerate: Analysis and Evaluation" [1969] 22 Vand. L. Rev. p. 1275.

with interstate presence.[888] Edwards announced, "in 1968 a sudden- change occurred: most of our largest banks decided to form holding companies. First National City Bank of New York, Chase Manhattan, Bank of America, and six more of the twelve largest banks in the country either formed or announced plans to form one-bank holding companies."[889] Representative Patman expressed that "the entire structure of the American economy is being changed through conglomerates centered on banking institutions. This is clearly a threat to everyone-both inside and outside the financial community-and it is essential that the Congress act quickly to provide meaningful remedies."[890]

Again, the bank definition was reformulated to add a second element to the *formula approach*:

> " 'Bank' means any institution organized under the laws of the United States, … which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans.[891]

In practical terms, the 1970 amendments only excluded one institution, the Boston Safe Deposit and Trust Company.[892] As the formula expressed the conjunction "*and*", any subsidiary that engages in either accepting deposits with the legal right to withdraw *or* making commercial loans would not be subject to the BHCA. The consequence of this new definition was the creation of the so-called "non-bank banks", which could offer banking and non-banking services, something that was prohibited for BHCs.[893]

In 1987 the Congress passed the CEBA, and this changed the bank definition for the third time. It defined a bank as an institution that:

> (i) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others; and (ii) is engaged in the business of making commercial loans.

Consequently, the "non-bank banks" that were born from the 1970 BHCA amendments that were not grandfathered by them became banks.[894] As per the aforementioned bank definition, the FDIA defines insured bank as "any bank (including a foreign bank having an insured branch) the deposits of which are insured in accordance with the provisions of this Act."[895]

The list of insured banks is quite long. However, the CEBA explicitly excluded certain financial institutions from the definition of a bank; most importantly certain foreign banks, insured associations that include federal savings associations or federal saving banks, building and loan associations, trust companies, credit unions, credit card banks and industrial banks. The main reasons for the exclusion of these financial institutions

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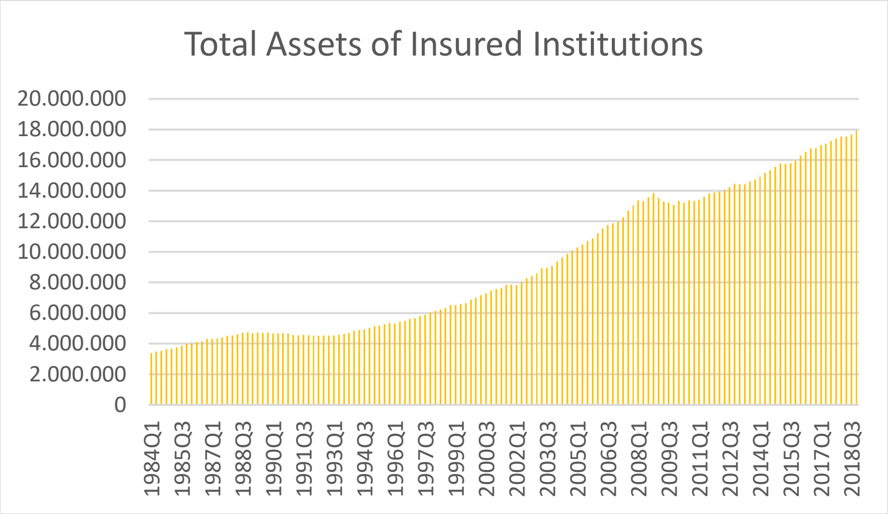
[888] C. H. Golembe, "One-Bank Holding Companies" in H. Prochnow, *The One-Bank Holding Company* (1969) ps. 66-71.
[889] F. Edwards above note 887 p. 1275.
[890] 115 CONG. REC. 902 (daily ed. Feb. 17, 1969) cited by F. Edwards, above note 887.
[891] BHCA Amendments of 1970, Pub. L- No 91-607, § 101 (a) 84 Stat. 1760 236 (1970).
[892] Executive Session: Tuesday 13 June 1970 Hearing before the S. Comm. On Banking and Currency 91st Cong. 10 (1970).
[893] S. Omarova and M. Tahyar, above note 831 p. 142.
[894] Ibid.
[895] 12 USC. 1813(h).

were the small size of these institutions, the fact that they were specialised in a limited range of activities and centred on consumer financial services.[896]

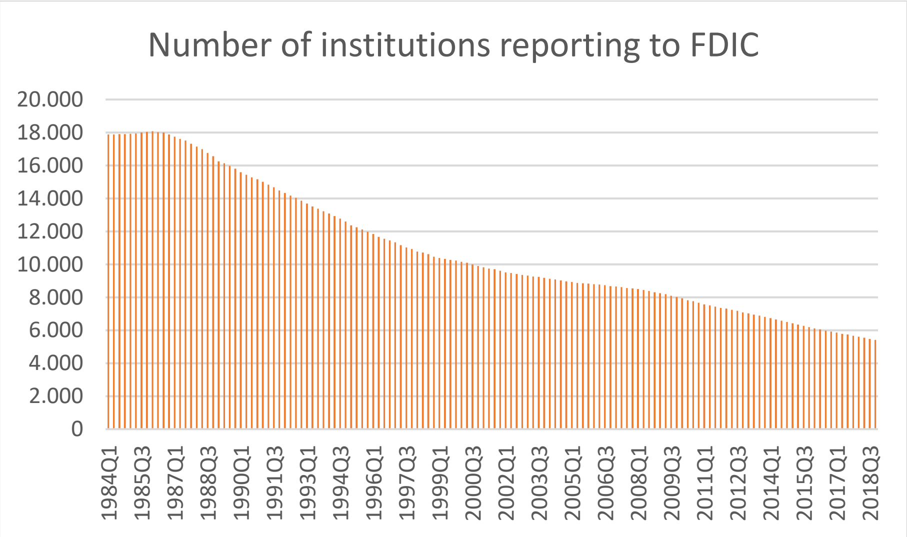
From a size perspective, FDIC insured institutions in the US have been falling from 1984 from almost 18,000 to less than 6,000 in 2018. However, the total assets held by these institutions has been climbing from 337,412,063 million in 1984 to 17,943,122,396 million in 2018. According to the FDIC, the whole insured system employs more than 2 million people.[897]

Figure 15. Total assets of institutions reporting to the FDIC in USD millions



Source: FDIC

Figure 16. Number of institutions reporting to the FDIC



Source: FDIC

[896] S. Omarova and M. Tahyar, above note 831 p. 153
[897] FDIC Quarterly Banking Profile <https://www.fdic.gov/bank/analytical/qbp/> accessed 20 March 2019.

A classical classification of depository institutions in the US comprises commercial banks, thrifts and credit unions.[898] Other non-bank institutions include industrial loan companies and industrial banks, credit card banks, and limited purpose trust companies. A separate chapter deals with foreign banks doing business on US soil. An analysis of these institutions follows.

5.1.5.3 Commercial banks

Using a parallel classification of the "three pillar structure" of German banks, the US banking system may be studied following a similar pattern, analysing commercial banks, followed by thrifts and credit unions.

Commercial banks may obtain a federal charter (national banks) or state (state banks). As stated above, national banks are full-service insured commercial banks chartered under the NBA. National banks are permitted to engage in general banking activities including deposit-taking and lending,[899] investing in real property for their own business purposes,[900] acting as a finder,[901] personal property leasing,[902] providing consulting and advice,[903] corresponding banking services and payment services[904] and derivative contracts, among others.

A limitation on commercial banks activities is that national banks are subject to lending limits to one borrower. In the case of unsecured loans and extension of credit, the limit is 15% of banks' unimpaired capital and surplus. In the case of secured loans, the limit is 10%.[905] State banks are chartered by the state and are subject to the banking law of the state in which they are chartered. The scope of permissible activities is determined also by state law.

A second limitation is that "an insured State bank may not engage as principal in any type of activity that is not permissible for a national bank" under certain conditions.[906]

A third limitation is that national banks may not engage generally in underwriting and dealing in securities.[907] Regarding investments in "bank eligible securities", national banks may invest in certain government securities.[908] The amount of investments in marketable debt securities may not "exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund."[909] However, commercial banks may engage in buying and selling securities on behalf of

[898] M. Labonte, "Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework" ([2017] Congressional Research Service; R. Kumar, *Strategies of Banks and Other Financial Institutions: Theories and Cases* (Elsevier 2014) p. 189.
[899] 12 USC § 24 (Seventh) and 12 USC§ 371.
[900] 12 USC § 29 (First).
[901] 12 USC § 24 (Seventh).
[902] 12 USC § 24 (Seventh and Tenth).
[903] 12 USC § 24 (Seventh).
[904] Commercial Banking (Practical Law Note 2-5070807) (Thomson Reuters 2019).
[905] 12 USC § 84.
[906] 12 USC § 1831a.
[907] 12 USC § 24 (Seventh) and 12 USC § 335.
[908] 12 USC § 24 (Seventh).
[909] According to 12 USC§ 24 (Seventh).

their customers.[910] Additionally, national banks may enter into derivative transactions as principal when the bank may "lawfully purchase and sell the underlying instrument or product for its own account as a dealer or marketmaker" or when it uses the derivative to hedge the risks arising from permissible activities, among other circumstances.[911] Moreover, the OCC affirms that banks may buy and "take physical possession" of certain equity securities in order to hedge "customer-driven equity derivative transactions" when certain safeguards are in place.[912]

A fourth limitation is that national banks and their subsidiaries may not "provide insurance in a State as principal except that this prohibition shall not apply to authorized products"[913] within certain exceptions.[914] They are also not allowed generally to underwrite or sell title insurance.[915] However, national banks may engage in certain insurance activities, both as agent and as principal, i.e., they act as agents and sell most kinds of insurance in populations of less than 5,000 inhabitants.

From a size perspective, the most important group of insured institutions are commercial banks. The larger commercial banks in terms of consolidated assets are JP Morgan, Bank of America, Wells Fargo, Citibank, US Bank, PNC, Capital One, Toronto-Dominion Bank (TD), Bank of New York Mellon and State Street, among others. The US has 4,687 commercial banks (See Figure 17). One reason for the large number of commercial banks stems from the restrictions in the establishment of branches in the past, which made a unique "unit bank system", which has permitted a proliferation of many commercial banks along the US geography. The industry reacted with financial innovations such as the BHCs, which were excluded from branching restrictions. "The growth of bank holding companies has been dramatic over the past three decades. Today bank holding companies own almost all large banks, and more than 90% of all commercial bank deposits are held in banks owned by holding companies." One explanation for the fall in the number of commercial banks in the US is to be found in bank consolidation.[916] It has also been imposed by the regulatory authorities post GFC, as exemplified in the Bank of America – Merrill Lynch merger.[917]

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910 *Securities Industry Assoc. v Comptroller of the Currency*, 577 F.Supp. 252 (D.C. Cir. 1985).

911 *Risk Management of Financial Derivatives, Comptroller's Handbook* (OCC, 1997) <https://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/risk-mgmt-financial-derivatives/pub-ch-risk-mgmt-financial-derivatives.pdf> accessed 3 April 2019.

912 *Permissible Securities Activities of Commercial Banks Under the Glass-Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)* (Congressional Research Service, 2010) p. 12.

913 15 USC 6712.

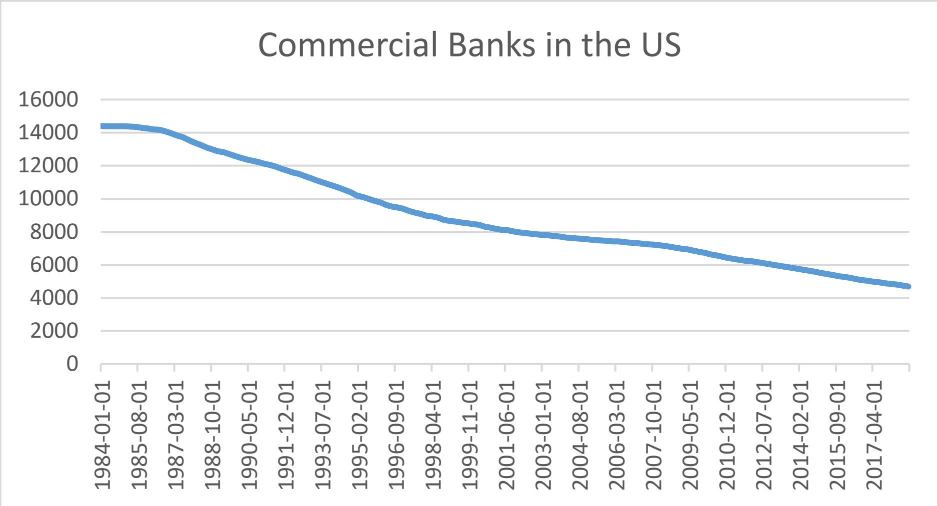
914 15 USC 6712.

915 15 USC 6713 (a).

916 F. Mishkin, *The Economics of Money, Banking, and Financial Markets* (Pearson Education Limited 2016) p. 296.

917 M. Morris and E. Anicich, 'Bank of America and Merrill Lynch Merger' [2015] Columbia Business School Case Works https://www8.gsb.columbia.edu/caseworks/node/534/Bank%20of%20America%20and%20Merrill%20Lynch%20Merger, > accessed 22 January 2020.

Figure 17. Number of commercial banks in the US



Source: St Louis Federal Reserve[918]

5.1.5.3.1 Commercial bank subsidiaries

Commercial banks may form subsidiaries. US banking regulation recognises two different types of commercial bank subsidiaries: operating subsidiaries and financial subsidiaries.

Operating subsidiaries of a national bank may conduct "activities that are permissible for a national bank to engage in directly either as part of, or incidental to, the business of banking, as determined by the OCC."[919]

An operating subsidiary of a national bank may take the legal form of a corporation, limited liability company, limited partnership or similar. It will be an operating subsidiary if: the bank has control of the management of the subsidiary; or the bank owns or control more than 50% of the voting interest, or the bank otherwise controls the operating subsidiary "and no other party controls a percentage of the voting interest of the operating subsidiary greater than the bank's interest"; and "the operating subsidiary is consolidated with the bank under generally accepted accounting principles (GAAP)."[920]

Financial subsidiaries may be subject to both national and state law. An important feature of financial subsidiaries is that they are permitted to perform certain securities and insurance activities not permitted to banks.[921] The financial subsidiary may engage only in activities that are "financial in nature" or "incidental to a financial activity" and activities that are permitted for national banks to engage in directly.[922] However, the same

[918] "Commercial Banks in the US", St Louis Federal Reserve <https://fred.stlouisfed.org/series/USNUM> accessed 26 March 2019.
[919] 12 CFR § 5.34.
[920] 12 CFR § 5.34 (e) (2).
[921] 12 USC § 24a (a) (2) (A) and 12 USC § 1831w; Commercial Banking (Practical Law Note 2-5070807), above note 1098.
[922] 12 USC 24a (a) (2)(A).

statute restricts the scope of permitted actives of financial subsidiaries since the following activities are forbidden: i) "insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death" and ii) "real estate development or real estate investment activities, unless otherwise expressly authorized by law."[923]

The requirements for having a financial subsidiary are that the national bank and each depository affiliate are well capitalised and well managed and that the "the aggregate consolidated total assets of all financial subsidiaries of the national bank do not exceed the lesser of 45% of the consolidated total assets of the parent bank or USD 50,000,000,000".[924]

Financial subsidiaries may take the same legal forms as a BHC including LLCs.[925]

5.1.5.4 Thrifts

"Thrifts" or savings institutions, include savings banks, savings associations (former "S&Ls"), and cooperative banks.[926] Thrifts were born as state-chartered institutions with the purpose of encouraging savings and to "help persons belonging to a deserving class, whose earnings and (were) small, and with whom the slowness of accumulation discourage (d) the effort…to become…owners of homesteads."[927]

Federal regulation of thrifts was designed as a separate legal framework from commercial banking, since its aim was to encourage home ownership. The Federal Loan Act of 1932 established the Federal Home Loan Bank System (FHLBS, which was a source of liquidity for S&Ls.[928] During the Great Depression 1,700 of these institutions failed,[929] inducing a new regulatory regime under the Home Owners' Loan Act of 1933 (HOLA).[930] The HOLA empowered the FHLBB to regulate and charter S&Ls.[931] Congress specified a thrift's purpose in section 5 "to provide for the financing of homes."[932]

As the US system is federal in nature, there are state thrifts and federal thrifts. Pursuant to the FDIA "Savings association" means "any Federal savings association; or any 'State savings association'"; any corporation that functions as a thrift according to the OCC".[933] Federal saving associations are chartered "giving primary consideration of the best practices of thrift institutions in the United States. The lending and investment powers conferred by this section are intended to encourage such institutions to provide credit for housing safely and soundly."[934] The aim of thrifts is "the extension of credit for homes

923 12 USC 24a (a) (2)(A) and12 CFR § 5.39(e) and (f).
924 12 USC § 24a.(a)(2) and 12 CFR § 5.39(g).
925 12 CFR § 5.39 (d)(3).
926 W. Lovett and M. Mallow, above note 626, p. 271; R. Ayadi et al., above note 449 p 27-29; J.L. Williams and S. Zesch, *Savings Institutions: Mergers, Acquisitions and Conversions* (Law Journal Press 2010).
927 L. Broom and J. Markham, *Regulation of Bank Financial Service Activities* (4th ed, 2011) p. 73; S. Omarova et al., above note 831 p. 179.
928 The Federal Home Loan Bank Act, Pub.L. 72–304, 47 Stat. 725; A. Moysich, *History of the Eighties: Lessons for the Future*. Vol. 1, *An Examination of the Banking Crises of the 1980s and Early 1990s* (FDIC 1997) p. 170.
929 Ibid.
930 Home Owners' Loan Act of 1933, Pub. L. No 73-43, 48 Stat. 128 (1933).
931 A. Moysich above note 928 p. 170.
932 HOLA Original Act, s 5.
933 12 USC § 1813 (b) (1).
934 12 USC § 1464 (a) 2.

and other goods and services."[935] Federal savings associations may "raise funds through such deposit, share, or other accounts, including demand deposit accounts…and issue passbooks, certificates, or other evidence of accounts."[936]

A limitation of savings association activities is that they may not deal in lottery tickets or deal in bets.[937] Law restricts the scope of permissible activities of federal saving associations. Federal savings associations may not permit overdrafts.[938] In addition, the loan authority is restricted because some loans are limited to a certain percentage of assets, e.g., commercial loans (20%) and non-residential real property loans (400% of federal savings capital), among others.[939]

The original HOLA restricted thrifts' activities from accepting deposits: "No deposits shall be accepted and no certificates of indebtedness shall be issued except for such borrowed money as may be authorized by regulations of the Board."[940] It also restricted their permitted loans mainly to secured residential mortgages.[941] However, in 1980 when the US Congress passed the Depository Institutions Deregulation and Monetary Control Act, thrifts were permitted to make commercial loans, offer NOW accounts and issue credit cards.[942] In 1982, the Garn St-Germain Depository Institutions Act broadened the scope of permissible activities by permitting raising capital in the form of savings deposits, shares and other accounts.[943]

A second limitation for thrifts is that the FSA is required to be a qualified thrift lender (QTL) by HOLA.[944] The FSA must hold "qualified thrift investments (QTI) equal to at least 65 percent of the FSA's portfolio assets."[945] QTI examples are: loans to purchase, refinance, construct, improve or repair domestic residential or manufactured housing; real estate owned,; home equity loans; securities backed by domestic residential or manufactured housing; and federal home loan bank stock, among others.[946]

The FSA may sell insurance through service corporations on an agency basis without geographic restriction.[947] It may also engage in securities brokerage only via a service corporation, and on agency basis.[948] A federal savings association may generally engage in transactions involving a financial derivative if it is authorized to invest in the corresponding underlying assets, and the transaction is "safe and sound".[949]

935 12 USC § 1464 (a).
936 12 U.S. C. § 1464 (b) (1)(a)(i).
937 12 USC § 1463 (e) 1.
938 12 USC § 1464 ((b) B).
939 12 USC § 1464 (c) (2) (A) and (B).
940 HOLA Original Act, s 5 (b).
941 HOLA Original Act, s 5 (c).
942 Depository Institutions Deregulation and Monetary Control Act of 1980, Pub, L. 96-221§ 401-402 94 Stat. 132, 151-156 (1980); S. Omarova et al., above note 831, p. 180.
943 Garn St Germain Depository Institutions Act, Pub.L. 97-320, § 312, 96 Stat 1469 (1982) (codified as amended at 12 USC § 1464).
944 12 USC § 1467 a(m).
945 OCC, "Comptroller's Handbook, Safety and Soundness" (2013).
946 Ibid.
947 12 CFR § 559.4 (f) (3).
948 12 CFR § 545.74.
949 12 CFR 563.172.

The deregulation movement resulted in an S&L crisis in the 1980s.[950] During 1981-1983, 118 S&Ls failed, costing the FSLIC an "estimated $3.5 billion to resolve". Tangible net worth for the S&L industry "was virtually zero", "having fallen from 5.3 percent of assets in 1980 to only 0.5 percent of assets in 1982". One of the reasons of the S&L crisis was the "interest-rate mismatch of the institutions balance sheets."[951] The US government proved to be ill-prepared to solve the S&L crisis.[952] This was in part because there were not enough resources to close insolvent S&Ls. As thrifts were allowed to take the form of mutual saving associations or stock owned thrifts, during the 1980s thousands of mutual thrifts converted into stock owned thrifts.[953] Deregulation had unintended consequences. "The devastating consequences of adding many new institutions to the marketplace, expanding the powers of thrifts, decontrolling interest rates, and increasing deposit insurance coverage, coupled with reducing regulatory standards and scrutiny, were not foreseen."[954] One consequence of the S&L crisis was that it induced new regulation by President George W. Bush in 1991, the FDICIA. It imposed federal banking agencies to take "prompt corrective supervisory actions" when an institution's capital declines, as well as imposed the FDIC to apply a resolution method "that minimizes the costs to taxpayers of a bank failure."[955]

Similar to commercial banks, HOLA regulated thrift holding companies (THC). According to HOLA, "the term 'savings and loan holding company' means any company that directly or indirectly controls a savings association or that controls any other company that is a savings and loan holding company."[956] Before the GLBA, these companies could engage in "any type of activity (including insurance and manufacturing)."[957] However, the GLBA restricted the scope of their permitted activities

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[950] S. Omarova et al., above note 831, p. 180; Federal Deposit Insurance Corporation (FDIC), above note 643. See also generally, J. Adams, *The Big Fix: Inside the S&L Scandal: How an Unholy Alliance of Politics and Money Destroyed America's Banking System* (Wiley Publishers 1990); "Financial Institutions and Regulations, the S&L Crisis: Death and Transfiguration" (1991) 59 Fordham Law Review S1; K. Day, *S&L Hell: The People and the Politics Behind the $1 Trillion Savings and Loan Scandal* (W. W. Norton & Co. 1993); R. DeSoto and L. Bascom, *Bailout: The Bankrupting of America*, (Futura Press 1992); N. Eichler, *The Thrift Debacle* (University of California Press 1989); E. Langston and S. Brandt, *Understanding the S&L Crisis: A Guide for Beginners and Congressmen* (Squeaky Wheel Press 1990); M. Lowy, *High Rollers: Inside the Savings and Loan Debacle* (Praeger Publishers 1991); M. Mayer, *The Greatest-Ever Bank Robbery: The Collapse of the Savings and Loan Industry* (Charles Scribner's Sons 1990); P. Pilzer, *Other People's Money: The Inside Story of the S&L Mess* (Simon and Schuster 1989); 'The S&L Crisis: A Chrono-Bibliography' <https://www.fdic.gov/bank/historical/sandl/> accessed 11 April 2019.

[951] Federal Deposit Insurance Corporation (FDIC) 1997, above note 643.

[952] National Commission on Financial Institution Reform, Recovery and Enforcement, above note 819, p. 32.

[953] A. Sinan Cebenoyan, E. Cooperman and C.A. Register, "Ownership Structure, Charter Value, and Risk-Taking Behavior for Thrifts" (1999) 28(1) Financial Management ps 43-60; See generally K.A. Carow, S. R. Cox and D.M. Roden, "The Role of Insider Influence in Mutual-to-Stock Conversions" [2007] 39(6) Journal of Money, Credit and Banking; F.R. Chaddad, and M.L. Cook, "The Economics of Organization Structure Changes: a US Perspective on Demutualization" [2004] 75(4) Annals of Public and Cooperative Economics; L.R. Cordell, G. Mac Donald and M. Wohar, "Corporate Ownership and the Thrift Crisis" (1993) 36(2) The Journal of Law & Economics.

[954] Federal Deposit Insurance Corporation (FDIC), 1997, above note 643.

[955] Federal Deposit Insurance Corporation Improvement Act of 1991. Federal Reserve History <https://www.federalreservehistory.org/essays/fdicia> accessed 21 January 2021.

[956] 12 USC §1467a(a)(D)(i). There are also some exceptions described under12 USC §1467a(a)(D)(ii).

[957] US Banking Law: Overview, Practical Law (2021).

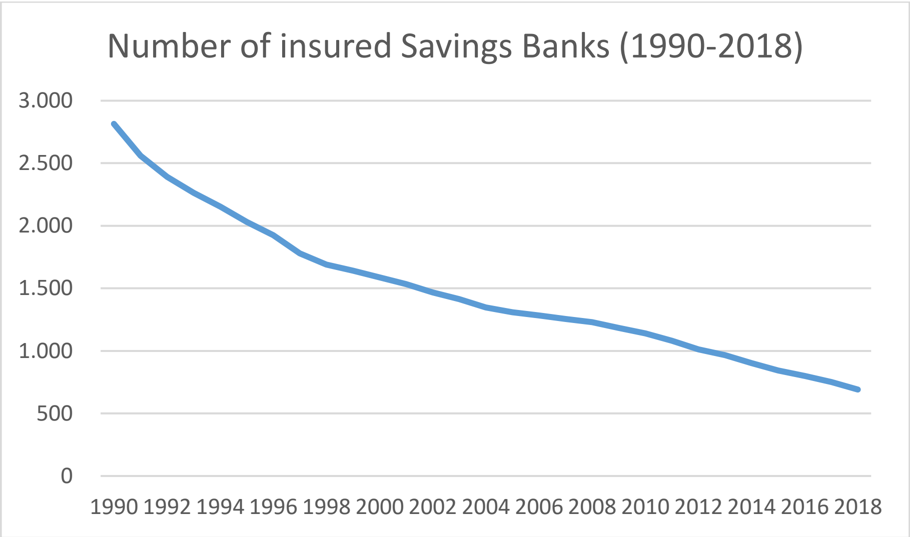
to those activities permissible to BHCs,[958] to financial activities permitted for FHCs under certain requisites and others.[959] Nonetheless, certain grandfather unitary thrift companies may continue to engage in any activity as long as they meet certain conditions.[960]

The DFA eliminated the OTSand transferred its authority to the OCC and the Federal Reserve, and "by taking other steps effectively erase[d] regulatory differences between thrifts and banks."[961] Unitary thrift holding companies need to place all their financial activities in an "intermediate holding company" that is subject to regulation by the Federal Reserve System as an SLHC,[962] and the parent company will serve as a source of strength for the intermediate company.[963]

Also, in parallel with national banks' subsidiaries, thrifts may create their own "operative subsidiaries" and "service corporations". Operative subsidiaries may engage in the same activities as thrifts, while "service corporations" may engage in broad activities, such as business and professional services, credit-related activities, consumer services, securities activities, liquidity management and investments, among others.[964]

From a size perspective, thrifts have suffered the same trend as commercial banks. From 1990 to 2018, the number of insured savings banks has declined from 2,815 in 1990 to 691 in 2018.

Figure 18. Number of insured savings banks (1990-2018)



Source: FDIC[965]

[958] 12 USC §1467a(c)(2)(F)(i).
[959] 12 USC §1467a(c)(2)(H). 12 USC §1467a (c)(1)(B); 12 USC §1467a(c)(2)(F) (ii); 12 CFR § 238.53 (b) 12; 12 USC §1467a(e)(1)(A) (iii).
[960] 12 USC. § 1467a(c)(9)(C).
[961] S. Omarova et al., above note 831, p. 187.
[962] 12 U.S. Code § 1467b (b)(1) (A); ibid.
[963] 12 U.S. Code § 1467b (b) 3.
[964] 12 CFR § 559.2, 559.3(e)(2) and 559.4.
[965] <https://www.fdic.gov/bank/statistical/stats/> accessed 10 April 2019.

The third type of depositary institution in the US is the credit union.

5.1.5.5. Credit Unions

A credit union is a "non-profit financial cooperative"[966] and it has been described as a "member owned democratic institution ... emphasising self-help and voluntarism."[967] Credit unions arose in the US in the first decades of the twentieth century to serve the needs of the working class.[968] The Bureau of Federal Credit Unions originally regulated credit unions in the US. In 1970, the newly created NCUA replaced the Bureau.[969] The NCUA is responsible for the charter and supervision of federal credit unions. It also is in charge of administering the NCUSIF.[970]

The first credit union in the US was *St*. Mary Cooperative Credit Association, in Manchester, New Hampshire, in 1909. The introducers of the credit union movement into the US were Alphonse Desjardins, Pierre Jay and Edward Filene. It was Desjardins, a Canadian journalist and politician, who organised St. Mary cooperative with the help of Jay and Filene. Jay also lobbied in Massachusetts for the instauration of a new credit union state charter. However, Filene lobbied the most and funded organisations for the promotion of credit unions throughout the country.[971]

Like credit unions in the UK, the "common bond" shapes credit unions in the US, and it is the first factor that differentiates credit unions from other depositories. The SCOTUS states:

> The common bond requirement "was seen as the cement that united credit union members in a cooperative venture, and was, therefore, thought important to credit unions' continued success." 988 F. 2d, at 1276. "Congress assumed implicitly that a common bond amongst members would ensure both that those making lending decisions would know more about applicants and that borrowers would be more reluctant to default.[972]

[966] N. Ryder, "The Regulation of Credit Unions: A Comparative Analysis Between the USA and Great Britain" [2005] 6(3) Journal of Banking Regulation p. 261.
[967] D. McKillop, J. Glass and C. Ferguson, "Investigating the Growth Performance of UK Credit Unions using Radial and Non-Radial Efficiency Measures" [2002] 26(8) Journal of Banking and Finance ps. 1563-1591.
[968] N. Ryder and C. Chambers, "The Credit Crunch-Are Credit Unions Able to Ride Out the Storm?" [2009] 11(1) Journal of Banking Regulation ps.76-86. US Supreme Court: "Credit unions were believed to enable the general public, which had been largely ignored by banks, to obtain credit at reasonable rates." Supreme Court, '*National Credit Union Administration, Petitioner, v First National Bank & Trust Co., et al.; AT&T Family Federal Credit Union, et al., Petitioners, v First National Bank and Trust Co., et al.*, Decided 25 February 1998, Nos. 96-843, 96-847. 118 S. Ct. 927.
[969] Ibid p. 80; Public Law 91-206 (10 March 1970, 84 Stat. 49) amended sections 2, 3, and 21 of the Federal Credit Union Act. "It created the National Credit Union Administration as an independent agency and transferred all of the functions of the Bureau of Federal Credit Unions to the new Administration" (Forward).
[970] Title II of the Federal Credit Union Act, as amended.
[971] J. Walter, "Not your Father's Credit" [2006] 92(4) Federal Reserve Bank of Richmond Economic Quarterly ps. 355-356.
[972] United States Supreme Court, *National Credit Union Administration v First National Bank & Trust Co.* (1998) No. 96-843.

The requisite of the common bond helped members of the credit union to know each other and to better assess the economic prospects of the fellow members of the institution. Desjardins believed “the main security is the fact that the association is working within a small area and that everybody knows each other.”[973] Another consequence of the common bond was that it encouraged compliance. Before 1970, when federal insurance coverage was granted, if someone defaulted members of the credit union would suffer losses.[974] Additionally, a defaulting member would damage the reputation of fellow members who share a common bond. Hence, the system was designed to prevent defaults.[975]

Original Section 109 FCUA provided that federal credit union membership shall be limited “to groups having a common bond of occupation or association, or to groups within a well-defined neighbourhood, community, or rural district.”[976] However, in the 1980s, many credit unions failed, and the NCUA believed one reason for this was that the common bond restricted the growth of credit unions, so they were too small to be viable.[977] In 1982, the NCUA broadened the term common bond to include “multiple occupational groups” which need only to be within a “well defined area.”[978] In 1998, the SCOTUS decided that the NCUA needed to stop granting multiple-group credit union charters.[979] That same year, the US Congress passed the Credit Union Membership Access Act of 1998 where it permitted credit unions that already had multiple common bonds before February 1998 to continue operating. It also permitted additional membership groups with multiple common bonds if they do not surpass 3,000 members.[980]

In 2018 the American Bankers Association (ABA) sued the NCUA[981] since, according to the ABA, the NCUA’s 2016 rule “allowed community credit unions — which Congress by statute limited to serving a single ‘well-defined local community, neighbourhood, or rural district’ — to serve large regions encompassing multiple metropolitan areas with populations in the millions.”[982] Judge Dabney Friedrich declared invalid the inclusion of “combined statistical areas” with fewer than 2.5 million people, and the definition of “rural area” to those up to 1 million people.[983]

A second factor differentiating credit unions from other depositories is the requisite of membership. Both state and federal credit unions are owners of the credit union. These might take the form of cooperatives or mutually owned institutions.[984] Contrary to commercial banks, a credit union’s typical funding is via retained earnings. Credit union

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973 J. Moody and G. Fite, *The Credit Union Movement: Origins and Development, 1850-1980* (Kendall/Hunt 1984) p. 16; J. Walter, above note 971 p. 357-8.

974 J. Walter, above note 971, p. 358.

975 Ibid 359.

976 Original FCUA Section 109.

977 N. Ryder and C. Chambers, above note 968, p. 81.

978 Interpretative Ruling and Policy Statement 82-3, 47 Red. Reg. 26808 (22 June 1982).

979 SCOTUS, above note 972.

980 Public Law 105-219, Credit Union Membership Access Act (7 August 1998) amended sections 102a(b), 109, 202(a)(6), 202(b), 202(c), 202(h), 205(b), 206(h), 206(k), and 207(a); repealed section 116; and added new sections 107A and 216.

981 *American Bankers Association v National Credit Union Administration*, Civil Action No. 16-2394.

982 M. C. Meiner, “ABA Wins on Two Counts in Credit Union Field of Membership Lawsuit” <https://bankingjournal.aba.com/2018/03/aba-wins-on-two-counts-in-credit-union-field-of-membership-lawsuit/ > accessed 17 April 2019.

983 *American Bankers Association* above note 981.

984 According to 12 USC § 1752 (a).

members, as depositors and owners, have the right to the repayment of their deposits and interests but also to access the funds that remain after the credit union is dissolved.[985]

Traditionally, credit unions have focused on “small value, nonmortgage loans to individuals and households, meaning uncollateralised loans for household expenses and the purchase of consumer durables.”[986] However, within community credit unions “businesses and other legal entities within the community boundaries or rural district may also qualify for membership.”[987] Likewise, credit unions that serve low-income members may accept deposits from non-members, including businesses.[988] From a tax perspective, credit unions are free from federal income taxes.[989]

Like banks and thrifts, credit unions are subject to lending limits. A credit union lending to only one member is limited to 10% of unimpaired capital and surplus.[990] Also, federal credit unions are subject to commercial lending limits. “The aggregate limit on a federally insured credit union’s net member business loan balances is the lesser of 1.75 times the actual net worth of the credit union, or 1.75 times the minimum net worth.”[991] Exceptions to this rule apply to low income credit unions, those chartered to make business loans or those that have a history of primarily serving business loans.[992]

There are certain activities that federal credit unions are not permitted to engage in directly, but via a credit union service organization (CUSO). A CUSO is an “organization that is owned by credit unions in whole or in part that provides permitted financial services and/or operational services primarily to credit unions or members of credit unions”.[993] Federal credit unions may not offer insurance or engage in securities brokerage directly, but may do so via CUSOs.[994]

From a size perspective, according to the Credit Union National Association Mutual Group, as of February 2020, there were 5,279 credit unions in operation.[995] According to Wilcox and Dopico, “In 1969, when their number peaked at 23,866, credit union assets totalled $16 billion, only 3% of the assets of commercial banks and 1.6% of GDP. Since1970, there have been nearly 13,000 credit union mergers. As the number of credit

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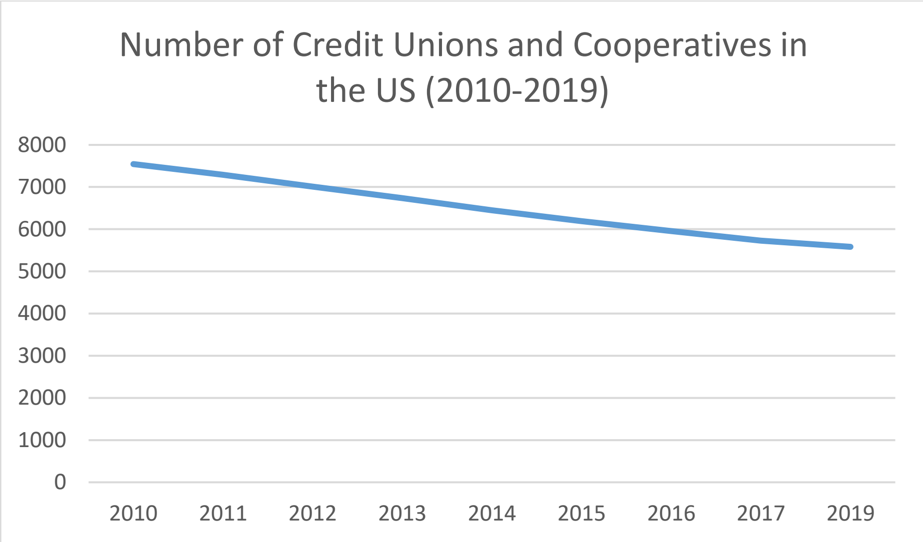
[985] J. Walter, above note 971, p. 360.
[986] Ibid p. 361.
[987] 12 CFR Appendix B to part 701 Section V.
[988] 12 USC § 1757 (6).
[989] 26 USC § 501 (c) (1); J. Reosti, “Do Credit Unions Still Warrant a Tax Exemption?” [2018] American Banker <https://www.americanbanker.com/news/do-credit-unions-still-warrant-a-tax-exemption>; J. Nussle, “BankThink Banker concerns about credit union mergers are overblown” [2019] American Banker <https://www.americanbanker.com/opinion/banker-concerns-about-credit-union-mergers-are-overblown?tag=00000157-6d0d-d460-a7f7-7f6ff5df0000 > accessed 17 April 2019; J. Walter, above note 971, p. 363.
[990] 12 USC§ 1757 (5)(A) (x).
[991] 12 CFR § 723.8 (a).
[992] 12 USC § 1757a (b).
[993] G. Messik, “Credit Union Service Organizations (‘CUSOs’)” (*NACUSO*, 2018) <https://www.nacuso.org/wp-content/uploads/2018/02/History-of-CUSOs-2-7-18.pdf> accessed 24 April 2019; “CUSOs at a Glance” (*NCUA*, 2019) <https://www.ncua.gov/files/publications/cusos-at-a-glance-2017.pdf> accessed 24 April 2019; A. Downin, “Ambidexterity Drives Credit Union Success, CUSOs Make it a Reality” *Credit Union Times* (12 April 2017).
[994] 12 CFR§ 712.5 (g) and 12 CFR § 712.5 (k).
[995] “Credit Unions Trend Report” (*CUNA*, 2020). <https://www.cuna.org/uploadedFiles/Global/About_Credit_Unions/CUMonthEst_Feb21.pdf> accessed 8 April 2021.

unions declined, so did the number of annual mergers. Nonetheless, the annual percentage of credit unions that merged was remarkably steady, ranging from 2.5% to 3.5% in all but three years since 1984."[996]

Figure 19. Number of credit unions and cooperatives in the US



Source: IMF, St. Louis Federal Reserve and NCUA Mutual[997]

One of the main concerns of the ABA and the banking industry is credit union concentration and expansion. In 2019 Pentagon Federal Credit Union, the third-largest credit union, merged with Progressive Credit Union "that gives PenFed an open charter, allowing anyone nationwide to join."[998] Ken Clayton from the ABA stated that "[t]his merger is just the latest example of large credit unions far exceeding their original mission to serve targeted communities of modest means…This not only hurts small credit unions playing by the rules, but also taxpayers who are unknowingly subsidizing this national expansion."[999]

Table 5. Comparative analysis of national banks, federal savings associations and federal credit unions

	National Banks	Federal Savings Associations	Federal Credit Unions

[996] J. Wilcox and L. Dopico, "Credit Union Mergers: Efficiencies and Benefits" [2011] FRBSF Economic Letter.
[997] International Monetary Fund, Geographical Outreach: Number of Credit Unions and Financial Cooperatives for United States [USAFCIODUNUM], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/USAFCIODUNUM>, 23 April 2019; and Credit Unions Trend Report (CUNA, 2020) above note 995.
[998] P. Ghosh and J. Reosti, "PenFed Deal Feeds Bankers' Fears of Unlimited Credit Union Membership" [2019] American Banker <https://www.americanbanker.com/news/penfed-deal-feeds-bankers-fears-of-unlimited-credit-union-membership?tag=00000157-6d0d-d460-a7f7-7f6ff5df0000> accessed 17 April 2019.
[999] Ibid.

Membership	No restrictions	No restrictions	Only serve members 12 § USC 1759
Deposit taking powers	Yes. 12 USC § 24 (seventh), 12 CFR §	Yes. 12 USC § 1464 (b), 12 CFR part 557, subpart B	May offer share certificate accounts. 12 USC § 1757 (6); 12 CFR § 701.35 (a)
Insurance	May sell liability, casualty, automobile, life, health and accident insurance on agency basis in places with less than 5,000 inhabitants. It may engage in general insurance agency functions through a financial subsidiary. 12 USC§ 92 and 24a; 12 CFR §7.1001 and 5.39	Similar to national banks but without restriction on places. Federal savings associations may sell insurance through service corporations on an agency basis without geographic restriction. 12 CFR § 559.4 (f) (3)	Federal credit unions may not offer insurance directly but may do so via a CUSO. 12 CFR§ 712.5 (g).
Securities brokerage and underwriting	National banks may engage in types of securities brokerage. 12 USC § 78c(a)(4) and (5). National banks may direct underwrite various securities. Financial subsidiaries may engage in underwriting of all types of securities. 12 USC §24 (seventh) and 24a; 12 CFR parts 1 and 12	Federal savings associations may engage in securities brokerage only via a service corporation, and on agency basis. 12 CFR § 545.74	Federal credit unions may not engage in securities brokerage directly but through a CUSO. 12 CFR § 712.5 (k)
Derivatives	Yes. 12 USC § 24 (seventh)	Yes. 12 CFR § 563.172	Only to manage the risk of loss via long put positions on Ginnie Mae, Fannie Mae and Freddie Mac securities. 12 CFR§703.110 and 701.21 (i) (2)
Ownership	Shareholders	Shareholders or members in mutual thrifts	Members 12 USC. § 1752(1)
Aim	For profit	Depends on stock ownership or mutual thrift	Not for profit

Source: US Treasury[1000]

5.1.5.6 Other non-bank institutions according to the BHCA

There are certain financial institutions that are exempted from the definition of a bank according to the BHCA. They are industrial loan companies and industrial banks (ILC),[1001] credit card banks,[1002] and limited purpose trust companies.[1003]

5.1.6 US regulation of international banking

In parallel with domestic legislation, foreign banks doing business in the US are also subject to the dual regulatory regime via federal and state law. In general, foreign banks are subject to similar regulations as domestic banks.[1004] The International Banking Act of 1978 (IBA) regulates non-US banks in the US and adopts the principle of "national treatment" between domestic and foreign banks.[1005]

The modes of foreign bank entry into the US include: i) US branch; ii) agency; iii) US bank subsidiary; iv) representative office; v) Edge corporation; and vi) commercial lending company.

US branches – as befits the nature of a branch – are not separate legal entities in the US but the same legal foreign entity. However, in certain cases, US law treats the foreign branches differently from the whole foreign bank.[1006] First, only US branches (and not the whole foreign banks) are eligible for federal deposit insurance.[1007] Second, US

[1000] Appendix. Comparison of Depository Institution Powers and Regulatory Requirements <https://www.treasury.gov/press-center/press.../curegapp.doc> accessed 23 April 2019.

[1001] M. West, "The FDIC's Supervision of Industrial Loan Companies: A Historical Perspective" [2004] Supervisory Insights p. 5; Government Accountability Office, "Industrial Loan Corporations Recent Asset Growth and Commercial Interest Highlight Differences in Regulatory Authority" (2005) p. 5; K. Spong and E. Robbins, "Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate" (2007) 41 Federal Reserve of Kansas City Economic Review p. 42; 12 USC §1841 (c)(2)(h)(i); J. Barth and Y. Sun, "A New Look at The Performance of Industrial Loan Corporations" [2018] Utah Center for Financial Services, The University of Utah p. 4. In 2017 FinTech Companies Square and SoFi applied for ILC charters, withdrawing their applications months later. C. Oney, "Fintech Industrial Banks and Beyond: How Banking Innovations Affect the Federal Safety Net" [2018] 23 Gordham J. Corp & Fin p. 542; L. Clozel, "SoFi Withdraws Bank Application in Wake of Scandal" (2017) American Banker; T. Stone, "The Past, Present and Future of the ILC Bank" (*De Banked*, 2019) <https://debanked.com/2018/07/the-past-present-and-future-of-the-ilc-bank/> accessed 24 April 2019.

[1002] S. Omarova et al., above note 831, p. 187; *Marquette Nat'l Bank v First of Omaha Corp*, 439 US 299 (1978). See 12 USC§ 1841 (c)(2)(F).

[1003] S. Omarova et al., above note 831, p. 173; 12 U.S. Code § 1841 2 (D); H.R. Rep. No. 261, 100th Cong., 1st Sess. 119, reprinted in 1987 U.S. Code Cong, & Admin. News 588 cited by H. N. Beck, "Opportunities for Nonbanking Companies to Acquire Depository Institutions in the Wake of the Competitive Equality Banking Act of 1987" [1988] 44 Bus. Law p. 1053.

[1004] US Banking Law: Overview, above note 957.

[1005] Pub. L. No. 95-369, 92 Stat. 607 (1978) (codified at 12 USC §§ 3101 et seq. (2010): J. Carr Jr. and T.J. Pax, "Forms of Entry, Operation, Expansion and Supervision of Foreign Banks in the United States" in M. Gruson and R. Reisner, *Regulation of Foreign Banks. United States and International* (Michie Butterworth 1995) ps. 1-10.

[1006] Meeting between Federal Reserve Board Staff and Representatives of Foreign Banking Organizations 9 July 2012 <https://www.federalreserve.gov/newsevents/rr-commpublic/Industry_Meeting_20120709.pdf> accessed 9 May 2019.

[1007] 12 USC§ 1815 (b).

branches are subject to BHC regulations while the foreign bank is treated as a parent, and the branch as a subsidiary.[1008] Third, a foreign bank may engage in any kind of activities outside the US, even though the US branch is subject to BHC activity restrictions.[1009] Fourth, state chartered branches and federal chartered branches are liquidated as separate legal entities under state and IBA law.[1010] According to 12 USC § 3101 (b). "'Branch' means any office or any place of business of a foreign bank located in any state of the US at which deposits are received."[1011] They must be approved by the Federal Reserve System.[1012]

A second mode of entry is through agencies. Agencies of foreign banks may not accept deposits from US persons, but may engage in other banking activities. They may be licensed via state or federal law, and they need FRB approval.[1013]

US bank subsidiaries are legal entities separate from their parent foreign bank (as all subsidiaries are). They need to charter under federal or state law. The regulation of foreign bank subsidiaries will depend on the type of banking organisation the foreign subsidiary is opting for (generally national bank, BHC or FHC).[1014]

A special mode of entry is the representative office. "The term 'representative office' means any office of a foreign bank which is located in any State and is not a Federal branch, Federal agency, State branch, or State agency."[1015] A representative office "engages solely in representational and administrative functions (such as soliciting new business or acting as liaison between the organization's head office and customers in the United States); and does not have authority to make any business decision (other than decisions relating to its premises or personnel) for the account of the organization it represents, including contracting for any deposit or deposit-like liability on behalf of the organization."[1016]

Edge corporations are federally chartered entities whose business generally must be limited to international banking and financial operations. Prior approval of the Federal Reserve System must be obtained.[1017] The "principal purpose of such a banking Edge Act corporation is to encourage the export of US goods and services."[1018] Edge corporation subsidiaries of US banks are permitted to perform a wide range of activities abroad,[1019] and may also perform some activities in the US incidental to international foreign business.[1020] Regulation K organises the types of overseas investments in which BHCs,

[1008] 12 USC § 1841.
[1009] 12 CFR § 211.23 (f) (l).
[1010] E.g NY Banking Law §606 (4)(c) et seq) and 12 USC § 3102 (j) (l).
[1011] 12 USC § 3101 (b).
[1012] 12 USC § 3105 (d)(1).
[1013] 12 USC § 3105 (d)(1).
[1014] US Banking Law: Overview, above note 957.
[1015] 12 U.S. Code § 3101 (15).
[1016] 12 CFR § 211.2.
[1017] 12 USC § 614.
[1018] J. Carr Jr. and T.J. Pax, above note 1005, p.1-33.
[1019] 12 USC § 615.
[1020] 12 CFR § 211.6.

banks or Edge Corporation may engage.[1021] Agreement corporations have the same functions as Edge corporations but are state chartered.[1022]

Finally, a commercial lending company ("CLC") "refers to foreign banks willing to have a limited operation in NY via an 'Investment Company chartered under Article XII of the New York Banking Law." A CLC may borrow and lend money, transmit money, trade coin and bullion, among other activities.[1023]

Annex 3 will analyse insurance regulation in the US in order to understand the nature of its activities and the character of US FCs that engage in the insurance business.

5.1.7 How FCs in the US structure themselves

Unlike the EU, where there is a directive on FCs, with clear definitions on what a FC is and how it needs to be regulated, in the US, multiple regulators focus on different aspects of FCs. The DFA tended to ameliorate that dispersion trying to close regulation arbitrage, putting the focus on systemic risk and establishing uniform capital adequacy standards for FCs.

Prior to the DFA the Office of Thrift Supervision (OTS) supervised THCs, which included large FCs such as AIG, Countrywide Financial, General Electric Company, General Motors Company, Merrill Lynch, Morgan Stanley and Washington Mutual.[1024] Some companies that were willing to hold a depositary institution but not willing to be regulated by the Federal Reserve System via a BHC or an FHC had this option. Also, prior to the DFA, a FC could elect to be regulated by the SEC as a consolidated supervised entity (CSE) or a supervised investment bank holding company (SIBHC). According to section 231 of the GLBA the SEC could act as a consolidated regulator of holding companies that were not regulated by bank or thrift holding companies by the Federal Reserve System or the OTS.[1025] The SEC, as a reaction to the lobby of FCs that had no primary regulator implemented this regime in 2004.[1026] These FCs did not want to be subject to regulation by FICOD that required competent authorities to verify whether FCs with head offices outside the EU were subject to supervision by a third-country competent authority, which was equivalent to the FICOD. The consequence of not having an equivalent regime was that those FCs would be subject to the FICOD.[1027] These firms preferred the SEC regime because it offered a "preferential capital treatment."[1028] Another consequence of the pre-DFA regime was that holding companies that hold industrial loan

[1021] 12 CFR 211.1 to 211.605.
[1022] J. Carr Jr. and T.J. Pax, above note1005 p.1-33.; US Banking Law: Overview, above note 957.
[1023] New York Consolidated Laws, Banking Law - BNK § 508.
[1024] E. Brown, "The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?" [2011] 60(5) American University Law Review p. 113.
[1025] 15 USC § 78q(i) (2006).
[1026] Ibid.
[1027] FICOD, art 18.
[1028] US SEC, Office of the Inspector General, Office of Audits, "SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program Report" No. 446-A (25 September 2008) p. 4.

or industrial banks but do not hold a bank or a thrift or a broker dealer were not subject to federal regulation.[1029]

After the DFA, the OTS's powers to regulate thrifts were transferred to the OCC, and the OTS's powers to regulate THCs were transferred to the Federal Reserve System. This closed the door to companies such as AIG or Merrill Lynch offering banking services via thrifts without Federal Reserve System regulation. A second consequence of the DFA was the elimination of the CSE and SIBHC regimes and the requirement for "securities holding companies" to be regulated by the Federal Reserve System.[1030] Sometime before the DFA, the SEC had stopped the CSE program due to Bear Stern financial problems.[1031] In addition, the DFA enacted the "Hotel California" provision by which a FC that became a BHC or an FHC, with more than 50 billion in consolidated assets by January 2010, and received pubic aid could not avoid regulation by changing the charter of any banking subsidiary.[1032] The DFA gave the Federal Reserve System the power to determine that the Board of Governors shall supervise a nonbank financial company in case it "could pose a threat to the financial stability of the United States."[1033]

By doing this, the Federal Reserve System has the power to close "regulatory arbitrage" of systemic important financial institutions since from now on FCs are not able to choose regulators. For example, AIG which has chosen to be treated as a thrift would not be permitted to do that anymore according to the law.[1034] Finally, the DFA adopted a provision to avoid the TBTF problem by prohibiting interstate mergers that create a depositary institution that controls more than 10% of the deposits in the US.[1035]

A FC, as defined by the Tripartite group, encompasses a group of companies that engage in at least two financial activities, banking, securities and insurance.[1036] FCs in the US may organise themselves via the following corporate structures:

Via a BHC, with a broad variety of permitted banking activities, but with very limited insurance agency and underwriting activities and very limited agency transactional activities for customer investments
Via an FHC, with a broad variety of permitted insurance, securities and banking activities
Via a national bank with broad permitted bank activities, and very limited securities activities (may engage in certain types of securities brokerage and others) and insurance activities (may sell certain types of insurance in places of 5,000 inhabitants or less)
Via a national bank operative subsidiary, with broad permitted banking activities, and the power to provide title insurance as principal under certain circumstances

[1029] E. Brown, above note 1024 p.107.
[1030] 15 USC § 78q.
[1031] E. Brown, above note 1024 p. 153
[1032] 15 USC § 78q; E. Brown, above note 1024.
[1033] 12 U.S. Code § 5323.
[1034] The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report. Final Report of the National Commission on the causes of the financial and Economic crisis in the United States* (Official Government ed, 2011) 352.
[1035] 12 USC § 1852.
[1036] BIS, above note 71.

Via a national bank financial subsidiary, with broad permitted banking activities and certain securities (may underwrite all types of securities) and general agency insurance activities
Via a THC, with the same broad permitted activities of an FHC if they meet similar conditions as the FHC
Via a thrift, with the same permitted banking activities as national banks, with similar powers as national bank insurance activities, but without the geographic restriction of 5,000 inhabitants
Via a thrift service corporation (issuing notes, bonds, debentures, or other obligations or securities)
Via a credit union, with broad banking activity, with limited insurance and securities activities
Via a CUSO, it may broker and sell insurance and other broker securities
Via a "non-bank institutions according to BHCA" holding company, which may have banking activities via an ILC or a credit card bank, and may also include an insurance company that would be regulated by state law, and a securities firm that would generally be regulated by the SEC. In certain cases, if labelled as a SIFI, the Federal Reserve System may also regulate them
Via a nonbank financial company that has been subject to prudential supervision by the Federal Reserve System, which engages in at least two of the typical financial activities
Via a foreign bank branch, with the limitation of a BHC
Via a foreign bank subsidiary, that will have the limits of the type of charter it opts for when chartering

As stated above, most US BBFCs choose the FHC as a preferred structure since it permits engagement in banking, insurance and securities in a way that may resemble universal banks.

5.1.8 Concluding remarks

1. American federalism and a unique "unit banking system"

Unlike European universal banking, which is based on an "activities list approach" that includes commercial, insurance and securities activities under the same umbrella, the evolution of BBFCs faced different phases. The first three phases, which comprise the charter banking system, free banking and the Federal Reserve System (until the 1930s), permitted universal banking in the US. It was only in 1933 with the GSA that traditional financial activities were separated.

While German universal banking had its philosophical foundations in Saint Simon's ideas, and the UK based its system in classic liberalism and self regulation, federalism provides the rationale to understand the nature and evolution of the US model. Federalism shaped the banking system in the US since its inception and its regulators tended to replicate the governmental federal structure at the banking level, preventing abuse of power and undue concentration of financial resources. This is why the US banking system relied on a quite unique system of "unit banks" that were the result of heavy restrictions on branching at both the state and federal levels.

This thesis believes the costs of unit banks outweighs their benefits. While it is true that unit banks may have not been altered by a branch because that was not a possibility and that managers of local banks may have had better knowledge of their customers, these facts should not be enough to to restrict branching altogether. Also, the fact that branch banking may lead to capital outflows from rural areas is not a defining argument if that may be compensated by other means of finance or by opening branches in those areas. The argument held by the Comptroller of the Currency in 1924 that branch banking may be monopolistic is something to take into account; nonetheless, it is not a typical note of branch banking but of big banks. The same tools that are now available to fight TBTF and trusts would apply to any institution that may present a monopolistic character. Finally, to say that branch banking opposes federalism is an outdated argument since federalism is intended, in the words of Justice Scalia, to find a midway between two extremes, disunity and uniformity. Allowing banks to freely branch among states does not undermine federalism in a way that would denaturalise its meaning. Federalism will continue to be a way of regulating the "practicalities" of US matters.

On the contrary, allowing branch banking had accelerated growth in states that permitted it, and there is evidence that unit banks were less efficient than branch banking in the use of capital and reserves. Additionally, unit banks were inadequate to finance industrial firms in the US and they hindered the development of large firms in the twentieth century. They imposed costs on large firms that had to rely on expensive investment banking syndicates. Some research believes unit banks were more associated to bank panics than branch banking. There is also evidence that unit banks hindered financial integration and diversification and they prevented competition among banks.

The unit banking system created a mismatch between big firms and unfitted small banking systems. The role of law in the US was repressive in the sense that branching restrictions stimulated the growth of capital markets. While universal banks in the German model relied on a capitalism based on long-term relations, insider dealing and industry development, in the US, a new form of capitalism emerged based primarily on capital markets. The UK has proven to rely both on capital markets and banks, while the preemince of banks is not as clear as in Germany.

2. The chicken and the egg situation in American financial regulation

The relationship between the corporate form of BBFCs and regulation may be described as a "chicken and egg situation". Indeed, as stated above, American branching restrictions led the private sector to circumvent them via new corporate forms. The creation of chain and group banking was in part a reaction to the unit banking system. Prior to 1956, bankers started using the holding company structure as a way to have presence in different states, *de facto* applying interstate banking. The BHCA was partly a reaction to regulate the use of holding companies to prevent the side step of the McFadden Act. Later on, the deregulation movement built up to the GFC of 2007-2009. As a reaction to the GFC, the US legislature enacted the DFA. The DFA ended up the possibility of FCs to be regulated by the SEC. It also prevented the possibility of avoiding regulation by the Federal Bank System if a holding company holds industrial loans or industrial banks. The DFA also gave the Federal Reserve System the power to regulate non-bank financial companies in the case they could pose a threat to financial stability in the US. This way, the DFA closed regulatory arbitrage to FCs.

3. Corporate form and American regulators

Section 5.1.6 analyses the "business of banking" and the definition of a bank under US law as well as examining each of the traditional depository institutions in the US: i) commercial banks; ii) thrifts; and iii) credit unions. One special feature of the American system is the existence of a state and federal charter of these institutions. A second feature is the existence of second level institutions, which comprise commercial bank operatives and financial subsidiaries, thrift service corporations and CUSOs. As in Germany, thrifts were born to encourage savings and help people of "deserving classes". In the US, thrifts are not independent instrumentalities of public law but private associations. Thrifts in the US may have stock ownership or mutual ownership. One special feature of thrifts in the US is that they are required to have at least 65% of their portfolio in housing-related assets. As with commercial banks, there are also THCs. Finally, credit unions are cooperatives which are governed by i) cooperative principles of democratic vote; ii) self-help; iii) a common bond requirement; and iv) mandatory membership. Similar to their European counterparts, credit unions are not for profit. Similar to the UK, the US system comprises commercial banks and credit unions. They share with Germany the existence of thrifts (saving banks) and commercial banks.Contrary to some examples in Europe, there are no globally systemically importantthrifts or credit unions in the US.

Unlike the EU where there is FICOD, in the US multiple regulators focus on different aspects of FCs. The DFA focused on systemic risk and uniform capital adequacy standards. While following the deregulation period US bank-based conglomerates may choose from a variety of forms to perform banking insurance and securities, big international bank-based conglomerates have chosen primarily the FHC as their preferred structure.

4. Icarus and American financial regulation

In Greek mythology, Icarus is the son of Daedalus, a famous artisan who created the labyrinth on the instruction of King Minos, in order to imprison the Minotaur, a half bull-half man creature. "This labyrinth was so very intricate, that those who entered could not find their way out; and even Daedalus and his son Icarus, after many days' attempt, found they could not leave it."[1037] In order to leave the labyrinth Daedalus manufactured a pair of wings for each of them made of wood, feathers and wax.

Daedalus warned Icarus not no fly too high nor too low:

> 'My Icarus!' he says; 'I warn thee fly
>
> Along the middle track: nor low, nor high;
>
> If low, thy plumes may flag with ocean's spray;
>
> If high, the sun may dart his fiery ray.'[1038]

Icarus flew swiftly along but forgot the warnings of his father and rose up higher and higher until he was very high, near the sun. The heat melted the wax of the feathers, and Icarus fell into the sea and drowned.

[1037] H. A. Guerber, (American Book Company, 1893) p. 254.
[1038] Ibid.

Skeel has used the image of Icarus to understand the flaws of American corporate regulation in his book *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From.*[1039] He correctly points out that American corporate regulation has consisted of federal regulatory interventions after major scandals. According to him, these scandals have two common factors: 1) Excessive risk-taking, many times influenced by competition, and 2) the manipulation of the corporate form.

A similar metaphor may be applicable to American FCs regulation. The wise warning of Daedalus is extensive to financial regulators. Do not overregulate (fly too low) because you will be limiting innovation and flexibility, and at the same time do not deregulate (fly too high) because you may endanger financial stability.

Interestingly, when considering virtues, Aristotle taught that virtue is the mean between two extremes. In one extreme, there is an excess and in the other, there is a defect. For him, "Virtue then, is a state of character concerned with choice, lying in the mean, i.e. the mean relative to us, this being determined by a rational principle, and by the principle by which the man of practical wisdom would determine it."[1040] While not virtues *per se*, another metaphor may be drawn here. Between overregulation and deregulation lies virtue. As with habits, which need repetition to be acquired, regulators need to repeat good practices in order to acquire the correct balance between the two extremes. (See Figure 20 below).

Figure 20.

The SUN

Fly too high: deregulation (flexibility and innovation)

____

"Virtue middle"

____

Fly too low: overregulation (stability and red tape)

THE SEA

Source: Author´s elaboration

American history over the last two centuries has experienced both extremes. Branching restrictions led America to a "unit banking" system that proved to be unique. Small unit banks could not finance the needs of big industry in the US. Empirical ratios show that universal banks in Germany did provide sufficient funds and were determinant in helping

[1039] D. Skeel *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From* (OUP 2006) p.1.
[1040] Aristotle, *The Nicomachean Ethics of Aristotle* (Sir D. Ross tr, OUP 1963) p.1.

the development of economic growth in that country. However, American innovation used other means for financing its industry via bank syndicates and capital markets. Branching restrictions were an indirect means of the development of capital markets in the US.

At the opposite extreme, financial deregulation may have run up the GFC. As Skeel proposed, excessive risk taking is one typical factor of corporate scandals. The major sin of Icarus was hubris, a sober overconfidence in his capabilities that made him ignore the warnings of his father. Virtue lies in the middle, and the right balance between these two extremes is fundamental to control the potential damage of a future financial crisis. History is a good ally for regulators to find the wiser solutions, in order not to fly too low nor too high.

CHAPTER 6. RESOLUTION OF BBFCs

6.1 Resolution planning frameworks

In November 2011, the FSB issued the *Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes)* with the aim to "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". [1041] The scope of the document are SIFIs or "systemically significant" financial institutions. As of April 2019, most FSB jurisdictions have adopted resolution planning frameworks.[1042] While the Key Attributes were adopted with SIFIs in mind, different jurisdictions apply resolution planning to all banks (EU, HK) others to G-SIBs and D-SIBD-SIBs (Brazil, China, Japan, Switzerland) and others apply an "asset size threshold" that includes G-SIBs and other large financial institutions (US).[1043]

As stated by FSB, resolution strategies and resolution tools are generally based on "type, size, complexity and significance of a bank…Most jurisdictions report considerations related to the characteristics of the bank (i.e. structure, interconnectedness), resolution objectives and circumstances at the time of failure. In particular, consideration is given to the systemic nature of firms and factors such as bank structures, critical functions and geographical reach." [1044]

There are three main resolution strategies: i) a bail in strategy, which may be divided into SPOE and MPOE; ii) partial transfer strategy; and iii), a modified insolvency strategy. [1045]

G-SIBs and D-SIBD-SIBs resolution strategies in general focus in maintaining the bank structure and operations intact.[1046] According to the FSB 2018 *Seventh report on the Implementation of Resolution Reforms*, 26 out of 28 G-SIBs prefer a bail in, SPOE strategy:

> "In most cases a single point of entry combined with a bail-in is preferred for G-SIBs and most D-SIBs, as this enables the resolution authority to stabilise the firm and provide for continuity of its critical functions by keeping operational subsidiaries open" [1047]

[1041] Key Attributes of Effective Resolution Regimes for Financial Institutions (2011) <https://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/ >

[1042] FSB "Thematic Review on Bank Resolution Planning. Peer Review Report", 29 April 2019.

[1043] Ibid, p. 11.

[1044] Ibid, p. 20.

[1045] C.H.R. Morris above note 809 p. 267; The Bank of England's approach to resolution October 2017, p. 16. For resolution tools see generally J-H. Binder "Concepts, Requirements and Tools" in J-H. Binder and D. Singh *Bank Resolution: The European Regime* (OUP 2016). J-H. Binder "Resolution Planning and Structural Bank Reform within the Banking Union" in J. Castaneda *European banking Union. Prospects and challenges*, (Routledge 2015).

[1046] Ibid, p. 20

[1047] FSB 2018 Resolution Report: "Keeping the Pressure Up". Seventh Report on the Implementation of Resolution Reforms, 15 November 2018.

A second group of smaller institutions, which have less critical functions and less complex structures, may find that a transfer of assets and liabilities to a bridge bank or a third party is more appropriate for them. Also, a liquidation of the remaining of the old bank may follow.[1048] Bank of England (BoE) has adopted this strategy to banks which "only critical function they supply relates to accounts relied on by customers for day-to-day payments and cash withdrawals". BoE applies this strategy to firms with more than 40,000–80,000 transactional accounts if their balance sheet is less than £15 billion–£25 billion.[1049]

The liquidation strategy may apply to jurisdictions that apply resolution planning to all banks, as long as it does not threat financial stability.[1050] This kind of strategy count of deposit guarantee schemes, which safeguard client assets via a preferential place in credit hierarchy or via set up of trusts outside of the bank´s estate.[1051]

The following section will examine the bail in resolution strategy applied by BBFCs.

6.2. Resolution of a BBFCs

After the GFC, the focus of regulators has been placed on how to make FCs "safe to fail". A number of different tools have emerged in order to fulfill this objective. In 2014, the FSB announced two different "resolution strategies" based in bail in, for global systemically important banks: SPOE and MPOE strategy. The FSB allows national regulators to choose the most appropriate resolution strategy for their G-SIBs. The question here would be: what are the main elements regulators need to take into account in order to choose the most appropriate resolution strategy for their G-SIBs?

In this chapter this thesis use words like banking groups, financial institutions and banks, and FCs, whenever applicable to BBFC in order to build a workable framework.

There are certain indicators that regulators should take into account. The first indicator is how FCs/groups structure themselves, i.e. via branches, subsidiaries or a mix of both. The second indicator is the degree of centralization of global banks: centralized or decentralized type of global bank. The third indicator is the business model of the global bank; i.e. retail or wholesale banking. The fourth indicator is the territorial or unitary approach to resolution.

First indicator: branches or subsidiaries

The global bank may organize itself through branches, which are part of the same legal entity, inseparable from the parent, and therefore fully responsible for their financial obligations. Contrary to this, the subsidiary is a fully independent legal entity, which is

1048 FSB "Thematic Review on Bank Resolution Planning. Peer Review Report", 29 April 2019, p. 20.
1049 Bank of England, above note 1045 p.16.
1050 Ibid, p.20.
1051 C.H.R. Morris, above note 809 p. 273.

licensed, supervised and regulated by local authorities. As such, the parent company has no legal obligation to support it in times of distress.[1052]

The branch system might be more cost effective for the banking group, since there is no need for maintaining capital and liquidity buffers in each unit, which result in less need of capital and funding for the group. In addition, the global bank may mobilize funds from a healthy branch to another in times of distress, with no legal restrictions that might be present in a subsidiary model. Moreover, subsidiaries might face more costs of external funding if they borrow in their own name instead of doing so in the parent´s name.[1053]

On the other hand, it is recognized that in principle, the subsidiary structure may be better fitted to contain losses in the event of failure of a subsidiary.[1054] In some cases, a subsidiary located in country A may continue as a going concern even if the parent or other subsidiary fail, since losses in those entities might be isolated. However, in practice, a parent might be forced to support a failing subsidiary due to reputational reasons.[1055]

The subsidiary model might help to solve asymmetric information problems regarding shareholders and creditors. While shareholders might be tempted to substitute safer assets to risky assets once the lending conditions have been met, creditors might want to increase their premium or stop lending if they perceive these conditions will persist over time. One solution would be to create subsidiary where safe assets would be placed and therefore increase the creditors' perception that shareholders will stop risk shifting.[1056]

In certain cases, where bank divisions have different compensation practices and cultures, holding separate subsidiaries might help oversight and control.[1057] Another advantage of the subsidiary system is that a separate public listing of shares may make the price system more informative, since there is an increase in the number of traded securities.[1058] From a group management perspective, a subsidiary model might help the managerial resistance to a merger, since it would keep in place the local structure. Also, the subsidiary model benefits from proximity. As a local entity, it might better influence the environment, i.e. by being member of the national bankers association. In terms of facilitating the merger, the subsidiary model might help to keep the business as usual after the merger, with no need to change the brand. From a tax perspective, a subsidiary model might be more flexible than a branch structure, i.e. startup losses are more easily preserved in a subsidiary than in a branch. [1059] Finally, and based on the Icelandic bank crisis, the subsidiary model would be most suitable for smaller countries with limited

[1052] J. Fiechter, I. Okter Robe, A Ilyina, M. Hsu, A. Santos and J. Surti "Subsidiaries or Branches, Does one Size Fit All? [2011] IMF Staff Discussion Note p.8; R. Lastra, R. Ayadi, R. Olivares Caminal and C. Russo above note 53, p. 13.

[1053] J. Fiechter et al ibid p.8.

[1054] J. Dermine "European Banking integration: Don´t Put the Cart before the Horse" [2006] New York University Salomon Center, Financial Markets, Institutions & Instruments V 15, No 2 p. 83.

[1055] E. Cerrutti, G. Dell' Ariccia, and M. Martinez Peria "How Banks Go Abroad: Branches or Subsidiaries? [2005] Policy Research Working Paper; No. 3753 World Bank p. 1671; However, in some cases the cost of a bailout might be higher that the reputational risk, as showed in the cases of Nova Scotia, which did not support its argentine subsidiary Quilmes, as well as Credit Agricole with its subsidiary Banco Bisel, both in the Argentine crisis of 2002. J Dermine, above note 1054 p. 83.

[1056] J. Carmassi and R.J. Herring "Complexity and systemic risk: what´s changed since the crisis" in A. Berger, P. Molyneux, J. O. S. Wilson *The Oxford Handbook of Banking* (OUP 2015) p.86.

[1057] Ibid.

[1058] M.A Habib, D. B. Johnsen and N.Y. Nail "Spinoffs and Information" [1997] Journal of Financial Intermediation 6:2 ps 153-176.

[1059] J. Fiechter el al above note 1052, p. 11

fiscal capacity. If a foreign branch fell into distress, the host country would have less obligations and burdens than if the failing entity were a subsidiary.[1060]

From a regulatory viewpoint, home authorities are typically responsible for the supervision of foreign branches of a group, while host authorities are generally responsible for the supervision of the foreign subsidiaries.[1061]

There are different reasons for why FCs/groups organize through branches or subsidiaries. According to empirical work by Cerrutti et al. on branches and subsidiaries, foreign banks tend to organize through subsidiaries if the host jurisdiction limit the permitted activities and when regulation difficult the establishment of new banks. Second, banks tend to use branches in host countries with high corporate taxes, in order to maximize the shift of profits across jurisdictions. Third, there is an association between "degrees of penetration" in the host market. Subsidiaries are more common in retail business while branches are smaller and not focused on retail orientation. Finally, banking groups tend to prefer the subsidiary system when host countries present a high-risk macroeconomic environment, while the use of branches is preferred in countries that face risk of government intervention and political instability, since subsidiaries often have higher capital and reserve requirements and more local assets than branches.[1062]

Although the legal definition of branch and subsidiary is in general common to all jurisdictions, from a regulatory perspective sometimes those definitions are blurred. Contrary to what happens in other jurisdictions, in the US, even though a branch is not a separate legal entity from the bank, US law treats bank branches as separate entities in various aspects. In the first place, as stated above, insolvency law treats US branches of foreign banks as separate entities. [1063] Similarly, for state chartered branches, state law has the power to liquidate the branch. For instance, State of New York law provides that the Superintendent of Financial Services has authority to seize all assets situated in NY.[1064] Second, the US branch of a foreign bank is treated as a US bank under the IBA, and not the whole bank. [1065] Third, the US branch of a foreign bank, and not the bank as a whole, is eligible to apply for federal deposit insurance for deposits payable at the branch.[1066] Forth, US branches of foreign banks are subject to BHCA and its limits, and the foreign company is treated as the holding company and the branch as it subsidiary.[1067] Fifth, only US branches may apply to Federal Reserve Discount Window.[1068]

[1060] Ibid, p. 16.
[1061] IMF "Cross-Cutting Themes in Economies with Large Banking Systems" (IMF 2010), p. 9.
[1062] E. Cerrutti et al, above note 1055 p. 11.
[1063] International Banking Act of 1978, Section 4 (2) j, codified to U.S. Code § 3102. N. Noked "Separate Entity Doctrine for U.S. Branches of Foreign Banks" Harvard Law School Forum on Corporate Governance (2012) <https://corpgov.law.harvard.edu/2012/04/30/separate-entity-doctrine-for-u-s-branches-of-foreign-banks/ > Accessed 17 June 2020.
[1064] Meeting between Federal Reserve Board Staff and Representatives of Foreign Banking Organizations, July 9, 2012; NY BANKING LAW §606 et seq.
[1065] 12 USC 3102(b); Meeting above note 1063.
[1066] 12 USC 1815(b); Meeting above note 1063.
[1067] Ibid.
[1068] 12 USC 3102(b). See Meeting above note 1063 for further US regulation which treat the US branch of a foreign bank as separate entities for certain purposes.

Second indicator: centralized or decentralized type of bank

Although there is no straightforward banking business model, there are two main types of global banks: centralized and decentralized. The centralized model would perform management of liquidity, capital, risk exposures, information technology and processing from the "top tier entity". Decision-making and external funding are generally positioned at the top level. Centralized banks often use branches and subsidiaries are "managed as a whole".[1069] As Carmassi and Herring explain "so far regulations will permit, subsidiaries would be managed as if they were branches and lines of business will be managed to maximize the profits without regard for the legal entities in which the activities are conducted".[1070] The main advantages of this type of business model is that raising funds at the top level reduces the cost of funding and provides more flexibility, and at the same time allows gains from economies of scale.[1071] On the contrary, the decentralized model the top tier entity holds various local subsidiaries under a common brand, which are usually managed by local directors, locally funded and locally incorporated.[1072] Often, shares are listed in local stock exchanges.[1073] The decentralized model present various constrains on intra-group transactions.[1074] The main advantage of this model is that cross border exposure is limited, since subsidiaries would not normally rely on parent funding, and in times of crisis, contagion between units decreases.[1075]

Third indicator: retail vs non retail banking

BBFC may focus their business on different lines of business. One key business line is retail banking. Retail banking concentrates on the deposit-taking business of households and small to medium sized firms. The retail business will give greater importance to accessing local deposit guarantees.[1076] On the contrary, where a bank focuses on other business lines such as services to large corporate clients, a branch structure would allow "cross-border inter-affiliate funding" and facilitate the provision of a broad range of activities, i.e. wholesale and investment banking. Regarding risk management, a wholesale banking may internalize the clearing and settlement of securities and cash payment obligations, reducing the total liquidity needed by the group. In contrast, a retail global bank would be more interested in managing credit risk of their retail loan books.[1077]

From the public policy point of view, allowing global retail banks into a jurisdiction might imply direct competition for local retail banks, since large global retail banks may affect

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[1069] D. Schoenmaker "The different legal and operational structures of banking groups in the euro area, and the impact on banks´ resolvability" [2016] European Parliament, p.9

[1070] J. Carmassi and R. Herring "The Corporate Complexity of Global Systemically Important Banks" [2016] J Financ Serv Res p. 164.

[1071] D. Schoenmaker, above note 1069 p. 9.

[1072] J. Fiechter et al above note 1052, p. 16

[1073] J. Carmassi and R.J. Herring above note 1070, p. 165

[1074] J. Fiechter, et al above note 1052, p. 7

[1075] D. Schoenmaker, above note 1069 p. 9.

[1076] M. Merck Martel, A. van Rixtel and E. Gonzalez Mota "Business models of International banks in the wake of the 2007-2009 Global Financial Crisis"[2012] Estabilidad Financiera Num. 22 p. 110; J. Fiechter, et al above note 1052, p. 16.

[1077] D. Schoenmaker, above note 1069 p. 9.

price and market share, while wholesaling or investment banking tend to be smaller and underdeveloped in host countries.[1078]

Fourth indicator: territorial or universal approach to resolution

There are two mainly different approaches to resolution: the universal (and also a modified universal[1079]) approach, and a territorial approach. The universal approach or principle of "unity and universality in bankruptcy", which is generally tied to the "single entity" approach[1080] to resolution, implies a unique competent court in charge of the resolution or bankruptcy of the bank and a sole bankruptcy law applicable to the whole process, including the parent and branches in foreign jurisdictions.[1081] In a SIFI resolution, "all creditors of the same class, wherever located, would be treated equally, pursuant to the same country rules governing the ranking of creditor classes". For universal resolution to be effective, all national resolution authorities would have to recognize the universal principle. [1082]

Under the territorial approach, each unit of the SIFI would be resolved under national resolution authorities or national courts. Local bankruptcy or bank resolution laws will apply that would consider only local assets.[1083] The principle of "plurality of bankruptcy", which is generally tied to the separate entity approach to liquidation, prevails. Different bankruptcy or resolution procedures would need to be initiated in each jurisdiction in which the bank holds assets or branches. Under this approach a branch of a banking group would receive a "liquidation preference" since local assets would be "segregated for the benefit of local creditors" (ring-fencing).[1084] The organizational structure that best fits this approach is the subsidiary model.[1085]

Concurrence of the four factors

The concurrence of these four indicators allows us to make some preliminary conclusions. According to these, centralized banks tend to focus on wholesale and investment banking, while decentralized banking tends to focus on retail banking. As for the legal operational structure, centralized, wholesale and investment banking tends to rely on branches, while decentralized retail global banks tend to rely on subsidiaries. Universal approaches to resolution would best fit a SIFI organized mainly by branches, while a territorial approach would best fit the subsidiary model. While this is a general tendency, different FCs and groups organize in different ways. As stated above, there are different considerations that

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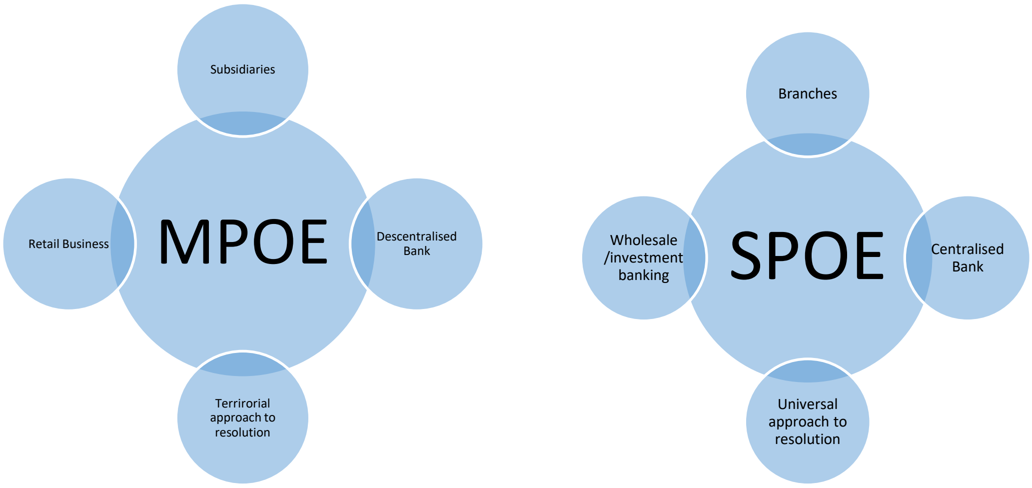
1078 E. Cerrutti et al, above note 1055, p. 1670.
1079 The "modified universal" is a model that would give host countries the right to "bring local resolutions against local parts of a SIFI" S. Claessens, R. Herring, D. Schoenmaker," A Safer World Financial System Improving the Resolution of Systemic Institutions" [2010] Geneva Reports on the World Economy 12, p.88.
1080 The organizational structure that best fits universal approach would be the single entity operating via branches in different jurisdictions. S. Claessens, R. Herring, D. Schoenmaker, above note 1079 p 87.
1081 R. Lastra "Cross-border Resolution of Banking Crisis" Paper presented at the Conference on "International Financial Instability. Cross-border Banking and National Regulation" [2006] Sponsored by the Federal Reserve Bank of Chicago and International Association of Deposit Insurers p.5; T. Huertas "A Resolvable Bank" in K. E. Scott, T. H. Jackson and J. Taylor *Making Failure Feasible: How Bankruptcy Reform Can End Too Big to Fail* Hoover (Institution Press 2015) p. 132.
1082 S. Claessens, R. Herring, D. Schoenmaker, above note 1079, p. 85
1083 Ibid.
1084 R. Lastra, above note 1081 p. 5.
1085 S. Claessens, R. Herring, D. Schoenmaker, above note 1079, p. 85.

groups take into account such as economics, politics, tax and governance. Therefore, in practice, global FCs and or banking groups choose to branch into some jurisdictions and incorporate subsidiaries in others, which makes resolution more difficult for resolution authorities.

Figure 21. Relationships between resolution strategies, business models, legal structural organization and approaches to resolution



Source: Own compilation

The special case of resolution of insurance companies

An additional challenge for resolution authorities would be the resolution of the insurance business of the BBFC. The outcome of resolving insurance business of a BBFC will depend on the jurisdiction involved. At the end of 2017, the FSB conducted a survey to monitor resolvability on the insurance sector in order to evaluate the development of the *Key Attributes* and the *Developing Effective Resolution Strategies and Plans for Systemically Important Insurers*, which showed comprehensive reforms in Australia, France, Hong Kong and Singapore.[1086] According to FSB, the preferred resolution strategy for many insurers is a "multiple point of entry strategy" that relies on the resolution of operative entities.[1087]

In the US, the OLA permits Systemically Important insurance holding companies to be resolved under DFA. However, individual legal entity insurance company subsidiaries are resolved by the State- based resolution regime.[1088] Contrary, in the EU, while there is a recovery and resolution framework in place for credit institutions and investment firms

[1086] FSB <www.fsb.org/2016/06/developing-effective-resolution-strategies-and-plans-for-systemically-important-insurers/ >accessed 18 June 2020; FSB 2018 Resolution report: "Keeping the pressure up" (15 November 2018).
[1087] FSB 2018 above note 1086.
[1088] IMF Country Report 18/207 (2018) "United States: 2018 Article IV Consultation – Press Release; Staff Report and Statement by the Executive Director for United States".

(BRRD) there is no EU legislation or resolution framework for insurers.[1089] Each insurer would follow a local insolvency proceeding.[1090]

6.3. Single Point of Entry and Multiple Point of Entry Strategy

As stated in the conceptual framework chapter, international regulators and soft law institutions have developed a framework of two different resolution strategies; (1) Single Point of Entry (SPOE); and (2) Multiple Point of Entry (MPOE).

The SPOE is the resolution strategy where the resolution authorities apply the resolution tools to the top holding or parent company, by only one resolution authority (i.e. where the global consolidation supervision of the financial group is exercised). The company at the top of the structure absorbs losses by bail-in. If the top company has sufficient loss absorbency capacity, its subsidiaries will continue operating without being resolved.[1091]

The MPOE, on the contrary, is the resolution strategy where various resolution authorities apply bail-in to different companies of the group where the most probable outcome would be the spin-off of the financial group. Possible outcomes would be the division of the group within national or regional boundaries, or by business lines, or both. Resolution authorities would be free to apply different resolution tools but would need to coordinate across borders in order to prevent conflicts of interest, run of assets and contagion among the whole group.[1092]

A distinctive difference between the two strategies is that under an MPOE, loss-absorbing capital is not shared across jurisdictions and it will not need cross jurisdictional transfers, whereas in SPOE, loss absorbing capacity is shared and there are transfers between jurisdictions.[1093]

Bolton and Oehme describe a third "hybrid" approach, whereby banking groups create intermediate national holding groups, which issue TLAC that would not be shared across the group. Therefore, there would be a shared loss-absorbing capacity, across jurisdictions, issued at the holding or parent level, and another loss-absorbing capacity issued at the "national intermediate holding" which is applied to the global parent or third-party investors.[1094]

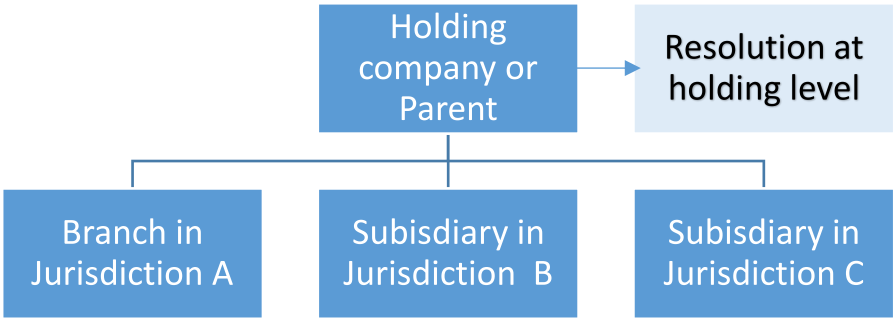
[1089] EIOPA Opinion to Institutions of the European Union on the Harmonisation of Recovery And Resolution Frameworks for (Re)Insurers across The Member States (July, 2017) <https://register.eiopa.europa.eu/Publications/Opinions/EIOPA-BoS-17-148_Opinion_on_recovery_and_resolution_for_(re)insurers.pdf >Accessed 18 June 2020.
[1090] European Systemic Risk Board. Report by the ATC Expert Group on Insurance. "Recovery and resolution for the EU insurance sector: a macroprudential perspective". (August 2017). <https://www.esrb.europa.eu/pub/pdf/reports/esrb.reports170817_recoveryandresolution.en.pdf >Accessed 18 June 2020. See also A. Dombret, P. Kenadjian *Resolution in Europe: The Unresolved Questions* (De Gruyter 2019).
[1091] FSB above note 1041.
[1092] Ibid. See generally for EU J-H Binder "Cross-border coordination of bank resolution in the EU: al problmes resolved?" in M. Haentjens, *Research Hanbook on Cross-border Bank Resolution*, (Edward Elgar 2019).
[1093] P. Bolton and M. Oehmke "Bank Resolution and the Structure of Global Banks" [2018] Discussion paper no 778. Paul Woolley Centre Working paper No 59, p. 2.
[1094] Ibid.

The US Federal Deposit Insurance Corporation (FDIC) approach consists of putting the holding company into receivership. The FDIC transfers holding company assets to a new bridge company. All of holding company's equity and long-term unsecured debt would be left at the holding company level.[1095] In Europe, the BBRD admits SPOE and MPOE approaches.[1096]

While at the beginning the SPOE was the preferred approach for key regulators, the TLAC regulation that proposes to "pre-position" sufficient amount of capital in each subsidiary might be a "step back" towards MPE regulation.[1097]

Advantages and disadvantages of the two strategies follows.

Figure 22. Single Point of Entry Strategy



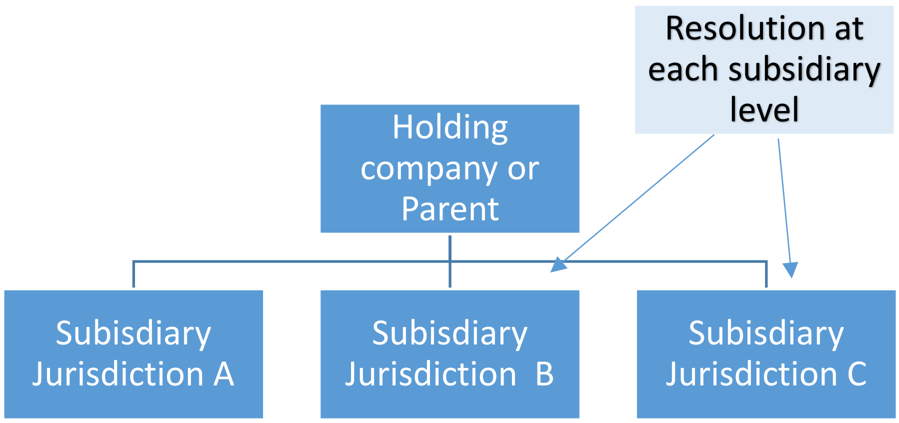
Source: own compilation

[1095] D. Skeel Jr "Single Point of entry and the Bankruptcy Alternative" in M. N. Baily & J. B. Taylor, *Across the Great Divide: New Perspectives on the Financial Crisis*, chapter 15, (Hoover Institution, Stanford University 2015) p. 312.

[1096] BBRD, whereas (80) "This Directive should allow for a multiple-point-of-entry or a single-point-of-entry resolution. The MREL should reflect the resolution strategy which is appropriate to a group in accordance with the resolution plan."

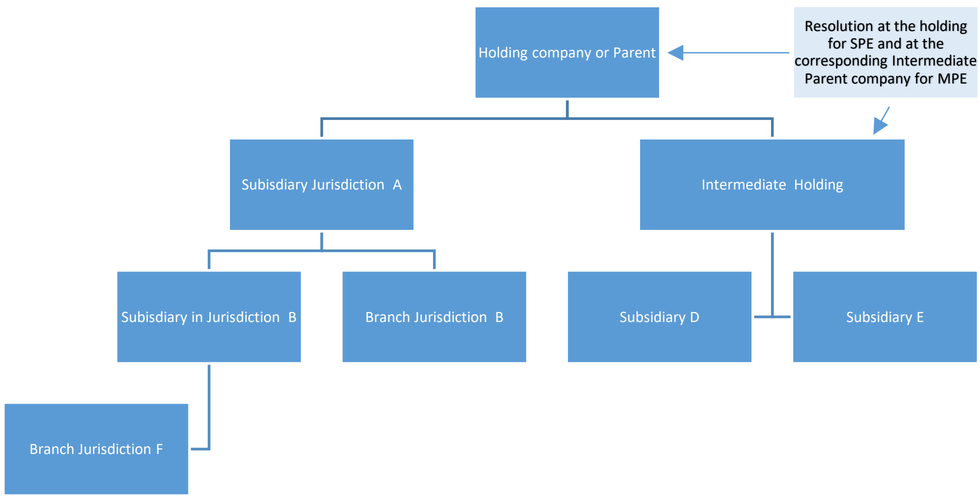
[1097] E.Faia and B. Weder di Mauro "Cross-Border Resolution of Global Banks" [2015] Federal Reserve Bank of Dallas Globalization and Monetary Policy Institute Working paper No 236, p. 25.

Figure 23. Multiple Point of Entry Resolution Strategy



Source: own compilation

Figure 24. Hybrid Resolution Strategy



Source: own compilation based various authors. [1098]

[1098] P. Bolton and M. Oehmke above note 1093, p. 2; S. Fernandez de Lis "TLAC Implementation in Retail Banks in Emerging Markets: The Multiple Point of Entry Model" European Economy, Banks, Regulation, and the Real Sector (2014), p. 103.

6.3.1 Advantages of SPOE strategy

1. *SPOE strategy is more efficient since it permits using lower loss-absorbing capacity*

SPOE resolution strategy allows regulators to transfer resources between units in different jurisdictions, and therefore use a lower amount of loss-absorbing capacity.[1099] A second efficiency effect would be that because of the savings anticipated by the SPOE approach, the "overall losses" expected would be much less than in an uncoordinated resolution approach.[1100]

2. *SPOE strategy would ensure continuity of critical functions of operating firms and of the group as a whole, and therefore reduce risks of financial stability*

As a SPOE bail-in is applied on the parent or holding level, subsidiaries will continue operating as a going concern.[1101] SPOE strategy would ensure the continuity of all critical functions performed by the operating firms, thereby reducing risks of financial stability.[1102] Foreign subsidiaries would be unaffected "minimizing risks of cross- border implementation",[1103] thus preventing a mass termination of contracts at the subsidiary level, since the counterparties of the subsidiaries would "have little incentive" to terminate their contracts.[1104] In addition, as sound subsidiaries would be open and operating, contagion effects would be limited[1105] and the bank would capture economies of scope and scale from shared services.[1106] This would help avoiding "disruptions,

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[1099] Ibid. D. Schoenmaker above note 1069, p. 18; S. Fernandez de Liz "The multiple-point-of-entry resolution strategy for global banks" [2015] BBVA Press Article, p. 2.

[1100] J. Gordon and W. Ringe "Bank Resolution in Europe: the unfinished Agenda of Structural Reform" [2015] ECGI Law Working Paper No 282 p. 11.

[1101] D. Skeel Jr above note 1095 p. 323; J. Crawford "Single Point of entry: The Promise and Limits of the Latest cure for Bailouts" [2014] UC Hastings College of the Law Legal Studies Research Paper Series, p.103; S. Eijffinger "Single Resolution Mechanism" [2013] in Banking Union: The Single Resolution mechanism. Monetary Dialogue, European Parliament, p.56; K-Y. Jin "How to eat an elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution" [2015] The Yale Law Journal p. 1757. H. Jackson and S. Massman "The Resolution of Distressed Financial Conglomerates" [2017] The Russell Sage Foundation Journal of the Social Sciences, 3(1), p. 51; FINMA "Resolution of global systemically important banks FINMA position paper on Resolution of G-SIBs" (2013) <https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/diskussionspapiere/diskussionspapier-20130807-sanierung-abwicklung-global-systemrelevante-banken.pdf?la=en> accessed Sept 29, 2019.

[1102] FDIC-Bank of England "Resolving Globally Active, Systemically Important, Financial Institutions"[2012] A joint paper by Federal Deposit Insurance Corporation and the Bank of England, p.10; M. Konczal "Sheila Bair: Dodd-Frank really did end taxpayer bailouts" *WSJ* (New York, May 18, 2013) <https://www.washingtonpost.com/news/wonk/wp/2013/05/18/sheila-bair-dodd-frank-really-did-end-taxpayer-bailouts/?noredirect=on&utm_term=.b894a53ddeaf >accsesed 27 Spetember 2019; E. Avgouleas and C. Goodhart "Critical Reflections on Bank Bail-ins" [2015] Journal of Financial Regulation, p. 10.

[1103] Ibid, p.ii.

[1104] K-Y. Jin, above note 1101 p.1759.

[1105] FDIC-Bank of England above note 1102 p.11

[1106] P. Bolton and M. Oehmke, above note 1093 p. 14.

destructive runs that can produce fire sale liquidations, negative asset valuation spirals and other knock-on effects".[1107]

3. *SPOE strategy makes resolution transparent and credible*

SPOE strategy would be more transparent and credible than other strategies because all the bail-in-able debt is "earmarked" and "available for regulatory activation". The market would recognize the foreseeability of resolution effects and enhance transparency. [1108]

4. *SPOE strategy would bundle the resolution power in one centre of control*

Unlike MPOEs, an SPOE approach would empower the home regulator avoiding multiple regulator frictions and a race for ring-fencing assets for the "protection of national creditors".[1109] SPOE would avoid the need to commence different separate territorial and entity focused resolutions, which would be "disruptive" and "difficult to coordinate".[1110] This process would align incentives of resolution authorities, directors and creditors of foreign subsidiaries and branches to cooperate rather than take legal action against the bank.[1111] According to Federal Reserve Governor Jerome Powell, the SPOE approach "is a classic simplifier, making theoretically possible something that seemed impossibly complex."[1112]

5. *SPOE strategy would enable quick resolution*

Proponents of SPOE strategy argue it permits a fast resolution of large financial institutions. SPOE would "move very quickly from non-resolution to resolution status, while maintaining continuity of operations". [1113] SPOE resolution is supposed to be performed over the "liquidation weekend" [1114]in order to apply the bail in and or other resolution tools ready for the opening of the markets the following Monday. A delay in resolution may be "catastrophic".[1115]

6. *SPOE strategy is preferred by regulators in key jurisdictions*

It is important to note regulators in key jurisdictions prefer the SPOE approach. The FDIC has adopted the SPOE approach as a proposed solution to solve the TBTF problem for US G-SIBS.[1116] As a way to reflect leadership, the FDIC published a joint paper in 2012 with the Bank of England describing the main features of SPOE as a viable approach for resolution of G-SIBS.[1117] The UK government introduced the Financial Services

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[1107] J. Gordon and W. Ringe, above note 1100 p. 1; FDIC-Bank of England above note 1102 p. 10.
[1108] J. Gordon and W. Ringe above note 1100 p. 9.
[1109] Ibid, p. 11; H. Jackson and S. Massman above note 1101, p.51.
[1110] FDIC-Bank of England above note 1102 p. 11.
[1111] Ibid, p. 12.
[1112] J. Powell "Ending "Too Big to Fail" [2013] Remarks at the Institute of International Bankers Washington Conference p. 6.
[1113] D. Tarullo "Toward Building a More effective Resolution Regime: Progress and Challenges" (Oct 18, 2003 at< https://www.federalreserve.gov/newsevents/speech/tarullo20131018a.htm accessed 27 September 2018,> p. 4; K-Y.Jin above note 1101.
[1114] FDIC-Bank of England above note 1102 p. 4.
[1115] K-Y. Jin above note 1101.
[1116] FDIC "Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy" [2013] Federal Register/Vol. 78, No. 243.
[1117] FDIC-Bank of England above note 1102; "Electronic submission by The Clearing House, SIFMA, ABA,FSR, GFMA to the FDIC Re. FDIC´s Notice and Request for Comments on the Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy" [2014] (FR Docket No 2013-30057)<https://www.afme.eu/globalassets/downloads/consultation-responses/joint-industry-

(Banking Reform) in 2013, which contains the bail-in tool.[1118] In Switzerland, the FINMA indicated the SPOE as a preferred strategy.[1119] According to Federal Reserve Governor Gruenberg, the German BaFin also prefers SPOE strategy.[1120] The Japanese Financial Services Agency has adopted SPOE for the four Japanese G-SIBS.[1121] According to official information, the US, UK, Switzerland and Japan will adopt SPOE strategy. While BaFin did not publish an official document embracing SPOE, the only German G-SIB, Deutsche Bank, has announced in its Annual Report, stating that it prefers SPOE too. Theoretically, if key jurisdictions prefer the same approach to resolution, it would be easier for them to cooperate and coordinate a cross border resolution of G-SIBS in these jurisdictions. In practice though, it might be more difficult because of the application of territorial approach of resolution of US branches of foreign banks in certain countries, such as the US.[1122]

7. *SPOE strategy would permit the G-SIBs to organize themselves in flexible ways through branches or subsidiaries or both*

One argument in favour of the SPOE strategy is that it respects the chosen organizational structure of the G-SIB, via branches, subsidiaries or both.[1123] Instead, in an MPOE strategy the group would need to organize itself through subsidiaries. As stated above, the reasons for banking, legal and operative organization respond to different factors such as tax, economic and political environments, hence the subsidiary structure would not always be the most efficient for global banks.

6.3.2 Disadvantages of SPOE strategy

1. *SPOE strategy may end up in a non-cooperative resolution and ring-fencing*

Even though the SPOE resolution approach is theoretically more efficient than MPOE, in practice, national regulators may have incentives to ring-fence their national banking industries.[1124] One of the prerequisites for a successful SPOE approach is, as the IMF contends, the need of

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comment-letter-on-resolution-of-systemically-important-financial-institutions-the-single-point-of-entry-strategy.pdf >Accessed 27 September 2019.

1118 Bank of England "The Bank of England's approach to resolution" (2017) <"https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/boes-approach-to-resolution >accessed 28 September 2018.

1119 FINMA above note 1101.

1120 Martin J. Gruenberg "Volcker Alliance Program" FDIC, (2013).

1121 FSA "The FSA's Approach to Introduce the TLAC Framework" (2018). <https://www.fsa.go.jp/en/news/2018/20180413/01.pdf >Accessed 28 September 2018.

1122 R. Lastra above note 1081, p. 5; T. Huertas, above note 1081 p. 139.

1123 Electronic submission by The Clearing House, SIFMA, ABA, FSR, GFMA to the FDIC< https://www.afme.eu/Portals/0/globalassets/downloads/consultation-responses/AFME-RRN-Joint-industry-comment-letter-on-Resolution-of-Systemically-Important-Financial-Institutions-The-Single-Point-of-Entry-Strategy.pdf > Accessed 28 September 2018.

1124 P. Bolton et al, above note 1093; D. Skeel Jr above note 1095 "British regulators …worry about whether US regulators will act as vigorously to recapitalize a troubled UK subsidiary as with a troubled US subsidiary", p. 324; S. Lubben and A. Wilmarth "Too Big and Unable to Fail" [2016] GW Law School Public Law and Legal Theory Paper No. 2016-44, p. 1209; E. Avgouleas and C. Goodhart above note 1102, p. 21; D. Schoenmaker, above note 1069 p. 10; E. Faia and B. Weder di Mauro above note 1097 p. 3; R. Herring "The Challenge of Resolving Cross-Border Financial Institutions"[2014] Yale Journal of Regulation Vol 31, p. 879.

"[a]n effective ex ante cooperation arrangement among the authorities of relevant jurisdictions. This strategy must be underpinned by aligned incentives that create confidence their respective national interest for promoting financial stability will be protected. In the absence of such mutual trust, host authorities tend to undertake parallel resolution actions or ring-fence branches or subsidiaries in their jurisdictions, with suboptimal outcomes for all creditors of the institution/group".[1125]

Avgouleas and Goodhart argue that, apart from the US-UK relationship that is based on trust, it is doubtful that "any form of non-binding bilateral arrangements, including MOUs, would hold in an event of a cross border banking crisis, involving a transfer of funds from one jurisdiction to another"[1126]. Even more, as argued by Bolton and Oelke, a SPOE resolution may not be followed even though it has been agreed ex ante. If the home resolution authority believes the transfer to foreign subsidiaries is too large, it may prefer to ring-fence national assets and avoid the transfer altogether. This is possibly the "biggest obstacle to a successful SPOE resolution".[1127]

2. *SPOE strategy may incentive subsidiary creditors' moral hazard and may discourage market discipline*

As the bail-in tool in a SPOE strategy is applied at the holding or top tier, shareholders and creditors of the holding company take the burden, but creditors of the subsidiaries are generally not affected by bail-in. The SPOE strategy may increase moral hazard of subsidiaries' creditors and counterparties.[1128] In this scenario, subsidiaries might obtain cheaper funding from creditors which would be willing to receive a lower yield for a perceived lower risk.[1129] For the same reason, subsidiary creditor´s incentives to monitor may be discouraged. A counterargument states the monitoring will shift to the creditors at the holding level, since the risk would have shifted towards them. However, it is doubtful creditors of the holding company are well positioned to monitor the whole structure effectively.[1130] Additionally, as the SPOE strategy would fully commit to protect derivatives in case of resolution, derivative counterparties would also be discouraged from monitoring.[1131]

3. *Regulators would not be capable of handling multiple SPOE resolutions at the same time*

According to some authors, regulators would not be able to operate "single point of entry resolutions of more than one systemically important institution at the same time".[1132] Regulators would not be able to handle simultaneous SIFIs resolutions in a "resolution weekend", as the GFC has demonstrated.

[1125] G. Dell'Ariccia, M. S. Martinez Peria, D. Igan, E. Addo Awadzi, M. Dobler, and D. Sandri "Trade-offs in Bank Resolution" [2018] IMF Technical Note p.31; See also T. Huertas above note 1081 p.132.
[1126] E. Avgouleas and C. Goodhart, above note 1102, p. 24
[1127] P. Bolton et al, above note 1093 p. 21; C. Randall "The FSB´s Key Attributes": The road to cross-border resolution of financial institutions" (Discussion Draft 12.06.2012).
[1128] K-Y Jin above note 1101 p. 1765; E. Avgouleas and C. Goodhart, above note 1102, p. 24. P. Kupiec and P. Wallison "Can the single Point of Entry strategy be used to recapitalize a systemically important failing bank? [2015] Journal of Financial Stability 20, p. 193; R. Herring above note 1124, p. 878.
[1129] S. Massman "The orderly Liquidation Authority: Fanatical or familiar? Idealistic or unrealistic?" [2014] DASH Harvard University, p.39.
[1130] Ibid, p 40.
[1131] D. Skeel Jr, above note 1095, p. 326.
[1132] D. Skeel, ibid, p. 324-26; R. Herring, above note 1124, p. 879.

4. Loss-absorbing capacity might not be sufficient

A challenge for a SPOE strategy is that there must be sufficient loss absorbing capacity at the top level.[1133] The key question here is if the FSB-proposed 16% to 20% of risk-weighted assets is sufficient or not. Crawford notes a few months before Lehman failed, it reported a 16.1% ratio of total capital-to-risk-weighted assets.[1134] In a crisis scenario, insufficient loss absorbing capacity would mean a government bailout. The result would be a failure of the system, since one of the purposes of the SPOE strategy is avoiding taxpayer's money to resolve banking failure.

5. SPOE strategy might encourage banking groups to issue more debt at the subsidiary level

Since the SPOE strategy relies on the issuance of unsecured debt at the holding level, and holding creditors will request a higher yield for this debt – with a proportional increase in banking group funding costs – managers at the holding level may be encouraged to issue debt at the subsidiary level instead.[1135] Even though the holding company will need to comply with the minimum total loss absorbing capacity at the holding level, if the banks issue more debt at the subsidiary level, the minimum TLAC might not be enough in a crisis scenario, hence the possibility of a bail out might increase.

6. Once the holding company is resolved, there might be a run by the subsidiaries' creditors

Some authors argue the sole resolution of the holding or parent company would trigger "contagious runs" by the creditors of the subsidiaries.[1136] As Avgouleas and Goodhart contend, the operating subsidiary might "suffer a flight due to reputational contagion, which triggers an irrational but quite likely panic, regardless of parent´s liability to sufficiently recapitalize the operating parts of the group through conversion of bail-in-able liabilities."[1137]

7. SPOE strategy might extend support for non- core banking foreign units

This argument is focused on the US. Before the adoption of the SPOE by the US, the "source of strength doctrine" imposed support obligations to the holding company in order to recapitalise "failing commercial banks" in trouble. In addition, a healthy bank subsidiary of the group would support the failing commercial bank via cross-guarantee provisions. The beneficiary was always a FDIC insured banking subsidiary.[1138] With the implementation of SPOE strategy, the scope of coverage is broader, since the support is given to any distressed affiliate, for instance insurance or securities branches or subsidiaries. This would mean any liquidity support from FDIC would indirectly support a non-insured entity. As Avgouleas and Goodhart explain, the US "would extend coverage of US deposit insurance and of the OLF to foreign depositors, probably a politically prohibitive action".[1139] In the case of insurance affiliates, the support would not even go to foreign depositors but to foreign insurance policy holders or investors,

[1133] H. Jackson and S. Massman, above note 1101, p. 53
[1134] J. Crawford, above note 1101 p. 110.
[1135] K-Y.Jin above note 1101, p. 1771; J. Sommer Why Bail in? And how! Economic Policy Review (2014) p.220; D. Tarullo, above note 1113.
[1136] S. Lubben and A. Wilmarth, above note 1124 p. 1209; S. Schwarcz "Beyond Bankrupcty: Resolution as a Macroprudential regulatory Tool." [2018] Notredame Law Review, p.20.
[1137] E. Avgouleas and C. Goodhart above note 1102, p. 24.
[1138] H. Jackson and S. Massman, above note 1101, p. 51.
[1139] E. Avgouleas and C. Goodhart above note 1102, p. 25.

which would make the US authority options much more difficult from a political perspective.

8. *Governments might face legal disputes from holding company creditors under SPOE strategy*

Given the fact that a failing subsidiary would be supported by resolving the holding company, its creditors might challenge the bail-in as an illegal appropriation. According to Kupiec and Wallison in the US,

> "If the government proceeds with a SPOE liquidation to recapitalize a failing bank subsidiary, BHC creditors may have a strong legal case that their investments were illegally confiscated in the SPOE liquidation to support a failing bank subsidiary that is explicitly identified as a non-covered institution in the OLA language."[1140]

6.3.3. Advantages of MPOE strategy

1. *MPOE strategy enhances financial stability as proven during the financial crisis*

According some authors, MPOE strategy has proven resilient during different financial crisis, limiting contagion. In 2001, the financial system failed in Argentina. Many banks abandoned the country and even subsidiaries of foreign banking groups were liquidated. Spanish banks stayed in the country. There was "almost no contagion" in the parent or other subsidiaries in the region given the limited intra-group exposure.[1141] On the other hand, during the Eurozone financial crisis there was almost no contagion of Spain's liquidity problems to subsidiaries in Argentina or other Latin America's countries.[1142]

2. *MPOE strategy foster the development of local capital markets*

MPOE strategy would foster the development of capital markets in developing countries because there would be a need of issuing capital and debt at the subsidiary level in order to fulfil the loss-absorbing capital requirements.[1143]

3. *MPOE strategy would be the most efficient outcome in a non-cooperative resolution scenario*

If, as stated above, national regulators wish to ring-fence their national banking industries, a MPOE strategy would be more efficient.[1144] Subsidiaries would be capitalised, shared services such as IT would be organised on a "stand-alone" basis, all of which would help an ordered resolution of each subsidiary.[1145]

[1140] P. Kupiec et al, above note 1141, p. 189.
[1141] S. Fernandez de Lis "The multiple-point-of entry resolution strategy for global banks" BBVA Press Article 25 February 2015 ps 1-3.
[1142] Ibid: H. Kamil and K. Rai's "The global Credit Crunch and the foreign bank's Lending to emerging markets, why did Latin America Fare better?"[2010] IMF Working paper No 10/102 p.14. Also see R. Cull and M. Martinez Peria "Bank ownership and lending patterns during the 2008-2009 financial crisis" [2012] The World Bank Development Research Group Finance and Private Sector Development Team p.18.
[1143] J. Fiechter et al, above note 1052, p.5; J. Pardo, P. Mirat, S. Fernandez de Lis, and V. Santillana"Multiple Point of entry resolution strategy: a natural approach for descentralised retail banking groups" BBVA Research (2014) p. 2.
[1144] P. Bolton and M. Oehmke, above note 1093 p.1. D. Schoenmaker, above note 1069 p. 12.
[1145] J. Pardo et al, above note 1143 p.1.

4. *Under a MPOE, strategy coordination between resolution authorities is easier than in a SPOE strategy*

While in both strategies coordination between resolution authorities is key, coordination under a MPOE strategy would not be as critical as in SPOE strategy. [1146] The role of the resolution authority in the host jurisdiction would be an "executing figure" while the home jurisdiction authority would be a "coordinator figure". Cross-border cooperation agreements may be more flexible under MPOE since the resolution strategy is applied locally.[1147]

5. *Decentralised business model and MPOE strategy reduces banking group complexity*

Subsidiary model reduces "bank complexity" since accountability and transparency are enhanced. These factors lower risk perceptions in financial markets.[1148] A counter argument might exist since one of the indicators of complexity is the amount of legal entities of a banking group. While it is true that more organizational complexity exists, decentralised groups generally have a simple "business complexity", which is focused on retail business. Overall, the lower interconnectedness of the subsidiary and decentralised model, and its lower business complexity would make banking groups less complex.[1149]

6. *MPOE strategy enhances market monitoring and prevents moral hazard at the subsidiary level*

One key difference between SPOE and MPOE strategies is that the bail-in is applied at different levels. In MPOE strategy bail-in would be applied at the subsidiary level, hence its creditors would have the incentive to monitor the subsidiary, with no enhancement of moral hazard.

6.3.4 Disadvantages of MPOE strategy

1. MPOE strategy is less efficient than SPOE strategy

The structural design of the MPOE strategy requires more loss-absorbing capacity for the whole group.[1150] The MPOE strategy has its own costs in terms of lower efficiency in capital and liquidity management.[1151] Moreover, in developing economies, loss-absorbing capacity would imply higher capital requirements because subsidiaries in those countries would not be able to issue sufficient bail-in-able debt. The TLAC would need to be covered by equity, increasing the overall capital amount.[1152]

[1146] J. Chew "Multipe Point of entry" The Forgotten Alternative" The Clearing House <https://www.theclearinghouse.org/banking-perspectives/2014/2014-q1-banking-perspectives/articles/multiple-point-of-entry> accessed 2 October 2018.
[1147] Ibid.
[1148] Ibid.
[1149] J. Carmassi and R. Herring "The Corporate Complexity of Global Systemically Important Banks" [2016] J Financ Serv Res 49, ps.175–201.
[1150] P. Bolton et al, above note 1093, p. 4.
[1151] S. Fernandez de Lis, J.C Pardo, V. Santillana and G. Martin "Compendium on resolution strategies: a multiple point of entry view" [2014] BBVA Regulation Outlook p. 4.
[1152] Ibid.

2. MPOE strategy would split the banking group

Normally, the result of MPOE bail-in at the subsidiary level would imply new owners at each point of entry, splitting the banking group.[1153] A consequence of this splitting is the "reduction in continuation value".[1154]

3. Under MPOE strategy critical shared services should be organised independently

The FSB argues making a MPOE strategy effective would demand

> "A degree of legal, financial and operational separation within the group, which may require changes to the way groups are structured or robust service level agreements to ensure the continuity of any critical shared services across entities subject to resolution at different points of entry."[1155]

In order to pursue this objective, banking groups with a MPOE strategy should create "separate operational subsidiaries" that would provide critical shared functions to the operating subsidiaries.[1156] Under the "centralised subsidiarisation approach", a single company provides shared services, while under a "decentralised subsidiarisation approach" a separate shared services company services each subsidiary or resolution entity.[1157] The first approach would need strong service agreements, which "would survive the resolution of any bank within the group and allow for that bank to leave the group if that is the consequence of its resolution".[1158] The need of redundant critical shared services subsidiaries is inefficient and lacks the benefits of economies of scale.

4. MPOE strategy restricts the organizational structure since it is designed as a subsidiary model

A pre-condition for a MPOE strategy to be effective is that the group must be structured by subsidiaries. As stated above, the subsidiary model has its advantages and disadvantages, but it is not effective for certain business models.

6.4. Which resolution strategy best fits the German model conglomerate?

This analysis will focus on the resolution of German model BBFC that pose systemic risk exposure to the whole system. Currently, there is only one G-SIB in Germany, which is Deutsche Bank. The main characteristics of DB are:

1) Its legal structure is complex, with parent legal entity with branches in many countries and subsidiaries in others, mainly in emerging markets;[1159]

[1153] P. Bolton et al above note 1093 p.2; P. Tucker "Solving too big to fail-where do things stand on resolution? Speech at the Institute of International Finance, October 2013; FSB "Principles on loss-absorbing capacity of G-SIBS in resolution total loss-absorbing capacity (TLAC) term sheet (2015).

[1154] P. Bolton el al, above note 1093 p. 9. New bank would have a new brand if the subsidiary shared the same name as the parent company, which will entail value destruction.

[1155] FSB "Recovery and Resolution Planning: Making the Key Attributes Requirements Operational Consultative Document" (2012), p. 28.

[1156] J. Chew, above note 1146; T. Huertas, above note 1081, p. 164 S. Fernandez et al, above note 1151 p.3.

[1157] S. Fernandez et al, above note 1151 ps 5.

[1158] J. Chew, above note 1144.

[1159] DB Annual Report 2020, available at: <https://www.db.com/ir/en/download/Annual_Report_2020.pdf > accessed 23 April 2021.

2) Its business model is focused on wholesale banking and investment banking;[1160]

3) It is a centralised type of bank; and

4) Its headquarters are located in Germany, hence governed by German law, which has a universal approach to resolution.[1161]

According to the four factors analysed before, a SPOE strategy would best fit the German model BBFC. However, the following pre-conditions need to align in order to hold an effective SPOE resolution in this particular case: i) Germany should have effective ex ante cooperation arrangements with authorities of relevant jurisdictions (EU, UK, US, Japan). This would give them assurance that the SPOE will be respected; ii) Every country where the German SIFI has assets, branches and subsidiaries should recognise the universal approach to resolution in order to avoid ring-fencing by national regulators; iii) German authorities need to monitor the amount of eligible liabilities to enable a sufficient bail-in. An important challenge concerns whether foreign resolution authorities would embrace the German universal resolution approach. If a foreign resoltion authority would ring-fence and liquidate a SIFI German branch, it would most probably end up in the liquidation of the parent entity as well. Additionally, the US resolution proceedings – where there is a territorial approach to foreign bank distressed branches acting in the US and a universal approach to US branches acting abroad – would make the German resolution authorities´ decision-making difficult. If such scenario takes place, it would have negative implications for the resolution of the reminder of the group, since all the assets of the US branches would be isolated from the SPOE resolution.

A number of conditions favours a SPOE strategy in the case of Germany. First, as stated above, the principle of universality insolvency law appliesthrough Directive 2001/24/EC on the Reorganization and Winding-Up of credit institutions, together with the BRRD, which provides for the automatic recognition within the EU of resolution decisions adopted by other EU member states' authorities, and to a considerable degree the SRM regulation This favours the SPOE strategy in the sense that the German authority would accept the leading role of the home resolution authority. German law would apply to the whole process and German resolution authorities would be in charge as coordinator with foreign regulators and as executor of the resolution tools. German legislation requires banks "to include in financial contracts governed by third country law provisions recognizing the power to the resolution authorities to bail in debt and suspend contractual termination rights".[1162] For all EU jurisdictions, BRRD guarantees that execution of bail in of the debt issued by German Banks in those jurisdictions are valid and recognised by local courts.[1163] Second, DB has signed the International Swaps and Derivatives

[1160] S. Vitols "Changes in Germany's bank-based financial system: A varieties of capitalism perspective" [2014] WZB Discussion Paper, No. SP II 2004-03, p.5.

[1161]Insolvency Statute of 5 October 1994 (Federal Law Gazette I page 2866), as last amended by Article 19 of the Act of 20 December 2011 (Federal Law Gazette I page 2854) section 335 <https://www.gesetze-im-internet.de/englisch_inso/englisch_inso.html > Accessed 17 June 2020; IMF Country Report No 16/194: Germany. Crisis Preparedness, bank resolution and crisis management frameworks-Technical Note (2016) p. 27; I. Fletcher *Cross-border Insolvency : National and Comparative Studies : Reports* (Tubingen 1992) p.107; American Bankruptcy Institute <https://www.abi.org/abi-journal/the-new-german-rules-on-international-insolvency-law >Accessed 17 June 2020.

[1162] IMF Country Report No 16/194, above note 1161.

[1163] Ibid p. 27.

Association (ISDA) 2015 Universal protocol on Resolution Stays[1164], which address the issue of recognition of resolution action regarding temporary stays.[1165] Third, as stated above,SRB prefers SPOE strategy, as detailed in their 2020 Annual Report.[1166]

The SPOE strategy has plenty of advantages, as analysed above, but it also faces profound challenges for German model conglomerates and banking groups. The first and most important one is the need of ex ante agreements in order to assure the SPOE resolution will be executed as planned. Even within the most advanced and trustful regulator relationships (UK and US) there is still some doubt concerning, for example, whether the FDIC would apply the resolution tool at the holding company level to support a distressed UK subsidiary of a US G-SIB, and indirectly apply liquidity support to foreign depositors.[1167]

The second challenge refers to the need to adjust the corporate structure of the German model to fully apply all the advantages of the SPOE strategy.[1168] While in theory the bail-in tool may be applied to the parent company, the SPOE strategy relies heavily on a non-operative holding company, which has the advantage of not posing problems with workers, commercial creditors and other stockholders other than shareholders and bail-in-able creditors.

Two approaches might be used in order to achieve such a structure. First, by insisting in a structural change via recovery and resolution planning under BRRD, and second, via a compulsory holding company structure for all European based SIFIs,[1169] which would have a similar purpose in terms of resolution to the newly proposed Intermediate Parent Undertaking in the EU.[1170]

[1164]DB Adherence to ISDA, November 2015 < https://www.isda.org/protocol-adherence/67599/ >Accessed 17 June 2020.

[1165]This is particularly important in cross-border SPOE strategy where the resolution process needs international cooperation between authorities. "ISDA 2015 Universal Protocol which enables parties to amend the terms of their Protocol Covered Agreements to contractually recognize the cross-border application of special resolution regimes applicable to certain financial companies until comprehensive statutory regimes are adopted and to support the resolution of certain financial companies under the United States Bankruptcy Code." <https://www.isda.org/protocol/isda-2015-universal-resolution-stay-protocol/ >accessed 22 June 2020.

[1166] DB Annual Report 2020 Above note 1159.

[1167] D. Skeel, above note 1095 p. 324; E. Avgouleas and C. Goodhart above note 1102, p. 25.

[1168] D. Schoenmaker, above note 1069, p. 16. S. Theodore and T. Sondergaard "Total Loss-Absorption Capacity (TLAC): Does it Matter? [2014] Scope Bank Ratings p.2.

[1169] J. Gordon and W. Ringe, above note 1100, p. 1364-65.

[1170] This proposal would be simple to implement, and it would mimic the Intermediate Parent Undertaking proposal in Europe. As the European Parliament state, Parliament Questions, January 2018 <http://www.europarl.europa.eu/sides/getAllAnswers.do?reference=P-2017-006880&language=EN >accessed 3 October 2018.

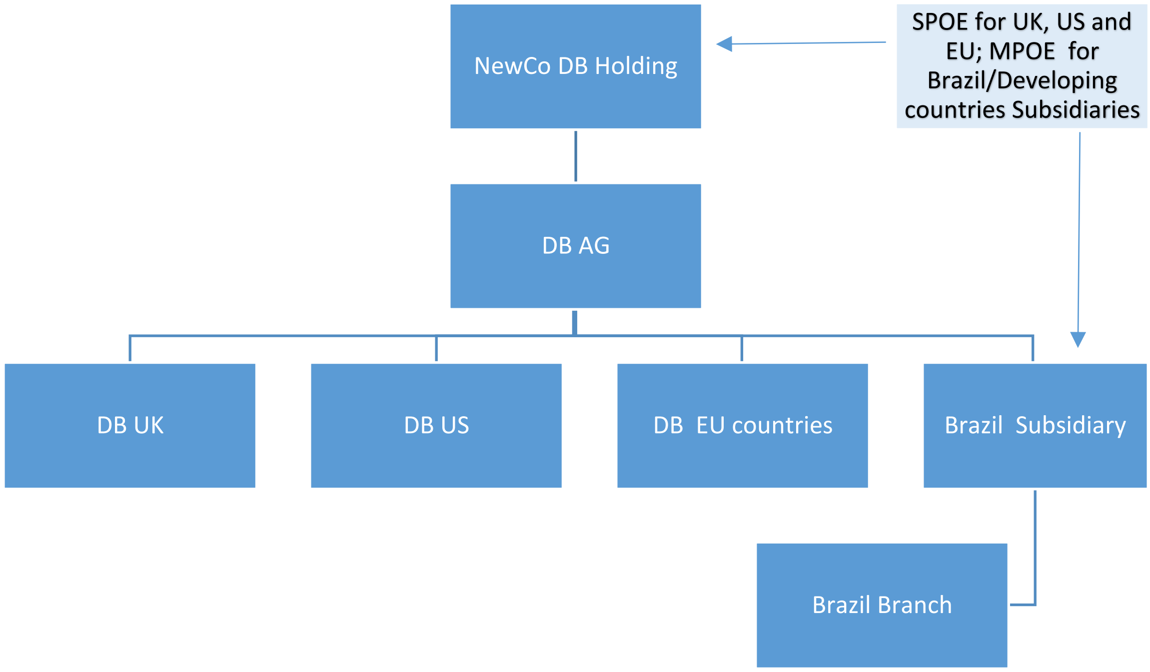
Advantages of SPOE as a preferred resolution strategy for German model conglomerates and banking groups	**Challenges of the SPOE strategy for German model conglomerates and banking groups**
Efficiency: a SPOE strategy allows cross-jurisdictional transfers and needs less loss-absorbing capacity needed as a group	Need to have ex ante agreements with other resolution authorities
Continuity as a group: critical functions assured	Doubtful that foreign jurisdictions would respect Germany's universal approach to resolution. Special case of the US insolvency approaches.
Flexibility: allows a flexible legal structure through branches and or subsidiaries	Need to change legal and operational structure to include a holding company on top of current parent company
Fast process: through a "liquidation weekend"	
Enhances transparency	
German Resolution authority would be in control of the process	
BaFin would prefer SPOE strategy	
Germany applies the universal approach to resolution	
SRB prefers SPOE as of Annual Report	
DB has signed the ISDA 2015 Universal protocol on Resolution Stays	

Furthermore, a possible hybrid model would be possible if Germany concludes that the branches and subsidiaries in certain jurisdictions would prefer the territorial approach. In such a disfavoured scenario, it might be possible to apply a SPOE strategy within certain jurisdictions and a MPOE with others. Since in the EU the bail-in tool is recognised and would be respected if BaFin used it in DB resolution, it would be wise to apply a SPOE strategy within these countries. If trustworthy ex ante agreements are available with the UK, Japan and the US (if certain assurances were made that SPOE strategy would be applied in both scenarios) SPOE strategy would be preferred with those countries too. On the contrary, in developing countries with a long tradition of territorial approach to resolution, such as Brazil, where branches need to have their own capital and other requisites in place as if they were subsidiaries,[1171] a MPOE strategy might be possible. This hybrid model would be less efficient than the pure SPOE approach[1172], but would

[1171] IIF "Achieving Bank Resolution in Practice Are We Nearly There Yet?" [2014] A report of the IIF Cross-Border Resolution Working Group September; 35 Cámara del Tribunal de Justicia de São Paulo, *Telenova Comunicações Ltda vs Telmex do Brasil Ltda* (6 june 2006); J. Garcez, *Elementos Básicos de Direito Internacional Privado* (Síntese 1999) p. 139; M. Noodt Taquela, "Concursos y Quiebras". In: Fernández Arroyo, Diego P. (Ed) *Derecho Internacional Privado de los Estados del Mercosur: Argentina, Brasil, Paraguay y Uruguay*. (Zavalia 2003) p. 1386.
[1172] J. Pardo et al, above note 1143 p.13.

give assurance to BaFin that an uncoordinated "ring-fenced type" resolution would not take place.

Figure 25. Simplified Hybrid Resolution Strategy for DB



Source: Own compilation based on DB Annual report 2020

6.5. Which resolution strategy best fits the British model?

This section will focus on the resolution of a British model BBFC with reference to its most important institutions. In the UK, there are two G-SIBS: HSBC and Barclays. HSBC has adopted a MPOE strategy, and will be analysed along with the Santander and BBVA in Annex 4. HSBC structure is based on a holding company and different intermediate holding companies comprising each continent where they operate. [1173]On the contrary, Barclays structure remains posing the bank as holder of the insurance and securities business, even though the apex of the group is now a Holding Company. For this reason, the exam of the best strategy for the British model will focus on Barclays and not in HSBC.

Regarding the first indicator, Barclays structure itself with both subsidiaries and branches. Units located in the following jurisdictions obtain 90% of Barclays´ turnover: Canada, France, Guernsey, Hong Kong, India, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Mauritius, Monaco, Portugal, Singapore, Spain, United Arab Emirates, USA, UK, Luxembourg, Mexico, and Switzerland. Most of them operate through branches, with the

[1173] HSBC Simplified group chart <https://www.hsbc.com/-/files/hsbc/who-we-are/our-businesses/pdf/group-structure-chart.pdf?download=1> Accessed 13 March 2019.

exception of Switzerland, Mexico and Luxembourg, which operate through subsidiaries. In Hong Kong there are both branches and subsidiaries, as well as in the US.[1174]

The second indicator refers to the banking business model, centralised or decentralised business model. Barclays is a centralised bank, where the investment bank model comprises 70% of risk weighted assets. Barclays is the 7th "investment bank" in the world, and even though there are voices willing to change the model, until now the investment banking- wholesale banking prevails.[1175]

The third indicator refers to retail versus no retail banking. After 2018 in the UK, Barclays is separated into Barclays UK PLC (ring fenced) bank and Barclays PLC (non- ring fenced bank). The retail banking business of Barclays as a whole is not prevalent in the bank.

The forth indicator deals with the universal or territorial approach to resolution. The UK embraces modified universalism, which underpins the UNCITRAL model Law on Cross-Border Insolvency, and the EC Insolvency Regulation on Insolvency Proceedings. Lord Hoffman in the UK Supreme Court *HIH Casualty & General Insurance Ltd, Re* case states

> "The primary rule of private international law which seems to me applicable to this case is the principle of (modified) universalism, which has been the golden thread running through English cross-border insolvency law since the 18th century. That principle requires English courts should, so far as is consistent with justice and UK public policy, co-operate with the courts in the country of the principal liquidation to ensure that all the company's assets are distributed to its creditors under a single system of distribution".[1176]

In the case *Kaupthing Bank HF*, regarding the application of EU Winding Up directive, Lord Briggs held that:

> "The very essence of the universalism sought to be achieved by making the insolvency law of the home Member State applicable across the territory of all Member States depends upon that being achieved in relation to every potential home Member State in which a credit institution is regulated and has its head office regardless whether, apart from those instruments, the State´s insolvency law would be anything more that domestic in its application. If that were not so, then the creation of a universally applicable law (subject to strict exceptions) for the insolvency of credit institutions, and other entities, would fall at the first hurdle, in relation to any home Member State the insolvency law which did not already have cross border effect".[1177]

Theoretically, as explained by Claessens et al, the organizational structure that best fits the universal approach is the Single entity, which is "a SIFI incorporated in one

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[1174] List of Barclays main entities (2017) <https://home.barclays/content/dam/home-barclays/documents/citizenship/our-reporting-and-policy-positions/Final-2017-LE-listing-CBC-disclosure.pdf >Accessed 13 March 2019. See also Barclays Annual Report 2020 < https://home.barclays/content/dam/home-barclays/documents/investor-relations/reports-and-events/annual-reports/2020/Barclays-PLC-Annual-Report-2020.pdf >Accessed 13 March 2021.

[1175] D. Crow and S Morris "Investment Banking: the battle for Barclays" *Financial Times* (London, 20 January 2019).

[1176] *HIH Casualty & General Insurance Ltd, Re [2008] UKHL 21 (09 April 2008) 1 WLR 852*.

[1177] *Tchenguiz &ors vs Kapthing Bank HF* [2017] *EWCA Civ 83, CA, 2017 WL 00817001* jurisdiction and operating a global network composed of branch offices".[1178] However, as stated above, most BBFCs structure themselves via both branches and subsidiaries.

The concurrence of the four indicators indicates SPOE would be the best solution for a "modified" British model. In the case of Barclays it best fits because: 1) Barclays is a centralized bank; 2) which operates mainly through branches, but also via subsidiaries; 3) Its main business comprises wholesale and investment banking, with a much reduced retail section; 4) the UK embraces universalism; 5) The apex of the banking group is a non-operative holding company.

As in the case of the German model, the following preconditions are needed for a SPOE strategy to be effective: 1) the UK should have effective ex-ante burden agreements and cooperation agreements with relevant jurisdictions (US, EU, Japan); 2) Every country where Barclays holds assets need to respect the universal approach to resolution, to avoid territorial ring fencing of assets; 3) UK authorities would need to monitor the amount of eligible liabilities to ensure bail in is applicable.

The SPOE strategy comprises certain advantages. First, the UK would lead the resolution process. Second, Barclays has adopted the ISDA 2015 Universal protocol on Resolution Stays, which address the issue of recognition of resolution action regarding temporary stays. Third, UK authorities prefer the SPOE strategy, as stated in the "US Resolution Planning 2018" document. Contrary to DB, the structure of Barclays comprises a holding company; therefore, from an organizational point of view, no structural changes are needed. In terms of efficiency, a SPOE strategy would allow regulators to transfer resources between units using a lower amount of absorbing capacity[1179]. From an organizational perspective, SPOE strategy would permit the subsidiaries to continue operating as a going concern, and thus it will ensure continuity of all critical functions, reducing financial stability.[1180] From a control of the resolution point of view, SPOE stretgy will empower British resolution authority and avoid multiple different resolution proceedings.[1181] In terms of duration, a SPOE strategy would be theoretically more expedite (it is supposed to be performed in a weekend) thus preserving stability.[1182] Regulators in key jurisdictions prefer the SPOE strategy, including the US, UK, Germany, Switzerland, Japan.[1183]

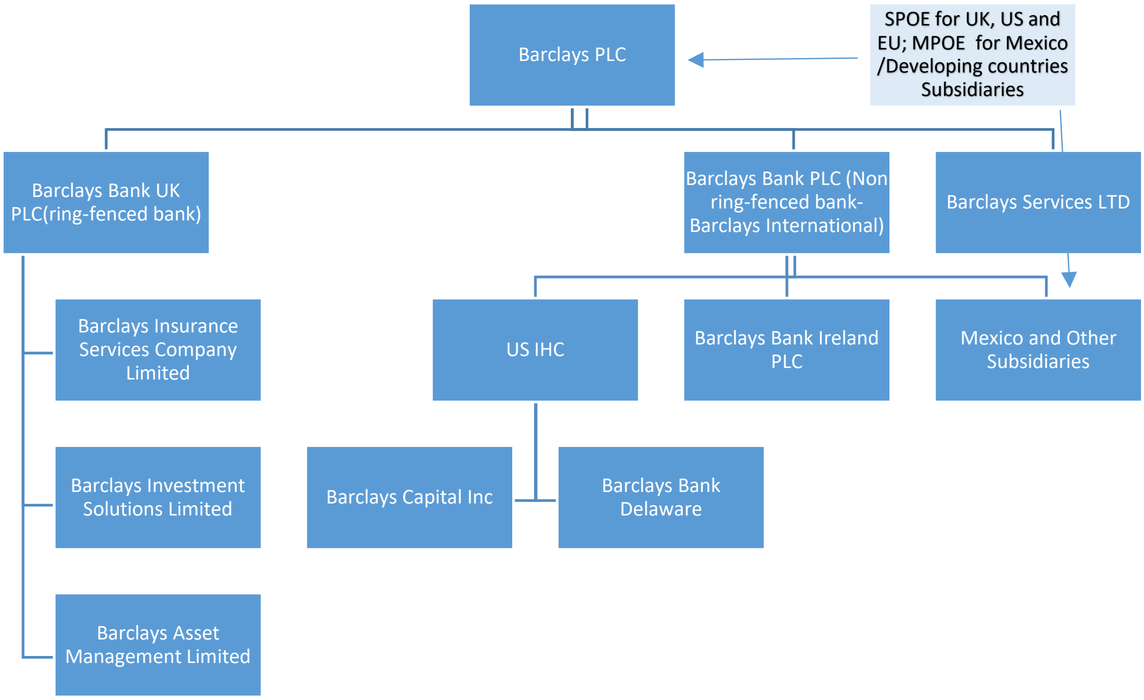
As well as in the case of DB, a SPOE strategy poses challenges. First, ex ante agreements are needed in order to execute the resolution plans. There are concerns about a lack of mutual trust between home and host resolution authorities that may induce a disorderly resolution. Second, all jurisdictions in place, especially those which include foreign assets need to respect the UK universal approach to resolution. If any jurisdiction ring-fences assets located overseas, the resolution would end up in disorder.

[1178] S. Claessens, R. J. Herring, D. Schoenmaker, K. A. Summe above note 1079, p.86.
[1179] D. Schoenmaker "above note 1069, p. 18; S. Fernandez de Liz above note 1112 p. 2.
[1180] D. Skeel Jr "abobe note 1095 p 323; J. Crawford above note 1101, p.103; S. Eijffinger above note 1101 p.56; K-Y. Jin above note 1101 p. 1757. H. Jackson and S. Massman above note 1101 p. 51; FINMA above note 1101.
[1181] FDIC-Bank of England above note 1102 p.10.
[1182] Ibid, p.4; D. Tarullo above note 1113 p. 4; K-Y Jin above note 1101 p. 1764.
[1183] See Section 6.3.1.

Advantages of SPOE as a preferred resolution strategy for the British model (Barclays)	**Challenges of the SPOE strategy for the British model (Barclays)**
Efficiency: SPOE allows cross-jurisdictional transfers and needs less loss absorbing capacity needed as a group	Need to have ex ante agreements with other resolution authorities
Continuity as a group: critical functions assured	Doubtful that foreign jurisdictions would respect UK`s universal approach to resolution. Special case of the US insolvency approaches.
Flexibility: allows a flexible legal structure through branches and or subsidiaries	Need to change legal and operational structure to include a holding company on top of current parent company
Fast process: through a “liquidation weekend”	
Enhances transparency	
UK Resolution authority would be is in control of the process	
BoE and Barclays prefer the SPOE strategy	
UK applies the Universal Approach to resolution	
Barclays has signed the ISDA 2015 Universal protocol on Resolution Stays	

As with DB, a hybrid approach would be possible if the bank believes certain jurisdictions would not respect the universality principle and employ a territorial approach to resolution. In such a scenario, a SPOE strategy might be applied to certain jurisdictions (US, EU), and a MPOE to others (developing countries). This approach would be less effective due to the need to ensure shared critical functions, but would avoid an uncoordinated resolution that would be less efficient than a coordinated MPOE strategy.

Figure 26. Simplified hybrid resolution strategy for Barclays



Source: Own compilation based on S&P Global Ratings, November 19, 2018, and "Important Information about Barclays Insurance Services", 2018; Barclays Bank UK PLC Annual Report, 2018

6.6 Which Resolution Strategy best fits the US model?

As Morris content, the "true innovator" in developing a resolution regime was the US, which created the FDIC in the Great Depression and since then it has resolved thousands of banks.[1184] The system evolved from simple way of returning deposits to insured depositors to a system that intended to reduce contagion, preserve public confidence in banking system and enhance financial stability.[1185] The FDIC bank resolution system was revised by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) during the Savings and Loan crisis. FDIA contains the US resolution statue[1186]. Gleeson resumed the resolution system as "a special type of insolvency code for US insured depository institutions administered by the FDIC".[1187]

As explained in Chapter 5 the US developed a unit bank system, which restricted interstate and intrastate branching. In 1956, after the enactment of the BHCA, banks moved to structure themselves via a BHC, owning a separate bank in each state. After the interstate restrictions where liberated, most of the US BBFC/banking groups maintained

[1184] C.H.R. Morris, above note 809 p. 254. S. Gleeson et al *Bank resolution and crisis management: law and practice* (OUP 2016) p. 67.
[1185] S. Gleeson, ibid, p. 67.
[1186] Specially ss 11–15 of the FDIA, 12 USC ss 1821–1825.
[1187] S. Gleeson, above note 1186, p. 67.

the US model (BHC with a non-operating company at the apex of the group). However, until the GFC the resolution system in the US only applied to insured banks.[1188]

As stated above, resolution processes for US BBFCs are performed under Title I or Title II of DFA, which now includes non-insured financial institutions. Title II provides for a SPOE resolution, only if resolution under the US Bankruptcy Code is not effective.[1189]

A second important change in the system was the inclusion of Section 165 of the DFA, which requires that nonbank financial companies supervised by the Federal Reserve System, and bank holding companies with assets of more than USD 50 billion to report a resolution plan. This plan must include: i) information about how the insured company is protected from risks from other nonbank subsidiaries; ii) descriptions of the ownership structure, balance sheet and contractual obligations, iii) description of cross-guarantees, iv) other information requested by the authorities."[1190]

Authorities around the world have recognised the US has the means to apply successfully the SPOE resolution strategy.[1191] D. Tarullo, member of the Board of Governors of the Federal Reserve System, endorsed the SPOE strategy as the "best potential for the orderly resolution of a systemic financial firm under Title II".[1192] J. Yellen has confirmed "right now the FDIC has the capacity and the legal authority to resolve, possibly using orderly liquidation authority, a systemically important firm that finds itself in trouble, and they have designed an architecture that I think is very promising in terms of being able to accomplish that."[1193] P. Tucker has acknowledged that "in short, the US authorities have the technology – via Title II of Dodd Frank; and, just as important, most US bank and dealer groups are, through an accident of history, organised in way that lends them to top-down resolution on a group-wide basis".[1194] On the academic side, a "Resolution Project" team lead by Professor T. Jackson has endorsed the SPOE strategy in his proposal to create a new Chapter 14 based on this resolution strategy.[1195]

According to the FSB´s "2020 list of global systemically important banks" the following G-SIBs have their headquarters and origin in the US: JP Morgan Chase, Citigroup, Bank of America, Goldman Sachs, Wells Fargo, Bank of New York Mellon, Morgan Stanley, and State Street.[1196] Although JP Morgan Chase has become the largest G-SIB in the world, this thesis will analyse Citigroup, which appears in the second place of the FSB

[1188] S. Gleeson, above note 1186, p. 67.
[1189] DFA Para. 203 (b)(2) and (5); Ibid, p. 274.
[1190] DFA Sec. 165 <https://www.fdic.gov/regulations/reform/dfa_selections.html#1> Accessed 30 March 2020.
[1191] See generally R. D Guynn, "Framing the TBTF Problem: The Path to a Solution" in M. Neil Baily and J. B Taylor (Eds) *Across the Divide: New Perspectives on the Financial Crisis* (Hoover Institution 2014).
[1192] D. Tarullo above note 1113, p.8.
[1193] J. Yellen " Hearing Before The Committee On Banking, Housing, And Urban Affairs, United States Senate, One Hundred Thirteenth Congress, First Session On Nomination Of Janet L. Yellen, Of California, To Be Chairman Of The Board Of Governors Of The Federal Reserve" (2013) <https://www.govinfo.gov/content/pkg/CHRG-113shrg85910/html/CHRG-113shrg85910.htm,>Accessed 13 April 2020.
[1194] P. Tucker above note 1153, p. 2.
[1195] T. H. Jackson, "Bankruptcy Code Chapter 14: A Proposal," in eds. K. E. Scott and J. B. Taylor *Bankruptcy Not Bailout: A Special Chapter 14*, (Hoover Institution Press, 2012), p. 14. Other members of the "Resolution Project" include A. Crockett, D. Duffie, R. Herring, W. Kroener, K. Scott (chair), G. Shultz, K. Summe, and D. Skeel.
[1196] FSB 2020 list of global systemically important banks above note 173.

2019 List. It is the third largest bank in America following JP Morgan Chase and Bank of America. The reason for this election is that Citigroup is an archetypical US model BBFC and has been the largest bank throughout its long history, until recent times, and has an impressive geographical extension (See Annex 4).

The case of Citigroup ("Citi") is illustrative of the US banking system. From its inception in 1870, it has grown to become the biggest bank in the US. However, the GFC turned the US authorities to implement one of the biggest bailouts in US history. Nowadays, a decade after the GFC, Citi is again in the hands of private owners and continues to be one of the most important BBFCs in the world.

The main characteristics of Citi according to the *four factor* classification are as follows:

1) Its legal structure is complex, with parent legal entity with branches in all continents and subsidiaries all over the world;
2) Its business model is divided into *Global Consumer Banking* (40.5% net revenue), and *Institutional Clients Group* (55.5% net revenue);[1197]
3) It may be characterised as a centralised BBFC since management of liquidity, capital, risk exposures and IT are processed, and decision-making is positioned at the top level;[1198]
4) Citi has a hybrid business model. According to its Annual Report, Global consumer Banking, which comprises "Retail banking &Wealth management, including local small business banking and commercial banking and Residential real estate" amounts almost have of the group´s net revenue. The other 52% corresponds to Institutional Clients Group, which resumes the following functions: Banking (Investment banking, Treasury and trade solutions, Corporate lending, Private bank) and Markets and securities services (Fixed income markets, Equity markets and Securities services).[1199]

As of the first indicator, Citi structure includes both branches and subsidiaries. Citi´s geographical expansion covers the five continents and expresses the long history of the bank. As SPOE strategy favours a flexible way of structuring the BBFCs, this would be a preferred resolution strategy if we focus on this first factor.

Contrary to Barclays, whose structure is more typical (Wholesale/Investment bank, centralised, structured mainly by branches), Citi has a hybrid approach: hybrid business model (retail/wholesale), centralised BBFC, and it operates via branches and subsidiaries with no clear pattern regarding factors 2 and 3.

The headquarters of Citibank N.A. are located in the US. From a US perspective, US applies the single entity approach to liquidation of US bank with foreign branches. As Lastra explains, the single entity approach to liquidation "goes hand in hand with the principle of unity and universality of bankruptcy, which means that there is only one competent court to decide on the bankruptcy of a bank and that the bankruptcy law of the country in which the insolvency has been initiated is effective in all other countries in which the bank has assets or branches".[1200] Universalism and single entity approach

[1197] Citi 2020 Annual Report https://www.citigroup.com/citi/investor/quarterly/2021/ar20_en.pdf?ieNocache=381 accesed 19 April 2021.
[1198] Ibid
[1199] Citi 2019 Annual Report p.5.
[1200] R. Lastra above note 27 p. 174.

would facilitate the resolution of US BBFCs with branches and subsidiaries abroad, since it would favour the lead of the US resolution authority over foreign authorities.

However, the US generally applies the separate entity approach to liquidation of US branches of foreign banks.[1201] Therefore, contrary to the case of Germany and Britain, the US applies a territorial bank insolvency approach for a US branch of a foreign bank, *de facto* permitting US authorities to ring-fence assets of such branch in the US.[1202] This "ring-fence" feature of US law may prevent a SPOE resolution of a foreign bank with US branches. This is something foreign jurisdictions will have to analyse before deciding to ensure a SPOE resolution, as stated above in the case of DB and Barclays.

Under Citigroup 2019 Resolution´s Plan the preferred resolution strategy is still SPOE.

> "Citigroup's preferred resolution strategy is "single point of entry" under the U.S. Bankruptcy Code…Citigroup Inc. (Citigroup Parent) would enter bankruptcy, but Citi's material legal entities (MLEs) would continue operating…Citi's Operating MLEs … would be recapitalized so that they would continue operating throughout Citi's Resolution."
>
> The SPOE Strategy is designed to (i) minimize the impact of Citi's Resolution on the U.S. and global financial systems, depositors, clients, and counterparties, (ii) maintain continuity of Citi's core business lines (CBLs), critical operations (COs), and material legal entities (MLEs), and (iii) maximize the value of Citi's businesses for the benefit of the Citigroup Parent bankruptcy estate. Citi believes that neither the Citi 2019 § 165(d) … shareholders and unsecured creditors of Citigroup Parent would absorb any losses."[1203]

According to the same document Citi is resolvable under the SPOE Strategy because it has: i) a trigger framework than enables it to take actions to execute the strategy; ii) sufficient financial resources at the appropriate Citi legal entities; iii) the capacity for the operating MLEs to receive funds where appropriate; iv) the capabilities to maintain the internal share services functioning; v) "credible divestiture" options for its businesses; and, vi) a process in place, ready for resolution.[1204]

Subject to the above analysis, a SPOE strategy would best fit the US model BBFCs. However, as in the case of DB and Barclays, in order to perform an effective SPOE resolution the following preconditions need to be aligned: 1) The US would have ex ante cooperation agreements in place with relevant jurisdictions; 2) jurisdictions where Citi has branches and subsidiaries would need to recognise the US universalism principles of insolvency; 3) US authorities should monitor the correct amount of eligible liabilities to assure the bail-in tool.

As in the German and British cases, a number of conditions favours a SPOE strategy in the US. First, the single entity approach to liquidation and universalism would give the

[1201] R. Lastra, ibid. After cases *Trinh v Citibank*, 850 F 2d 1164 /6th Cir 1988) and *Wells Fargo Ltd v Citibank*, 936 F 2d 723 (2d Cir 1991) New York Banking Law and Federal Reserve Act were amended to include a provision that a home office of a US bank would not have to repay a deposit held in a foreign branch in cases of government action (political risk). As Lastra stays, sometimes this is called "ring fencing" of foreign branch deposits.

[1202] P. Bolton and M. Oehmke above note 1093 p. 38.

[1203] Citigroup Inc. 2019 Resolution Plan Public Section July 1, 2019 <https://www.federalreserve.gov/supervisionreg/resolution-plans/citigroup-1g-20190701.pdf> Accessed 15 April 2020.

[1204] Ibid.

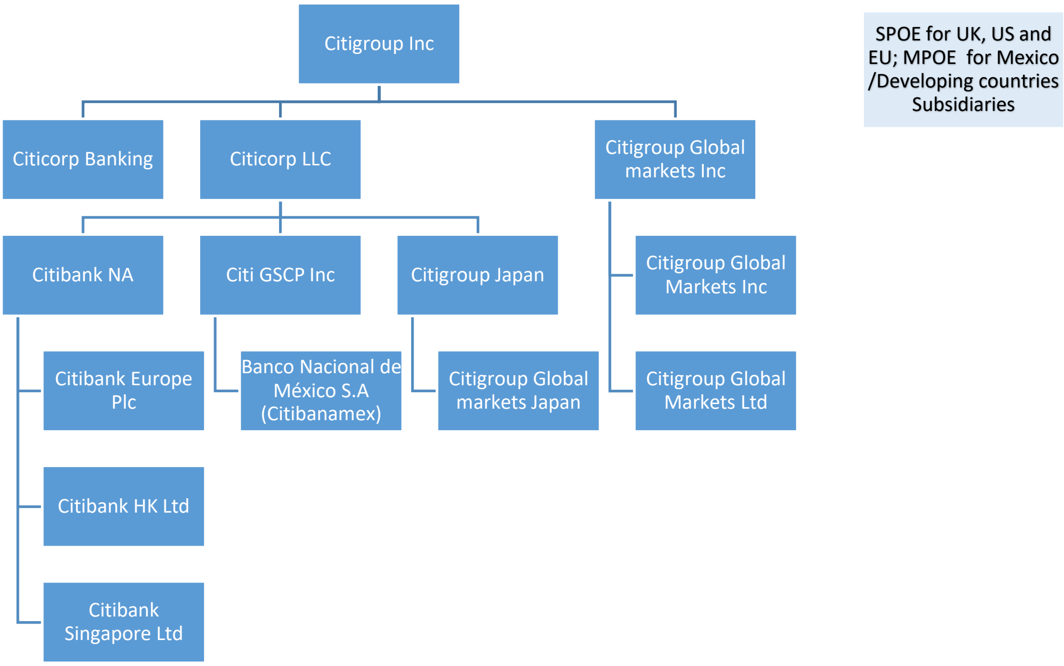
US authorities the role of resolution authority. US law would apply to the whole resolution process. Additionally, Citi has signed the ISDA 2015 Universal protocol on Resolution stays, and third, Citi´s preferred resolution strategy is SPOE, as stated above. Finally, and contrary to German counterpart, the corporate structure of the US model BBFCs makes a SPOE easy to apply since it relies on non-operative Holding companies at the apex of the structure.

Still, there are challenges for a SPOE strategy effective application for US model BBFCs. As in the German model and British model BBFCs, ex ante agreements are needed in order to avoid ring fencing of assets. Another possible scenario would be that foreign authorities would not recognise American universalism since the American system recognised territorialism for US branches of foreign banks. If such reciprocity applies, a SPOE resolution would not be effective.

Advantages of the SPOE as a preferred resolution strategy for US model BBFCs	**Challenges of the SPOE strategy for US model BBFCs**
Efficiency: a SPOE strategy allows cross-jurisdictional transfers and needs less loss-absorbing capacity needed as a group	Need to have ex ante agreements with other resolution authorities
Continuity as a group: critical functions assured	Doubtful that foreign jurisdictions would respect US's universal approach to resolution. Possible reciprocity from foreign jurisdictions since US applies territorial approach to US branches of foreign banks
Flexibility: allows a flexible legal structure through branches and or subsidiaries	Need to change legal and operational structure to include a holding company on top of current parent company
No need to change legal and operational structure to include a holding company on top of current parent company	
Fast process: through a "liquidation weekend"	
Enhances transparency	
US Resolution authority would be in control of the process	
US authorities prefer the SPOE strategy	
US applies the universal approach to resolution	
US authorities prefer the SPOE strategy as of Annual Report	
Citi has signed the ISDA 2015 Universal protocol on Resolution Stays	

Similar to the cases of DB and Barclays, Citi has physical presence in jurisdictions with territorial approach to resolution such as Brazil and others. Depending on the amount of business, turnover, and analysing the costs involved, Citi may prefer a hybrid model, applying a SPOE strategy to some jurisdictions and a MPOE strategy to others. A MPOE resolution will ensure that those jurisdictions will have its own liquidation according to local laws, assuring there is no risk of ring fencing of assets in the mentioned jurisdictions.

Figure 27. Simplified hybrid resolution strategy for Citi



Source: own compilation based on Citi Resolution Plan[1205]

6.7 Concluding remarks

This thesis compiles a four factor indicator which rely on: 1) how the BBFCs structure themselves (branches or subsidies); 2) on types of global banks (centralised or decentralised banks); 3) on how they develop their business (retail versus non-retail banking) and; 4) on how the jurisdictions where the head offices are incorporated apply a territorial or universal approach to resolution (territorial or universal approach to resolution). Based on these factors, the thesis examines the three BBFCs models to find which resolution strategy best fits each one.

As of the German model BBFC (DB) there are a number of factors that favour a SPOE resolution. DB legal structure is complex comprising both subsidiaries and branches, its business model is focused on wholesale banking and investment banking, it may be defined as a centralised BBFC and as its headquarters are incorporated and situated in Germany; German law and German resolution authorities will prevail and lead the whole resolution process. The fact that DB has signed the ISDA 2015 Protocol would help "support the cross-border enforceability of resolution action"[1206], that is especially important in a SPOE strategy, where cross border cooperation is essential for effective resolution. BAFin prefers the SPOE strategy and DB argues that SPOE is the preferred resolution strategy.

[1205] 2019 165 (d) Resolution plan: Citigroup Material Legal Entities < https://www.fdic.gov/regulations/reform/resplans/plans/citi-165-1907.pdf >Accessed 23 June 2021.
[1206] FSB "Principles for Cross-border Effectiveness of Resolution Actions" <https://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf > accessed 22 June 2020.

However, DB faces some challenges for an effective SPOE resolution. Ex ante agreements need to be effective before a SPOE strategy is planned. While these agreements may be in place, there are no guarantees that in a "resolution weekend" jurisdictions will be cooperative and for example, apply liquidity to foreign depositors. In the same vein, there are no guarantees that foreign jurisdictions will respect the German universal approach to resolution. This is particularly important with respect to the US, which applies territorial approach to US branches of foreign banks. Finally, the SPOE strategy relies on applying bail in to a holding non-operative company at the apex of the structure. DB apex is an operative company; therefore, some kind of corporate restructuring might be necessary to achieve an effective SPOE resolution strategy. An alternative of "hybrid model" resolution might as well be established. This model would apply a SPOE with certain jurisdictions (e.g EU, Japan) and a MPOE with jurisdictions with long tradition of territorial approach to resolution, such as Brazil.

When it comes to Barclays (British model BBFC), the four indicators show that SPOE strategy would best fit since its business model is based on wholesale, it is centralised and relies on both branches and subsidiaries. British universalism helps to ensure British resolution authorities would lead the process. As in the case of DB, the typical preconditions of SPOE strategy need to be met in order to fulfil an effective SPOE resolution. Contrary to DB, Barclays has a non-operative company apex, which is a resolution simplifier. On the other hand, as in the case of DB, the same challenges apply to Barclays: ex ante agreements are needed, and the peril of foreign authorities' ring fencing assets is still present. As in the case of DB, a hybrid resolution approach would be possible in order to separate jurisdictions that apply a territorial approach to resolution. In this case, a SPOE strategy would be granted to certain jurisdictions and MPOE to others.

Similar conclusions apply to Citi or US model BBFC. In this case, a SPOE strategy typically applies. Not only because Citi structure is constructed upon the holding model, but because US authorities prefer the SPOE strategy for US G-SIBs. The main problem for an effective SPOE strategy in the US is the dichotomy of resolution approaches. While US endorses universalism for US banks with foreign branches, it applies a territorial approach to US branches of foreign banks. This double system might jeopardize cross-border cooperation since for instance a German BBFC with US branches would not be able to fully apply a SPOE resolution for all their branches, since the US would "ring fence" and treat its US branches as local banks for resolution purposes.

While there is no "one fits all" solution for resolving G-SIBS, a careful analysis of the four indicators should be pursued by national regulators. In the first place, all G-SIBs will need to be "safe to safe" in the words of Huertas. In the second place, when the time comes to apply the resolution tools, all the pre-conditions of the chosen resolution strategy will have to be in place in order to maintain financial stability and to correctly balance the rights and interests of all stakeholders of the G-SIB in every jurisdiction involved.

When analysing the insurance business of the BBFC, while the FSB recognises a preferred "multiple entry resolution", the lack of convergence of resolution of this kind of companies in different jurisdictions pose regulators with an additional problem. While in the US, significant insurance companies will be able to be resolved under DFA, in Europe there is no harmonisation of recovery and resolution frameworks for insurers, which implies applying local insolvency proceedings.

CHAPTER 7- CONCLUDING REMARKS

> *"What's in a name? That which we call a rose By any other name would smell as sweet." Romeo and Juliet*, William Shakespeare

7.1 The definition of financial conglomerate is contentious

Chapter 2 of the book of Genesis tells how Adam gave names to different things

> "so out of the ground the Lord God formed every animal of the field and every bird of the air, and brought them to the man to see what he would call them; and whatever the man called every living creature, that was its name. [2:20] The man gave names to all cattle, and to the birds of the air, and to every animal of the field…" [1207]

Human beings had not lost their capacity to give names along history. Names not only define things but also qualify them in different systems and processes.

In the financial regulation sphere, modern "Adams" give names to new phenomena and are constantly trying to solve problems derived from a field that is underpinned by fast technological innovations. The term FC is one these phenomena. This thesis reaffirms the FC definition is contentious because of its cross-sectoral and cross-border dimensions. Form a cross-sectoral perspective, the FC deals with different risks along lines of financial business that make it difficult to supervise and regulate. From a cross-border dimension, FCs are difficult to regulate since there is a lack of harmonization and regulatory convergence in the international arena.

The same concept may have different meanings analysed through different lenses. A first lens is the geographical lens. This thesis has examined the Commercial classification of financial institutions, which comprises banking groups, mixed conglomerates and FCs. When the geographical lens is applied to the definition of a bank, the same institution is defined in the EU and the US by pointing out one of its core, albeit different i.e functions as "depository institutions" (taking deposits-US), and credit institutions (granting credit-EU). Drawing on practices of different countries, this thesis has analysed the definition of banks through different approaches, the list of activity approach, the formula approach and the hybrid approach, and this thesis insists on the need of maintaining "room for manoeuvre" or discretion to adapt the definition of bank to fast-changing reality constantly challenged by technology. Although we live in times of quantitative easing and there is a potential of the creation of central bank digital currencies, this thesis understands that as long as critical functions of banks persists as of today, banks will continue to be special and will continue to benefit from a special status in the financial arena.

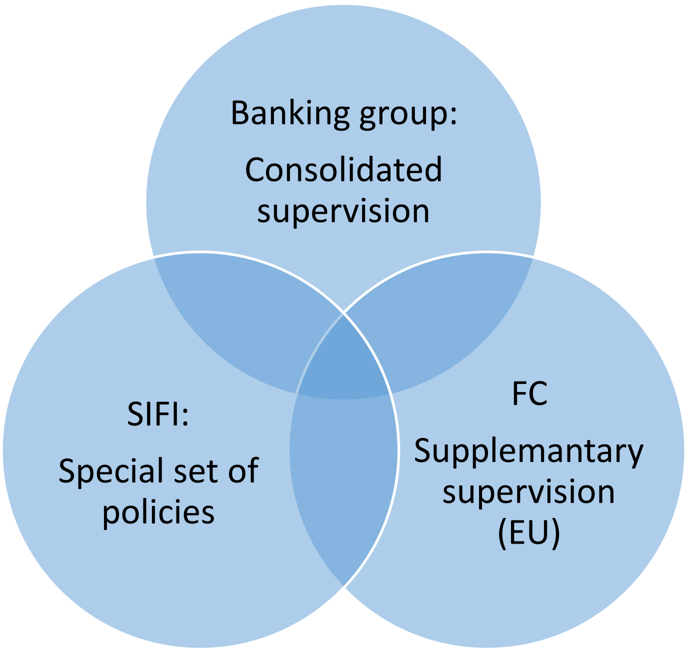
When dealing with "banking groups", there is also a broad understanding that consolidated supervision is a natural consequence of such a form of legal organization.

[1207] The Bible< http://www.vatican.va/archive/bible/genesis/documents/bible_genesis_en.html >Accessed 10 August, 2020.

However, when analysing how those banking groups are structured, even the meaning of "subsidiary" in the US has a different approach contrary to the conventional meaning in the rest of the wester world. The definitions did not change but the law give different effects to bank subsidiaries in the US assimilating them to branches which blurred the vision and challenge international cooperation in cross-border insolvency. Contrary, in the EU, the definition of subsidiary is critical, since the "passporting" system where banking groups are allowed to operate in the single market as far as it is authorised by one member country only applies to branches and not to subsidiaries.

When analysing the FC, whereas there is an international doctrinal definition (Joint Forum)[1208], the consequences of dealing with it will be different in the UE where supplementary supervision will apply due to the FICOD, and in the US where FC has no legal or regulatory consequence *per se*.

Contrary to the words that Shakespeare puts in Juliet´s mouth, in financial regulation, and in law in general, names do matter, since the consequences of being a solo bank, a banking group, a FC or a SIFI will have diverse consequences.



After the GFC, an additional lens was incorporated. The "systemic risk lens" was introduced to add a new perspective to old concepts. The FC and banking group definitions did lack this new perspective that added new categories such as SIFIs and G-SIIs, which complemented these definitions with new content. While in the US the SIFI labelling system under DFA may include non-banking institutions, in the EU the system (SSM) only includes banking systemic institutions and not others (e.g. insurance companies, hedge funds) like in the US.

[1208] Bank of Financial Settlements "The Supervision of Financial Conglomerates" [1995] A Report by the Tripartite Group of Bank, Securities and Insurance Regulators, p.13.

This thesis affirms the important role of soft law in integrating and providing a common language that protects international relations. Soft law and the institutions that developed those soft laws have done a lot in coordinating the effects of definitions in Internacional Financial law. However, a lot may be done to continue the efforts of international harmonization especially between the main actors, e.g. the USA, the EU, and the United Kingdom.

After examining the Commercial classification, this thesis draws on the Structural classification, first adopted by Herring and Santomero in the 1990s, that relies on the legal and operational separateness of FCs. Following this classification, this thesis provides a comparative analysis of BBFCs in Germany, the UK, and the US, that draws some light on the concept of FCs and what are the regulatory frameworks that applies to them. This classification proved to be resilient, since after the GFC regulators took the structural organization of the BBFCs and banking groups into account to design and implement the resolution strategies for SIFIs. The beauty of this classification stems from the fact that it helps regulators to understand the implications of risk, tax and resolution.

After the GFC, a Regulatory classification was proposed focusing on macro prudential and systemic risk, separating G-SIBs, G-SIIs and Non-Bank, Non-Insurers systemic important institutions at the international level, as well as D-SIFIs at the local level. The designation system or binary regulation has a set of disadvantages as litigation, politicization of the process, and forced restructuring that would discourage it. Additional costs of "under and over" inclusion of a SIFI are reasons for the regulator to adopt a more nuanced regulation. This thesis believes that since there is evidence that the risks of the different lines of finance differ, the banking like regulations applied to all SIFIs need to adapt to each recipient in order not to apply the "burden" of the SIFI labelling while not "benefiting" from the protection of banking regulation such as LOLR and deposit insurance.

Along chapters 3 (German model), Chapter 4 (British model) and Chapter 5 (US model) this thesis analysed different research questions. First it scrutinised the philosophical foundations of each model and if and how the banking system influenced the industry in each jurisdiction and its impact on types of capitalism. Second, it examined the way BFCCs are legally organised in each jurisdiction. Third, it answered what resolution strategy best fitted each model considering a selected BBFC-G-SIBs which represented the model in each jurisdiction.

The research has identified three different models and found that the corporate structure of BBFCs in two of them, i.e the German and the US models, have specially influenced the type of capitalism involved in Germany and the US. The pre-eminence of German banks, which were and are generally universal, shaped the financial needs of industrial enterprises in Germany and has proven to be the preferred financial institution in Germany, even after the Government tried to develop the *Finanzplatz Deutschland* in the 1980s. In addition, it can be argued that unit banking in the US helped the development of capital markets, (which is multi-causal), since big enterprises needed to find alternative sources of funding because there was a mismatch between big firms and small banks. While in the UK banks where not important in the development of the industry, the capital market is not as developed as in the US and the bank system is not as preeminent as in Germany.

As this thesis affirms below, it has also analysed the different philosophical and historical foundations of the different models. While Germany may root the beginnings of universal banking in Saint Simon ideas, the UK relied in self-regulation and classical liberalism, and the US in federalism.

Based on Herring and Santomero´s classical structural classification, this thesis identified the Integrated Model or German Model and analysed how BBFCs structure themselves in that prototypical jurisdiction. While there is only one G-SIB in Germany, i.e. DB, which is universal, the other three pillar entities (saving banks and cooperatives) where key in the development and in shaping Germany as it is known today. The second model, the British model, was modified because of the influence of European law, and this thesis has changed the original name for Modified British model, since in general, at the apex of British BBFCs there is a holding company. The British model has also been shaped by ring fencing regulations, which separates the core activities from other divisions of the group. British banks are classified in banks, credit unions, building societies and merchant banks. British banking developed a multinational or overseas banking which had great influence in Asia and Latin America, and which subsist in entities like HSBC. Finally, the US or holding model, the last identified model according to Herring and Santomero´s classification, has developed in the US after 1956, and its features have proven to be resilient since the SPOE resolution strategy heavily relies on this structure to function well. The US classifies its financial BBFCs in banks, thrifts and credit unions, and as stated above is the only of the selected jurisdictions that has the power to label both banks and non-bank SIFIs as such.

Finally, section 7.3 below summarises the findings of the analysis of which resolution strategy best fits in each jurisdiction. In Annex 4, this thesis analyses the case of Credit Agricole and Santander. In the latter case, the results differ from the other cases, in that for this thesis the most appropriate resolution strategy for Santander is MPOE. In the other cases, (i.e. DB, Barclays and Citi) the SPOE resolution strategy would best fit in each of the selected jurisdictions involved. Although there are certain preconditions that need to be in place, a SPOE resolution or a hybrid resolution, meaning a SPOE resolution for certain jurisdictions (such as the EU) and a MPOE resolution for others (i.e. Brazil) is preferred.

7.2 What are the philosophical foundations of each model? Did the banking systems finance the industry? What type of capitalism did they represent?

Keynes famously stated

> "[t]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air are distilling their frenzy from some academic scribbler of a few years back."[1209]

[1209] J.M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936), p. 383.

While *a priori* conventional wisdom would not say a banking system would be slave of a "defunct economist" but of a set of technical regulations, history shows intellectual influences are always present and are determinant to understand the present.

The philosophical foundations of universal banking in Germany are rooted in the work and deeds of Saint Simon and his disciples, the Pereire Brothers. There are several well-documented links between the work of Saint Simon, the foundation of the Credit Mobiliere and the Grossbanken in Germany, which were built upon the same pillars of the French bank. Credit Mobilier bylaws´ expressly affirm "the important services that the establishment of bank may favour the development of the industry".[1210] Saint Simon though the role of banks was to be "general agents of the industry" and that the industrial class was called to be in charge of "public wealth". By 1910 Grossbanken in Germany were called "Credit Mobilier Banks". This link between Saint Simon ideas and the creation of the first Grossbanken generated a particular type of bank, the universal bank. Universal banks in Germany (as well as in Austria and Italy) established very close relations with the industry, in the words of Gerschenkron, a German Bank "accompanied an industrial enterprise from the cradle to the grave, from establishment to liquidation throughout all the vicissitudes of its existence".[1211] This special relationship in Germany, contrary to BBFCs in the US and the UK, was anchored in four elements: i) providing all kinds of financial services (banking, securities, insurance); ii) owning shares in commercial and industrial firms; iii) taking positions in supervisory bodies; iv) controlling commercial and industrial firms via proxy rights.

Available data of Bairoch´s index of industrialization show Germany grew in a faster pace than the UK, even though the UK was the leading industrial power since the Industrial Revolution. Also, from 1870 to 1913 the Grossbanken in Germany where the three most important firms in Germany. There is evidence that German banks did finance heavy industry and the *housebank* long-term relationships were key to German economy. There is also evidence that while in the period 1850-1913, the US, UK had specialised commercial banks, and large markets, Germany had universal banks and small markets. While it is difficult to prove causality, it can be said that Germany was shaped by Grossbanks —helping the industry— and a sub developed capital markets, due in part by the application of incorrect incentives (taxes and share transfer restrictions, nationalisation of railways) and by direct participation of banks in stock markets.

On the other hand, banking system in the UK was organised under four pillars, a specialised system that historically separated merchant banking, brokerage and commercial services, a self-regulated industry where moral suasion was used by banking authorities, the reliance of other sources of funding to finance the industry, and the prominence of the City of London.

Contrary to Germany, where universal banking had a clear philosophical foundation on Saint Simon ideas, in the United Kingdom the intellectual nerve that moved the banking system may be found in classical liberalism[1212] and the primacy of private initiative and

[1210] Decret No 7433, above note 264.
[1211] A. Gerschenkron above note 272 ps 1-15.
[1212] S. Konzelmann, M. Fovargue-Davies, and G. Schnyder "Varieties of liberalism: Anglo-Saxon capitalism in crisis?" [2010] Centre for Business Research, University of Cambridge, Working Paper No.

self-regulation. Lord Leslie O'Brien, Governor of the Bank of England, stated in 1973 "[t]he supremacy of London as an international banking centre is founded on a freedom from vexatious banking legislation equalled in few countries in the world."[1213] It was only after the Banking Act of 1979 that the UK has a domestic formal banking regulation. Before that, the Bank of England used moral suasion to control credit institutions. Self-regulation in the UK proved to be stable from 1878 to 1991 where there were no major financial crisis in the UK. As Lord O`Brien states, another pillar of the UK banking system is the prevalence of the City of London. While not an intellectual nerve by itself, as may be the Saint Simon ideas in Germany, a differential motor of the UK banking system is the City of London. London is now the second ranked financial centre in the world second after New York. Data suggest London will be the major financial centre in Europe after Brexit. History tells how London championed the financial world, first because it was the capital of the Empire, then because it was located in a major economy and had a strong currency, and afterwards because it reinvented itself with the Eurobond market. Some poised questions on whether the City has failed the industry in the UK, or the economy as a whole, and Brexit has poised these questions again. Opportunities for further research are now opened.

Unlike Germany, and like the US, in the UK there is a consensus that "banks failed the industry" and that financial institutions concentrated on short-term lending and/or holding their long-term assets in government and public utility securities. Also, the City has preferred financing international trade to financing local industry. During the Industrial Revolution (1760-1830), industrialists used own funds to finance their enterprises, since country banks were small and circumscribed to their constituencies. The Bank of England was the only approved Joint Stock Company until 1825, restricting other banks to raise capital from the public. In 1708, Parliament limited associations of more than six people to conduct the business of banking, aggravating the problem. Usury laws also restrict the amount of customers banks could get and increased collateral lending. Data from 1860 to 1913 the UK show the manufacturing output decreased from 19 to 13 percent of the total manufacturing output. Before WWI there is evidence that banks were concerned with liquidity and short term lending, and that the UK foreign investment was inmense. The sum of these factors might have stymied the industry development in the UK. Things changed after the Big Bang. In 1988, the UK surpassed Germany for the first time in the Private Credit by Deposit Money Banks to GDP Index, and after 2002 Germany could not lead again against the UK.

On the other side of the Atlantic, different intellectual references other than Saint Simon ideas were determinant to shape the banking system in the USA. Federalism designed the US banking system from its inception. Its regulators tended to replicate the federal government structure at the banking level, preserving abuse of power and undue concentration of financial resources. Federalism refers to a means of governing the polity that grants partial autonomy to geographical defined subdivisions of such polity. Late

403, p.11; P. A. Hall and D. Soskice *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford Scholarship Online, 2003) p. 337.

[1213] L. O`Brien "Speech by the Governor of the Bank of England" Given at the biennial dinner of the Institute of Bankers in Scotland on 22nd January 1973< https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/1973/speech-by-governor-given-at-the-biennial-dinner-of-the-institute-of-bankers-scotland-22-jan-1973.pdf> accessed 19 April 2021.

Supreme Court Justice Antonin Scalia resumed federalism as a midway between two extremes, autonomy on the one side and division on the other. The US relied on a unique "unit bank" system, which was the result of heavy restrictions on branching at state and federal levels.

This thesis believes that restrictions on branching and the unit bank system had different outcomes when analysed from different perspectives. From a business bank perspective, the costs of unit banks outweighs its benefits. There is evidence that allowing branch banking accelerated growth in states that permitted it, and that unit banks were less efficient in the use of capital and reserves. Unit banks were more associated to bank panics than branch banking in certain regions, and there is evidence that unit banks hindered financial integration and diversification. However, from a national interest perspective, unit banks created a mismatch between big firms and unfitted small banking system that led those firms to find other sources of finance. US firms had to rely in syndicates and other forms of finance to substitute bank loans, which stimulated the bond market first, and equities market second. Anglo Saxon capitalism or market-based capitalism in the US may trace part of its success in an unwanted effect of heavy restrictions on bank branching.

7.3 How BBFCs are legally organised in each jurisdiction?

The second research question focuses of the legal organization of BBFCs on three selected jurisdictions, which are tied to each of the Structural classification´s model: Germany (German model), UK (British Modified model) and the US (Holding Company model).

In Germany the "three pillar Structure" of universal banking is represented by i) *Grossbanken* or big banks, ii) savings banks, and iii) cooperative banks. Historically, each pillar served different customers, which underpinned different business models. *Grossbanken* are joint stock corporations with national or international scope and their aim is profit maximization. Savings banks are independent instrumentalities organised by public law, with municipalities of local governments as responsible institutions. Contrary to *Grossbanken,* their aim is to serve the public interest, while they must also look for profit optimization. They organize themselves under the regional principle (*Sparkassen*) or under a national or international scope (*Landesbanken*). Cooperative banks are registered cooperative societies, where members or non-members as owners, with regional scope. Their principal aim is the promotion of members and profit optimization.

From a systemic importance perspective, only DB is a member of the first pillar and falls under the G-SIB category. The rest are not systemically important. From a size perspective, the regional territorial scope would segregate cooperatives and *Sparkassen* from the inclusion in the G-SIB list because they would not face cross border issues and they would maintain a size proportional to that of the region.

This thesis believes that there are several benefits and costs of universal banking. Theoretically, a universal banking system relies on long-term relationships, taking advantage of economies of scope and scale, diversification and the gains of one-stop shopping. On the other hand, the peril of creating "mammoth entities" which are difficult to manage, supervise and resolve is present in this kind of structures. While universal banking is not a synonym of "systemic", the universal banking encourages the formation of entities that are bigger than their specialised institutions. This poses additional focus on anticompetitive behaviour, abuse of information and benefiting of conflicts of interest.

[1214]This thesis sets out to show that discouraging universal banking because of the latter may not be sufficient, but special care need to be taken by regulators to encourage competition and ethical behaviour.

On the other hand, Chapter 4 examined the British model, or what this thesis calls British Modified model. This new classification adapts the original classification to a more complete one that best reflects the structure of British BBFCs, including the bank company/insurance and securities subsidiaries plus a holding company at the apex of the corporate structure. The UK system comprises: 1) Banks, 2) Credit unions, 3) Building societies and 4) Investment Banks. The first group includes the "big four" clearing banks, overseas banks and foreign banks. Credit Unions, as *Sparkassen* in Germany, are non-profit institutions based on cooperative values. Contrary, Building Societies are specialised institutions with the aim of making loans, which are secured on residential property and are funded by its members. Building societies were permitted to demutualised, being Northern Rock a renowned example. Investment banks or merchant banks had a historical origin in international trade (Barings: wool; Rothschilds, cotton; Schroeders and Kelinworts: sugar) with the aim of dealing in investments as principal or investment activities on a professional basis. After the Big Bang in the UK merchant banks were taken over by other continental and US counterparts. Nowadays, the only British Investment Bank regulated by the PRA is Barclays, after buying the investment banking division of Lehman Brothers in 2008.

From a systemic importance perspective, Barclays and HSBC are the two British based SIFIs. The rest are not systemically important. From a size perspective, the specialised scope would segregate Building societies form that list. The same applies to Credit Unions because they would not face cross-border issues and they would maintain a size proportional to that of geographical place where the common bond rules.

Chapter 5 analysed the corporate legal form of US BBFC. The US has since 1956 a Bank Holding Companies Regulation in order to enhance the control of BHCs and being consistent with the public interest. It was not until 1999 with GLBA that allowed FHC to operate in banking, insurance and securities market. Today almost all big BBFCs are registered as FHC.

The traditional classification of depository institutions in the US comprises: 1) commercial banks, 2) thrifts and 3) credit unions. One special feature of the American system is the existence of a dual banking system comprising a federal and state level. A second feature is the presence of second level institutions, which are commercial bank operative and financial subsidiaries, thrift service corporations and CUSOs. As in Germany, thrifts were aims to encourage savings and help working class. Contrary to Germany, thrifts are not independent instrumentalities of public law, but private associations, which may take the form of stock ownership or mutual ownership. Thrifts in the US need to have at least 65% of their portfolio in Housing related assets. As in the case of commercial banks, there are also thrift holding companies. Finally, as credit unions in the UK, they are cooperatives governed by cooperative rules and non-profit aims. Contrary to, for example Credit Agricole in France, there are no globally systemically important credit unions or thrifts in the US. While after the deregulation period, US BBFCs may choose from a variety of forms to perform the three finance functions, international BBFCs have chosen the FHC as a preferred structure.

[1214] See I. Kokkoris and R. Olivares-Caminal *Antitrust Law amidst Financial Crisis* (CUP, 2010) p. 5

This thesis concludes that the dilemma in the genesis or emergence of BBFCs (the "chicken and egg situation") may describe the relationship between corporate form of BBFCs and regulation. Chain and group banking were created in order to prevent branching restrictions in the US. At the same time, the use of the holding company structure before 1956 was used to operate in different states, applying *de facto* interstate banking. BHCA was partly a reaction to stop the use of holding companies as a way to circumvent the Mc Fadden Act.

Half a century later, the deregulation movement somehow build up to the GFC of 2007-09. The US legislator enacted DFA as a reaction to the GFC. The DFA ended up the possibility of FCs to be regulated by the SEC. It also prevented financial institutions that owned industrial banks from avoiding regulation by the Federal Banking System. The Federal Reserve System received the power to determine to regulate non-bank financial companies in the case they could pose a threat to financial stability in the US. In this way DFA close regulatory arbitrage to FCs. This proves banking regulation and corporate innovation feed each other and there is space to conclude the interaction in the US went on both sides.

7.4 Which resolution strategy best fits each model?

Chapter 6 compiles a four factor indicator underpinned on 1) how the BBFCs structure themselves, (via branches or subsidiaries); 2) on types of global banks, (centralised or decentralised); 3) on how they develop their business, (retail versus non-retail); and 4) on the jurisdictions approach to resolution, (territorial or universal). Based on these factors, this thesis examines the three BBFCs models to find which resolution strategy best fits each one.

The concurrence of the four factors indicate that pure models of BBFCs that rely con branches, are centralised, have a wholesale and investment banking business model and operate in jurisdictions where universal approach of resolution applies, would best fit a SPOE resolution strategy. On the other hand, BBFCs that are organised through subsidiaries, are decentralised, rely on retail business and operate in jurisdictions where territorial approach to resolution applies, would best fit a MPOE resolution strategy. While this might work on pure models, BBFCs are complex structures and an in depth analysis of each BBFC is necessary to assess the most effective resolution strategy.

As a general conclusion, the SPOE strategy prevails or best fits the three selected models. Contrary to the Santander case, studied in Annex 4, the SPOE strategy proved to be more resilient in the three chosen SIFIs: DB, Barclays and Citi.

This thesis insists that the SPOE strategy has weighted advantages. From a business perspective, the SPOE strategy is more efficient since it permits using lower loss-absorbing capacity and will ensure the continuity of critical functions of operating firms and of the group as a whole. It also permits the BBFC to organise itself through both branches and subsidiaries. From a market perspective, the SPOE strategy makes resolutions transparent because bail-in-able debt is earmarked and available for regulatory activation. From a resolution authority perspective, the SPOE strategy gives authorities a centre of control that avoids multiple territorial resolutions, and it would enable a quick resolution in a "liquidation weekend", which make it a preferred resolution strategy for authorities in the selected jurisdictions.

As of the first case, the German model BBFC (DB), meets elements that favour a SPOE strategy. DB´s legal structure is complex and it comprises both subsidiaries and branches.

As of the second indicator, DB is categorised as a global centralised bank. As for the third indicator, DB´s business model is focused on wholesale banking and investment banking. As for the fourth indicator, Germany adopted the universal approach to resolution. As DB has its headquarters and it is incorporated in Germany, German law and German resolution authorities will be in charge of a resolution process. The fact that DB is a signatory of the ISDA 2015 Protocol helps to support the cross border enforceability of the whole process. Finally, BAfin prefers the SPOE startegy, and DB authorities have stated they too prefer a SPOE strategy. Because all of this, the SPOE strategy would best fit the resolution strategy of DB.

However, this thesis shows DB faces certain challenges for effective resolution. First, ex-ante burden agreements need to be effective before a SPOE strategy is planned. Second, there are no guarantees that in the short window of time or "resolution weekend" jurisdictions will cooperate and apply liquidity to foreign depositors. Third, there is no guarantee that foreign jurisdictions will respect German universal approach to resolution and be tempted to ring fence local assets. This is particularly true with the US that applies a territorial approach to resolution to US branches of foreign banks. Finally, the SPOE startegy relies on applying the bail in tool to the apex, which is in general a holding company with no operative functions. As DB apex is an operative company, some kind of restructuring might be necessary in order to achieve an effective SPOE resolution. This thesis states that DB might as well establish a hybrid resolution strategy, where it might apply a SPOE resolution strategy in the EU and a MPOE resolution strategy in places where the territorial approach to resolution has a long tradition, such as Brazil, where DB has a subsidiary.

The concurrence of the four indicators show that SPOE would best fit the British Modified model BBFCs (Barclays). British universalism help to ensure UK authorities would lead the whole resolution process. As in the case of DB, preconditions of SPOE would need to be in place to assure a swift resolution. Barclays has also signed the ISDA 2015 Universal protocol that would help the enforceability of the process. Contrary to DB, Barclays has no operative apex, which is a resolution simplifier, since no restructuring would be needed. As in the case of DB, there are still challenges: ex-ante burden agreements will need to be in place, and the peril of foreign jurisdictions ring fencing assets may be present. As in the case of DB a hybrid solution may be possible, granting a SPOE strategy to the EU and MPOE to jurisdictions that would most probably apply territorial approach to resolution and avoid cooperation.

Similar conclusions apply to Citi or the US model BBFCs. In this case, the SPOE strategy applies not only because Citi is an archetypical example to a Holding model structure, but because US authorities prefer the SPOE strategy for US G-SIBs. As the US applies the single entity approach to liquidation and universalism, it would give the US authorities a leading role in the resolution of a BBFCs with branches and subsidiaries operating abroad. Citi has signed the ISDA 2015 Universal protocol, which would help the enforceability of the process. The same challenges apply to Citi, with the additional issue of the US double approach to resolution. The US endorses a single entity or universalism for US banks with foreign branches, but it applies the territorial approach to foreign banks with US branches. This may jeopardise cross border cooperation.

When it comes to international cooperation, trust relations are key in order to fulfil an effective relation. That said, when there is lack of convergence in key regulations such as universal or territorial approach to resolution, there will always be risks since no matter how deep trust might be if the law command to ring fence assets, no political partnership would suffice to stop an uncooperative resolution. Convergence in the EU would recommend a SPOE strategy for this territory since in many aspects the EU conducts itself as a single jurisdiction. In order to avoid uncooperative resolution processes, a hybrid resolution would be recommended, since it would not endanger financial stability and would offer tranquillity to the markets. Additional problems are added when it comes to the resolution of the insurance business of BBFCs. While in the US significant insurance companies are resolved under DFA, in the EU there is lack of harmonization of recovery and resolution frameworks, which implies different local resolutions in each member state.

The regulation of FCs is complex due to cross sector and cross border dimensions. In Chapter 5, this thesis formulated a metaphor based on the myth of Icarus and Daedalus. Icarus sin consisted in disobeying his father’s advice not to fly too high nor too low. Flying too high can be assimilated to overregulation and flying too low to overregulation. This thesis argues that regulators need to fly in the middle, to respect flexibility and innovation and at the same time safeguarding financial stability and the soundness of the economy.

ANNEX 1- ARE BANKS SPECIAL?

For centuries, banks have assumed special functions in the economy. Mainly because of this, governments and Central Banks have treated banks in special ways. This section will examine if the features that made banks special in the past remain true today, particularly after the GFC.

Banks are special in various ways. Banks as financial intermediaries have the following basic functions: (1) transformation of short-term liabilities (generally in small amounts by depositors) into long-term credits[1]; (2) provision to bank customers of means of payment being themselves payment intermediaries[2]; (3) transmission by Central Banks of monetary policy[3]; (4) screening of potential borrowers, monitoring their activity and enforcing repayments[4]; (5) being subject to regulation and supervision, and having access to central bank facilities.[5]

After the GFC[6] the financial authorities focused on the role of "critical functions" in order to design the relevant framework of resolution of failing banks. In this sense, according to the Financial Stability Board (FSB), the critical functions are "activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability due to the banking group size or market share, external and internal interconnectedness, complexity and cross border activities".[7] This definition recognizes the relevance of banking activities to the economy and is a demonstration of their special nature.[8] Indeed, the "critical function" literature is an extension of the old "list approach" banking definition, which is in fact functional. The continuity of the critical functions of a failing bank is an "objective of resolution" and stresses the specialty of banks as authorities aim to ensure the bank activities (or critical functions) are performed in a resolution circumstance.[9]

1. Maturity mismatch, the "Mary Poppins Effect" and Transaction Accounts

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[1] T. Beck, D. Coyle, M. Dewatripont, X. Freixas and P. Seabright "Bailing out of the Banks: Reconciling Stability and Competition- An analysis of state-supported schemes for financial institutions", CERP [2010], p. 9; T. Padoa Scioppa, "The Transformation of the European Financial System", ECB, 2002. p.7, R. Lastra, *International Financial and Monetary Law* (2nd edn Oxford 2015), p. 141.

[2] T. Beck et al above note 1 p. 9 and R. Lastra, above note 1 p. 141.

[3] E.W. Kelley Jr "Are Banks Still Special?" Federal Reserve (1997).<https://www.federalreserve.gov/boarddocs/speeches/1997/19970129.htm> accessed 20 January 2018.; E. Corrigan "Are Banks Special?" Federal Reserve of Minneapolis, 1982 <https://www.minneapolisfed.org/publications/annual-reports/are-banks-special> accessed 20 January 2018. T. Huertas, "Are Banks still special?" LSE, 2017 p.1.

[4] T. Beck et al, above note 1, p.9.

[5] E. Corrigan note above 3, T. Huertas, note above 3 p.1.

[6] GFC is an acronym used to define the financial crisis originated in the USA in July 2007 with the credit crunch. See R. Lastra and G. Wood "The Crisis of 2007–09: Nature, Causes, and Reactions" Journal of International Economic Law, Volume 13, Issue 3, 1 September 2010, ps. 531–550.

[7] FSB *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on identification of Critical Functions and Critical Shared services*" FSB, 16 July 2013.

[8] According to R. Lastra, R. Olivares Caminal and C. Russo, [2017] European Parliament "in the banking sector, the most important critical functions are deposit taking, lending and loan servicing, and payments (clearing and settlement)", 'The Provision of Critical Functions at Global, National and Regional Level-Is there a need for further legal/regulatory clarification if liquidation is the default option for failing banks?',

[9] Bank Recovery and Resolution (BRRD) - Directive 2014/59/EU.

In the first place the bank's special balance sheet structure produces a "maturity mismatch" between depositors- who can claim their credit at any time- and long term loans- generally not liquid- that make the banks vulnerable to runs.[10] In a seminal work in 1983, Diamond and Dybvig concluded that in the event of a panic even those depositors who would have preferred to maintain their deposits in the bank in other safer circumstances would require to withdraw their funds, and that the economic consequences of the run would be further reaching than in other areas of business since "even ´healthy´ banks can fail, causing the recall of loans and the termination of productive investment"[11].

Friedman and Schwarz conclude their work on the Great Contraction referring to this phenomenon: "it happens that a liquidity crisis in a fractional reserve banking system is precisely the kind of event that can trigger – and often has triggered – a chain reaction. And economic collapse often has the characteristic of a cumulative process (...). Because no great strength would be required to hold back the rock that starts a landslide, it does not follow that the landslide will not be of major proportions."[12] Although the liquidity crisis might be a common cause of triggering the bank run, because of the nature of the fractional reserve banking system, a bank run can be initiated even if the bank is solvent[13] by a psychological lack of confidence[14] or "Mary Poppins"[15] effect.

This specific mix of features of banks makes them vulnerable to runs "with a potential systemic impact and very important externalities to the economy".[16]

In the second place, banks issue transaction accounts where

> "they incur liabilities payable on demand at par and are readily transferable by the owner to third parties. The owner of a transaction account can demand and receive currency in the face amount deposited in the account; write a check in the full amount of the account; or perhaps most importantly the owner of the account can transfer the full amount of the account to a third party almost instantaneously by wire transfer. The liquidity, mobility, and acceptability of bank issued transaction accounts permit our diverse economic and financial system to work with the relative ease and efficiency to which we are accustomed"[17].

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[10] T. Padoa Scioppa above note 1, p.8; See R. Lastra, above note 1; Eva Hupkes "Form Follows Function- A New Architecture for Regulating and Resolving Global Financial Institutions", European Business Organization Law Review (2009) p. 372.
[11] D. W. Diamond and P.H. Dybvig "Bank Runs, Deposit Insurance, and Liquidity" Journal of Political Economy, Vol. 91, No. 3 (Jun. 1983), p 402.
[12] M. Friedman and A. Schwartz, *The Great Contraction 1929–1933* (Princeton University Press 1965) p. 123.
[13] T. Padoa Scioppa, above note 1 p. 8.
[14] R. Lastra, above note 1 p 192.
[15] The "Mary Poppins Effect" refers to the scene of the Disney film where the son of the main character initiates a bank run when he shouted to the bank manager that he wanted his money back. The run against the bank was triggered by a psychological fear that the bank would not comply with its obligations and was not related with the safety and soundness of the bank.
[16] Xavier Vives "Competition and Stability in Banking", IESE Business School, University of Navarre, Working Paper WP 852, (2010) p. 44.
[17] E. Corrigan note above 3.

The transaction account issuance is one of the key elements that distinguish banks from other types of financial and non-financial institutions.[18]

Not only are banks special, but also bank failures are special "since they create externalities (contagion to other healthy institutions; under a fractional reserve system a bank will be unable at any time to honour the convertibility guarantee) and affect the stability and integrity of the payment system. They often become a matter of public interest."[19]

At the same time, as the GFC has showed, there is a case for *lex specialis* for banks. This is firstly because insolvency proceedings might not be "speedy enough".[20] Secondly, the functions of insolvency are different from resolution. While the first are "fair and predictable treatment" of creditors and "maximization of assets" in the interest of creditors, the bank resolution functions are the "safety and soundness" of the financial system and the "integrity of the payment systems".[21] Thirdly, insolvency proceedings might not ensure the continuation of critical functions of the institution.[22] Fourth, delimiting insolvency and illiquidity might be difficult to establish in the banking sector, especially the trigger point of the insolvency.[23] Fifth, bank failures are of public interest mainly because of their functions (giving credit to real economy and ensuring the payment system) and need to be carried out by competent authorities. Sixth, liquidation is costly, mainly by dissipating the depositor´s base, disrupting community-banking services and damaging confidence.[24] In summary, bank insolvency procedures will "most often not sufficiently preserve financial stability".[25]

Additionally, the risk of contagion is particularly important where the size of the bank is significant: the "too big to fail problem".[26]

The contagion of healthy banks by the failure of another bank will depend on the degree of interconnection between them. What the GFC has demonstrated was that the financial institutions were indeed connected and there were four main transmission mechanisms: (1) the inter-bank, inter-institution, inter-instrument channel; (2) Payment system channel; (3) information channel; and, (4) the psychological channel.[27]

The first channel is anchored in the credit connections of banks within the system, mainly by interbank deposits, loans, and payment systems, but also through derivative markets - through for instance a major counterparty default.[28] The second channel would result if a

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[18] Ibid.

[19] R. Lastra "Northern Rock and Banking Law Reform in the UK" in F. Bruni and D. T. Llewellyn, *The Failure Of Northern Rock: a Multi-Dimensional Case Study* SUERF Vienna (2009) p. 141.

[20] Karl-Phillip Wojcik, "Bail-in in the Banking Union" 53 Common Market Law Review, Issue 1, (2016) p 97.

[21] R. Lastra, above note 19 p.141.

[22] K. Wojcik, above note 19 p. 92.

[23] R. Lastra, above note 19 p. 141. See C. Goodhart "Myths of the Lender of Last Resort" International Finance 2:3, (1999) p. 339.

[24] R. Lastra, above note 19 p. 167.

[25] K. Wojcik, above note 19 p. 92.

[26] M. Schillig, "Bank Resolution Regimes in Europe-Part I: recovery and Resolution Planning, Early Intervention, European Business Law Review, vol 24, no. 6, N/A, (2013) p. 755.

[27] R. Lastra, above note 1, p 183-192.

[28] Ibid, p. 184; G. Schinasi et al "Modern Banking and OTC Derivatives Markets- The Transformation of Global Finance and its implications for Systemic Risk" IMF Occasional Paper no 203 (2000) ps 49-58;

financial institution were unable to fulfil its obligations in a clearing and settlement system that would lead to a "severe liquidity shortage" as healthy institutions would not be able to pay their own obligations.[29] The information channel would transmit contagion through information. An "adverse piece of news, such as the failure of a particular bank" would make depositors examine the soundness of their institution, while that might not be an easy task in a crisis.[30] The last channel refers to panics and is related to the third channel: "the belief in panic is self-fulfilling".[31]

All these channels are exacerbated when the bank is part of an international group or conglomerate, where cross border externalities may arise. The consequences of a large international bank failure may affect depositors, creditors, counterparties and the economy of other countries.[32]

Where the bank is so big that the country would do whatever necessary in order to save it from failure, that bank would be categorized as "too big to fail", or "too complex to fail" or "too interconnected to fail"[33]. "Systemically important financial institutions" (SIFIs) are "an extension of the too big to fail doctrine" and enjoy an "implicit government guarantee".[34] Consequently, the size of the bank is a reason why governments understand special treatment needs to be assured to "too big to fail" banks.[35]

2. Payment System

As Huertas explains it, traditionally, non-banks rely their money on banks, while at the same time banks have access to accounts at the central bank. Households and institutions "use banks to access the payment system. Banks lend to non-banks and provide the economy at large with liquidity back-stop"[36].

The Committee on Payments and Securities Settlement affirms that one essential element of the financial system is to provide a safe and efficient payment and securities settlement system. "Payment systems…are a major channel by which shocks can be transmitted across domestic and international financial systems and markets. Robust payment systems are, therefore, a key requirement in maintaining and promoting financial stability".[37]

A.R. Waldman "OTC Derivatives and Systemic Risk; Innovative Finance or the Dance into the Abyss? (1994) 42 American Law Review 1023.

[29] R. Lastra, p. 188. C. Freedman and C. Goodlet "Large-Value Clearing and Settlement Systems and Systemic Risk (1996) 7(2) North American Journal of Economics and Finance p. 153

[30] R. Lastra p, 190; G.G Kaufman and K. Scott "What is Systemic Risk and Do Financial Regulators retard or Contribute to it? (2003) 7(3) Independent Review 371

[31] R. Lastra, p 192.

[32] C. Randell "The FSB's "key attributes": The Road to Cross-Border Resolution of Financial Institutions" Scoping Paper prepared for the Cross-Border Resolution Symposium Bingham Centre for the Rule of Law (2012) p. 5; S. Claessens, R. Herring, and D. Schoenmaker, "A Safer World Financial System: Improving the Resolution of Systemic Institutions' (International Center for Monetary and Banking Studies, Centre for Economic Policy Research July 2010), Geneva Reports on the World Economy.

[33] D. Gros "Too interconnected to fail = too big to fail: What is in a leverage ratio?" (*Vox.org*, January 2010)< http://voxeu.org/article/too-interconnected-fail-too-big-fail >accessed 7 July 2017.

[34] R. Lastra, above note 1, p. 194.

[35] See further in Section 2.3.1.

[36] T. Huertas, above note 3, p.2.

[37] Committee on Payments and Securities Settlement (2001, January 2001). Core Principles for Systemically Important Payment Systems. BIS (2001) <https://www.bis.org/cpmi/publ/d34e.pdf>. accessed 20 January 2018.

Bank failures are also special since they determine the integrity of the payment system. Ordinary people rely on banks to pay their bills and a sudden interruption of the chain of payments would imply serious social problems. In this regard, banks "perform a quasi-utility function" similar to the electricity or gas access functions.[38]

The Payments and clearing systems exhibit "utility-like" features and characteristics of "natural monopoly".[39] The economic literature has examined the reasons for regulating the banking industry. The most relevant reasons are the existence of market failure and deficiencies, the negative spill overs into society (such as the costs of bank runs), the existence of information asymmetries and the persistence of natural monopolies. In the particular case of the Payment system, it has been considered a public good, especially after the GFC.[40]

3. Monetary Policy transmission mechanism

Because of the bank special balance sheet and fractional reserve system, banks have been used by central banks as the "transmission belt" for "money and credit creation". As Corrigan puts it,

> "the required reserves of the banking system have often been described as the fulcrum upon which the monetary authority operates monetary policy. The reserves in the banking system also serve the complementary purpose of providing the working balances which permit our highly efficient financial markets to function and to effect the orderly end-of-day settlement of the hundreds of billions of dollars of transactions that occur over the course of each business day."[41]

Historically the central banks have used banks through a policy rate that is: a. the rate that central banks lend to banks, or b. the rate "at which banks can borrow central bank money in the market". Monetary policy has traditionally conducted open market operations with banks, or "varying the amount that they lend directly to banks." When central banks vary the banks reserves, they change the ability of banks to lend, with direct impact on other economic variables such as employment and inflation.[42]

4. Monitor function

Several scholars argue that banks are special since they solve "information asymmetries". Theoretical models developed by Diamond, Tamakrishnan and Thakor, and Fama stress

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[38] M. Schillng above note 46, p 751–779. C. Goodhart "If banks should act as utilities, why not treat them as such?" (Vox, 2011)< https://voxeu.org/article/if-banks-should-act-utilities-why-not-treat-them-such >accessed 12 March 2018

[39] B., Summers, "Clearing and Payments Systems: The Role of the Central Bank," Federal Reserve Bulletin, (1991), p. 86.

[40] R. Lastra, above note 1, p. 114. See Charles Goodhart *Money, Information and uncertainty* MacMillan, London, 1989, p. 202-203.

[41] E. Corrigan, above note 3. For a different vision see B. M. Friedman and K. N. Kuttner "Implementation of Monetary Policy: How Do Central Banks Set Interest Rates?" NBER Working Paper No. 16165 July 2010, JEL No. E43,E52,E58: "Central banks no longer set the short-term interest rates that they use for monetary policy purposes by manipulating the supply of banking system reserves, as in conventional economics textbooks; today this process involves little or no variation in the supply of central bank liabilities".

[42] T. Huertas, above note 3 p.3; T. Adrian, and H. Shin, "Financial Intermediaries, Financial Instability and Monetary Policy." Proceedings of the Federal Reserve Bank of Kansas City Conference at Jackson Hole, (2008) ps. 287-334; M King "Twenty years of inflation targeting. Stamp Memorial Lecture London School of Economics" (9 October). (2012) < http://www.bis.org/review/r121010f.pdf.> accessed 12 March 2018.

the special "monitoring functions of banks", the "comparative advantage" of banks against other financial institutions, as the "enhanced incentives (relative to public debt holders), in monitoring debt contracts".[43]

Fama argues that banks have a low-cost financial information history of the client, who is usually at the same time borrower and depositor, which gives bank a "comparative advantage" in making and monitoring "repeated short-term inside loans."[44]

While this function is still important for banks, as Huertas correctly states, other financial institutions, especially Private Equity firms, monitor companies in which they invest or to which they lend.[45]

5. Provision of central bank facilities, regulation and supervision

Since banks provide essential functions to the economy, financial stability[46] has relied on the stability of the banking sector, especially on the safety and soundness of systemically important institutions.[47] Mainly because of this, banks have access to central bank lending facilities and are subject to supervision and regulation.[48]

As Corrigan states, "banks and bank regulators have long since recognized the importance of banks acting in ways that preserve public confidence in banks' capacity to meet their deposit obligations, thereby minimizing the likelihood of large, sudden drains of bank deposits. Deposit insurance and direct access to the lender of last resort are uniquely available to banks to reinforce that public confidence. Indeed, deposit insurance and access to the lender of last resort constitute a public safety net under the deposit taking function of banks. The presence of this public safety net reflects a long-standing consensus that banking functions are essential to a healthy economy".[49]

In a recent article Huertas has argued that after the GFC, the traditional features of banks that made them special have weakened, making them "less special". In the first place, after the crisis, the bank monetary policy mechanism weakened since a second core element of monetary policy has emerged in the form of quantitative easing[50] and "eligibility easing", which reduced the need for central bank lending facilities[51]. Secondly, the payment systems are becoming "more robust", meaning that they are able

[43] A. Gande and A. Saunders "Are Banks Still Special When There is a Secondary Market for Loans? Journal of Finance 67, (2012) ps. 1649–1684; D.W. Diamond, "Financial intermediation and delegated monitoring", Review of Economic Studies 51, (1984) ps. 393-414; R. Ramakrishnan, and A. V. Thakor, "Information reliability and a theory of financial intermediation", Review of Economic Studies (1984) 51, ps. 415-432; E. Fama, "What's different about banks?" Journal of Monetary Economics 15, (1985) ps. 29-39.
[44] E. Fama, ibid, p 38.
[45] T. Huertas above note 3 p.2.
[46] J. Fell and G Schinasi "Assessing Financial Stability: Exploring The Boundaries Of Analysis" National Institute Economic Review No. 192 April 2005 p. 102. For Financial Stability definition see Section 2.3.1 below.
[47] T. Huertas, above note 3 p.1.
[48] Ibid.
[49] E. Corrigan, above note 3.
[50] R. Lastra above note 21, p.42.
[51] T. Huertas, above note 3, "During the crisis, however, central banks supplemented QE with EE (eligibility easing). They expanded the collateral eligible to support normal central bank liquidity facilities and they extended the range of counterparties eligible to access normal central bank liquidity facilities. p.6.

to continue to operate even if a bank is resolved or liquidated. Central banks have implemented real time gross settlement basis payments, which might in the future permit any institution to gain access to it.[52] Thirdly, macro prudential supervision has a broad scope encompassing many different financial institutions and not only banks.[53]

Another important challenge to banks would be the establishment, in the future, of digital currencies by the central banks. This would also make banks less special.[54] The first implication of the distributed ledger technology would be that every individual would be able to have a bank account in the central bank. This might have some advantages in comparison to the traditional bank account. As Broadbent argues "Shifting deposits to the central bank, and away from the leveraged commercial banking sector, has two important implications. On the one hand, it would probably make them safer. Currently, retail deposits are backed mainly by illiquid loans, assets that can't be sold on open markets; if we all tried simultaneously to close our accounts, banks wouldn't have the liquid resources to meet the demand. The central bank, by contrast, holds only liquid assets on its balance sheet. The central bank can't run out of cash and therefore can't suffer a ´run`".[55]

In summary, as Huertas recognizes, banks would be as special as central banks would like them to be[56]. As long as the system is based in the basic functions discussed above, banks will remain special and regulation and supervision would still be indispensable for the economy to work as we know it today.

[52] Ibid.
[53] R. Lastra, above note 1, p. 114; House of the Lords, European Union Committee "The Future of EU Financial Regulation and Supervision. <https://publications.parliament.uk/pa/ld200809/ldselect/ldeucom/106/106i.pdf>. accessed 20 January 2018.
[54] T. Huertas, above note 3, p. 12.
[55] B. Broadbent "Central banks and digital currencies" (March 2, 2016). <https://www.bankofengland.co.uk/-/media/boe/files/speech/2016/central-banks-and-digital currencies.pdf?la=en&hash=8D9B0F2911064BD7570B10370DF521FAE174217D> accessed 20 January 2018.
[56] T. Huertas, above note 3, p.1.

ANNEX 2- SYSTEMIC RISK IN INSURANCE AND ASSET MANAGER ACTIVITIES

1. Systemic risk in core and noncore insurance activities

Analyses generally conclude that core insurance activities pose little systemic risk in comparison with banking activity. The main explanation for this is that insurers generally have a high capital to liability ratio, small exposure to short-term liabilities and resilience to shocks.[1]

Insurance activities may be classified into core activities and noncore activities. Core activities include insurance underwriting, reserving, claims settlement and reinsurance, while noncore (sometimes called "banking activities") refer to asset lending, provision of financial guarantees, issuing credit default swaps (CDS)[2], investing in sophisticated securities and reliance on short term financing.[3]

A part of core insurance activities is sometimes called "traditional insurance", which includes underwriting property, accidents, liability, life, health, and legal risks in the life and non-life sectors.[4]

The literature on systemic risk in traditional non- life insurance concludes that its contribution to systemic risk is very low. These authors explain that the interconnectedness is low, while claims are generally independent from the business cycle. Also, claim settlement is a slow process. Hence, these activities have a low impact on systemic risk.[5]

Regarding life insurance, Harrington and Cummins and Weiss state that systemic risk is higher due to a high fall in asset prices plus a mix of high leverage. However, shocks to life insurers do not jeopardize the payment system as with commercial banks.[6] The

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[1] S. Harrington "The Dodd Frank Act, Solvency II, and the US Insurance regulation". [2013]The Journal of Financial Perspectives, EY p.4; Geneva Association "Systemic Risk in Insurance- An analysis of Insurance and Financial Stability [2010] ps. 1-75; J.D. Cummins and M.A. Weiss "Systemic Risk and the US Insurance Sector, Journal of Risk and Insurance" ps. 489-527; C. Guine "Global Systemically Important Insurers" [2014] Financial Stability Report p. 3; IAIS Insurance and Financial Stability "The characteristics of the insurance business model including insurance techniques make it very unlikely for traditional insurance to be systemically relevant" p. 18 (IAIS, 2011) <https://www.iaisweb.org/page/supervisory-material/other-supervisory-papers-and-reports//file/34379/insurance-and-financial-stability-november-2011> accessed 15 March 2018.

[2] "CDS or credit default swaps. These offer protection against the non-payment of unsecured corporate or sovereign debt. A typical CDS contract features one counterparty agreeing to "sell" protection to another. The "protected" party pays a fee each year in exchange for a guarantee that if a bond goes into default, the seller of protection will provide compensation" S. Ishmael "A PIK of the ABCDS of arcane credit derivative terminology" <https://bazaarmodel.net/phorum/read.php?1,4127> and *Financial Times* Lexicon <http://lexicon.ft.com/Term?term=credit-default-swap--CDS>. accessed 15 March 2018

[3] J.D. Cummins and M.A. Weiss above note 1 ps. 489-527

[4] Ibid.

[5] J.C. Trichet "Financial Stability and Insurance Sector" Geneva Papers on Risk and Insurance-Issues and Practice, 30, (2010) ps. 65-71; J.D. Cummins and M.A. Weiss above note 1 ;Geneva Association above note 1 ps. 1-75.; J. D. Cummings and M.A, Weiss, above note 1 ps. 489-527.

[6] S. Harrington "The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation" The Journal of Risk and Insurance, Vol 76 No 4 (2009) ps. 785-819.

Geneva Association, Klein, and Eling affirm that there is “no systemic risk” from life insurance activity. The main argument for this is that the failure of a life insurance company will not impact negatively on participants and the economy in general. According to them, the experience of insurance company bankruptcy was not contagious, and would not imply fire sales since the insolvency proceeding is a long process.[7]

Analyzing reinsurance activity, Baluch[8], Cummins and Weiss[9] believe reinsurance might be more risky than other core activities due to the concentration of the reinsurance market and because there is high interconnectedness between insurance and reinsurance companies. Also, the bankruptcy of one reinsurer could trigger contagion in other reinsurance companies. However, based on a study by Park and Xie[10] on the impact of global reinsurance insolvency on the US, Cummins and Weiss conclude that the failure of a reinsurance company would be “minimally disruptive” in the US insurance market. In addition they observe that historically, reinsurance failures have not been a cause of insurance bankruptcies.[11]

Yet noncore insurer activity does “constitute a potential source of systemic risk, and interconnectedness among financial firms has grown significantly in recent years”.[12] The literature found that some underwritings of non-life activities such as financial guarantees and CDS increase insurer vulnerability.[13] Eling et al, Drake and Neale, Chen et al and the Geneva Association found that financial guarantee businesses which underwrite debt and structure finance products have a strong interconnectedness with the financial system because banks are exposed to guaranteed derivatives.[14]

As it is common that CDS sellers provide collateral based on the risk of bankruptcy, CDS underwriting business is exposed to liquidity risk. A majority of academics, regulators and industry actors conclude CDS underwriting “increases vulnerability to impairments of the financial system”.[15] Finally, according to the Geneva Association, another cause of systemic risk is the “mismanagement of short term funding raised using commercial paper or securities lending” which may lead to liquidity risk.[16]

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[7] Geneva Association, above note 1, ps. 1-75; R. W. Klein “Insurance Market Regulation: Catastrophe Risk, Competition and Systemic Risk in G. Dionne (ed) *Handbook of Insurance* (Springer 2013) ps. 909-939; J.D. Cummins and M.A Weiss, ibid; M. Eling and D. Pankoke, “Systemic Risk in the Insurance sector: A review and directions for future research” [2016] Risk Management and Insurance Review p. 276

[8] F Baluch, S. Mutenga and C. Parsons “Insurance, Systemic Risk and Financial Crisis” [2011] Geneva Papers on Risk and Insurance-Issues and Practice, 36(1) ps. 126-163.

[9] J. D. Cummings and M.A, Weiss, above note 1 ps. 489-527.

[10] S.C. Park and X. Xie “Reinsurance and Systemic Risk: The Impact of Reinsurer Downgrading on Property-Casualty Insurers”, [2011]. Working Paper, California State University.

[11] J. D. Cummings and M.A, Weiss, above note 9, ps 487-527.

[12] Ibid, p 524. See M. Eling and D. Pankoke, above note 7, p. 276.

[13] M. Eling et al, ibid.

[14] Ibid; H. Chen, J.D Cummins, K Viswanathan and M.A. Weiss “Systemic Risk Measures in the Insurance Industry: A Copula Approach; working paper, [2013]; Template University; P. Drake and F.R. Neale “Financial Guarantee Insurance and Failures in Risk Management”, [2011] Journal of Insurance Regulation” 30 (2) ps. 29-76; Geneva Association, above note 1 ps 1-75.

[15] F. Heyde and U Neyer “Credit Default Swaps and the Stability of the Banking Sector” International Review of Finance (2010) ps. 27-61

[16] Geneva Association, above note 57, p. 7.

To sum up, core insurance activity would not pose systemic risk, while some noncore insurance activities—which resemble banking activities—, would pose systemic risk and would, therefore, need to be on the radar of the regulators.

2. Systemic risk in Asset Management Industry

The asset management industry is an agency activity where assets are managed on behalf of end-investors, mainly by two types of vehicles: 1) mandates where a single investor´s (usually a high net worth individual) assets are managed separately[17] and 2) funds of various end-investors which are managed jointly (usually small investors).[18]

The key economic function of the asset manager industry is channelling savings towards productive activities. It also helps small investors to gain access to capital markets, while providing short- and long-term financing to corporations and government. In addition, it contributes to price discovery.[19] An important aspect of the role of the asset manager industry is the spread of losses across end-investors due to its agency nature. Losses are borne by clients rather than management companies. Assets are held by a custodian in the name of the client rather than the asset manager.[20] The main revenues of asset managers are fixed basis points fees from client assets under management.[21]

Because of the industry's agency nature, asset managers "do not bear credit, market and liquidity risk on their portfolios…Asset Managers are, to a large extent, insolvency-remote".[22]

Even hedge funds, which have fewer regulatory restrictions on leverage, and which may impose restrictions on redemption and may implement a free investment strategy, did not play a "pivotal role" in the GFC[23] and are not seen as a "major concern with respect to their effects on financial stability".[24] This is because managers are small in size, do not achieve "substantial maturity transformation" and use moderate leverage in comparison with banks.[25]

However, according to the Office of Financial Research (OFR) of the US Treasury, some types of asset management activities are like bank activities and may create

[17] The terms and conditions of the separate accounts are established in the Investment Management Agreement (IMA), of contractual nature between client and asset manager.

[18] A. Haldane "The age of asset management" BIS Central Bank Speech (LSE, 4 April 2014); J-B. de Franssu, M. de Manuel Aramendia, K. Lanoo "Rethinking Asset Management From Financial Stability to Investor Protection and Economic Growth" Report of CEPS-ECMI Task Force (2012) p. 9; D. Elliot "Systemic Risk and the Asset Management Industry (The Brookings Institution 2014) p.2; C. Lopez "The Asset Management Industry, Systemic Risk, and Macroprudential Policy", Journal of Financial Transformation, 2017, vol: 45 (2017) pp. 121-128; Office of Financial Research (OFR) "Asset Management and Financial Stability" (2013) p.1

[19] J-B Franssu, et al, ibid, p. 10; J. Wan "Systemically Important Asset Managers: perspectives on Dodd-Frank´s Systemic designation Mechanism" Columbia Law Review Vol 116, no 3 (2016) ps 804-841

[20] D. Elliot, above note 18 p 2; OFR above note 293, p.1.

[21] BlackRock "Who owns the assets? Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation (2014) p. 7.

[22] A. Haldane, above note 18, p.4.

[23] D. Elliot, above note 18 p. 6.

[24] J.B Franssu et al, above note 19 p. 10 , J. de Larosière, L. Balcerowicz, O. Issing, R. Masera, C.M. Carthy, L. Nyberg, J. Pérez et al. Report of the High-Level Group on Financial Supervision in the EU, [2009] European Commission, ps 1-67 ; IOSCO "Hedge Funds Oversight", [2009], p. 7. L. Dixon, N. Clancy, K.B. Kumar *Hedge Funds and Systemic Risk* (Rand Corporation, 2012) p xxvi.

[25] J.B Franssu et al, above note 24 p.10.

vulnerabilities. These include “risk taking in separate accounts” and “reinvestment of cash collateral from securities lending”. The critical factors acknowledged to be vulnerable to shocks are: “1) “reaching for yield” and herding behaviours; 2) redemption risk in collective investment vehicles; 3) leverage, which can amplify asset price movements and increase the potential for fire sales, and 4) firms as sources of risk”.[26]

This first factor of vulnerabilities- reaching for yield- is identified by OFR as “seek(ing) higher returns by purchasing relatively riskier assets than they would otherwise for a particular investment strategy”. The main reason for this is the existence of a low interest rate scenario. Also, “herding” refers to those behaviors of asset managers that tend to buy popular asset classes “regardless of the size or liquidity” of the assets. The consequences of these behaviours would be the increase in asset prices, enlarged market volatility and distress if there is a sudden shock.[27]

The second factor is redemption risk. Asset managers (especially collective investment vehicles which offer unrestricted redemption rights) may be susceptible to sudden and large redemptions. In scenarios like this, investors may think they would get an economic advantage over slower-to-redeem investors, creating a race to redeem first. In some cases investors may believe there will be a sponsor support of the fund, even though there is no legal basis for that. Owing to reputational damage, some funds may be obliged to offer such support. If there exists a feeling in the market that such support is failing, large investors would be tempted to redeem funds extensively.[28]

The third factor is leverage. The GFC showed that companies that use leverage might be subject to margin calls and liquidity constraints that increase the risk of fire sales in stress scenarios. Leverage can be obtained through borrowing, derivatives, securities lending and repo agreements.[29]

The fourth factor is the firm as a source of risk. The failure of a large asset management firm may be a source of risk, depending on size, complexity and interconnectedness with other financial firms. The distress of a large asset manager may spread risks to other actors within the financial system. For instance, some asset manager companies offer in-house broker dealer services, trust companies, captive insurance, and consulting to other asset managers. Additionally, there are subsidiaries in many countries which increase the difficulty of supervision. A firm failure may also trigger a redemption run over its funds due to a lack of confidence in the safety and soundness of the firm.[30]

The OFR have encountered opposition in the industry and from other regulators. The SEC Commissioner Daniel Gallagher has stated that “applying bank regulatory principles to capital markets regulation is a fatally misguided approach, the regulatory equivalent of trying to jam a square peg into a round hole”.[31]

Scholars and industry actors argued that because of their agency nature, asset managers do not have the same kind of “balance sheet obligations” that would complicate the

[26] OFR see above note 74, p 2.
[27] Ibid, p.9
[28] Ibid, p.14
[29] Ibid, p.18
[30] Ibid, p. 20
[31] D. M. Gallaguer, Comment Letter on OFR Study on Asset Management Issues 2 (May 15, 2014).

"unwinding process". If an asset manager fails, the end investors would change custodian and continue investing their assets as before[32].

As for the first factor, Lopez argues that it is "unclear to what extent these herding dynamics contribute to financial bubbles or if they are merely symptomatic".[33] According to Elliot, it is unclear that the herding behaviour of asset managers differs from what end investors would do and that "it is easy to overstate" the systemic risk posed by this factor, since the total net risk is small compared to the size of the invested assets.[34]

As for the second factor, scholars and industry actors point out that the redemption risk depends on the entity under consideration. While the separate account does not present systemic risk since there is no first-mover advantage, there are some Collective investment vehicles (CIVs) that may induce this move by investors.[35] Elliot affirms that, apart from the money market funds that resemble in certain ways banking deposit activity, the rest of the industry, as investors are fully aware of their risks of losing money (unlike in the bank) it is not clear that CIVs would create new systemic risk that would not have existed in the clients investing directly.[36]

While leverage is recognized as a factor for vulnerability in general, according to Elliot "it does not appear to be a huge factor for the industry as a whole".[37] US Mutual funds and other regulated funds "make little or no use of leverage".[38] High leverage is generally limited to hedge funds and private equity funds, which is a small part of the share of the industry.[39] However, Blackrock believes leverage is a better metric to screen systemic importance. It also affirms that "without substantial leverage, we believe there is little chance that an investment fund could present systemic risk".[40]

Finally, the commentators argue that the firm would not pose systemic risk per se, since the failure of asset managers in the past has not posed systemic risk, and because the agency nature of asset management activity make asset managers' failures smooth in that clients may just change custodian and continue their activity. Also owing to the industry's nature, end-investors bear all losses and do not benefit from insured deposits or a central bank discount window.[41]

[32] D.M. Gallaguer, ibid, J. Wan, above note 75, p. 826; Blackrock, above note 77.
[33] C. Lopez. Above note 18, p. 123.
[34] D. Elliot, above note 18, p. 9
[35] Blackrock, above note 17, p. 12
[36] D. Elliot, above note 18, p. 9
[37] D. Elliot, ibid, p. 9
[38] D. Waters, "Financial Stability and Regulated Funds" ICI Global (March 2014).
[39] H. Oura "The Asset Management Industry and Financial Stability" (IMF, 2015) p.1
[40] Blackrock "Comments on the Consultative Document of Assessment Methodologies for Identifying Non-Bank, Non-Insurer Global Systemically Important Financial Institutions" (2014) p. 9.
[41] Blackrock, ibid, p.4

ANNEX 3. INSURANCE REGULATION IN GERMANY, UK AND US

1. Insurance regulation in Germany

The 'Allfinanz phenomenon', where financial institutions cross-sell banking and insurance products under the same roof, developed in Germany in the second part of the 1980s. As part of this process, two powerful financial conglomerates were formed: Deutsche (which acquired Deutsche Herold and Gerling) and Dresdner Allianz. The latter financial groups formed a pact in 1988. In 1991 Allianz (the biggest German insurance company) acquired 22% of Dresdner (third biggest bank in Germany).[1] In 2001 the insurer acquired Dresdner Bank for more than €20 billion. 7 years later, in August 2008, Allianz sold Dresdner Bank to Commerzbank[2] for €9.8 billion.[3] At a later stage, in 2014 DB sold its stake in Deutsche Herold and in 2016 it sold its shares in Abbey Life Assurance Company, closing the Allfinanz period for both Deutsch Bank (DB) and Allianz. When big financial conglomerates combining insurance and banking in Germany had lost influence, DB was willing to give Allfinanz a second chance. This time, focusing on digital technology. In 2018 it partnered with Friendsurance to offer online insurance products. DB transformed itself into an insurance broker.

In 2020, according to the Joint Committee[4] there were 6 financial conglomerates with a coordinator in Germany which are not exempted from supplementary supervision:

- DZ Bank Gruppe, a banking group with net income of €907 million from insurance business in 2017, reflecting a rise in premiums earned in all segments of R+V Insurance company subsidiary.[5]
- Allianz, which holds Allianz Investment Bank AG, and develops an Asset Management Division internally.[6]
- DEBEKA Group, an insurance company which offers opening bank accounts with its partner BBBank.[7]
- Inter Group.

[1] E. Owen Smith *The German Economy* (Taylor & Francis Group 2002), p.337.
[2] According to 2016 Commerzbank Annual Report, the "Insurance business" income for 2016 was 0. Its mBank subsidiary sold its insurance business to AXA in 2015 for €45 M.
[3] M. Thomas "Allianz and its fateful acquisition of Dresdner Bank", Strategic Direction, Vol. 32 Issue: 6, (2016) pp.23-26.
[4] Joint Committee "List of Financial Conglomerates 2020 Financial conglomerates with head of group in the EU/EEA" (October 2020) https://esas-joint-committee.europa.eu/Publications/List%20of%20Financial%20Conglomerates%202020.pdf accessed 6 September 2019
[5] DZ Bank Annual Report 2017, p 4 https://www.dzbank.de/content/dzbank_com/en/home/DZ_BANK/investor_relations/reports/Archiv.html accessed 6 September 2019
[6] Allianz 2017 Annual Report https://www.allianz.com/v_1520585373896/media/investor_relations/en/results_reports/annual_report/ar2017/en-se-2017-annual-report-allianz-se.pdf accessed 6 September 2019.
[7] Deberka.de https://www.debeka.de/produkte/konten/index.html accessed September 6, 2018

- LVM Group, an insurance company which owns Augsburger Aktienbank AG (AAB).[8]
- Signal Iduna Gruppe, an insurance and asset management group.[9]
- Wüstenrot und Württembergische Group, an insurance-focused financial conglomerate, with a banking business sector.[10]

The importance of the integration of financial services was one reason why in 2002 the government consolidated the three different supervisory agencies for banking (BAkred), insurance (BAV) and securities (BAWe) into the newly created BaFin.[11] Insurance supervision is based on the Insurance Supervision Act (*Versicherungsaufsichtsgesetz* - VAG). Both federal government and the federal states share responsibility for insurance supervision. Insurance companies require a license to operate. In the EEA, the "single license principle" applies, therefore insurers who have been granted a license in another EEA country would be allowed to provide services in Germany.[12] Insurance companies may engage only in insurance business and directly related business.[13] The Insurance Supervision Act defines the "Segregation of Business" principle by which an insurance company may not engage in various lines of insurance at the same time. For instance, a life insurance company may not participate in health or property insurance.[14] There are also requirements as to what permissible legal entities may engage in insurance business. According to section 7: "(1) The authorization may only be granted to public limited companies, mutual societies and corporations and institutions under public law. The head office must be located in Germany." Section V (c) of the Insurance Supervision Act regulates the supplementary supervision of insurance undertakings forming part of a financial conglomerate in Germany.

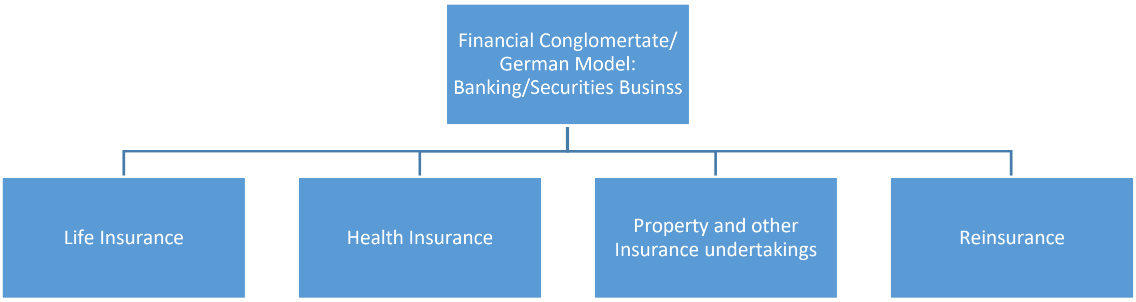
The Insurance Supervision Act also regulates reinsurance business. Like the insurance business, BaFin needs to authorize reinsurance companies, which may only be granted to certain legal entities: i) public limited companies, ii) mutual societies and iii) corporations and institutions under public law. The head office must be located in Germany. The segregation principle also applies to reinsurance, since BaFin requires an operating plan

[8] Augsburger Aktienbank https://www.aab.de/aabweb/partner/Unternehmen/aktionaer accessed 6 September 2019.
[9] Signal Iduna Gruppe https://www.signal-iduna.de/privatkunden/geld-und-vermoegen/investmentanlagen.php accessed 6 September 2019.
[10]Wüstenrot und Württembergische Group, https://www.wwag.com/en/ueber_uns/unternehmen_der_w_w_gruppe/Groupcompanies.html accessed 6 September 2019.
[11] M. Schuler "Integrated Financial Supervisor in Germany" Discussion paper No. 04-35 (ZEW, 2004).
[12] M. Eichhorst "The Insurance and Reinsurance Law Review – Germany" Edition 5 (2017) The Law Reviews https://thelawreviews.co.uk/edition/the-insurance-and-reinsurance-law-review-edition-5/1141028/germany accessed 11 September 2018.
[13] Section 7 (2) of the Insurance Supervision Act: "(2) Beyond insurance business, the insurance undertakings are only permitted to carry on such other business as is directly related with insurance business. Such a relationship shall be deemed to exist in the case of dealings in futures, options and other financial instruments if these are to serve as hedge against price and interest rate risks in connection with existing assets or future purchases of securities or if any additional return is to be generated on existing securities, without performance of delivery obligations causing a shortfall of the restricted assets."
[14] Section 106c Insurance Supervision Act, see also Bafin "Insurance Supervision" https://www.bafin.de/EN/DieBaFin/AufgabenGeschichte/Versicherungsaufsicht/versicherungsaufsicht_node_en.html accessed 11 September 2019,

that “may be limited to property and casualty reinsurance, including personal reinsurance other than life reinsurance (non-life reinsurance), or life reinsurance.”[15]

According to the 2016 GSII list, Allianz is the only German GSII, along with Aegon N. V. American International Group, Inc., Aviva plc, Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc. and Prudential plc.[16]

Figure 1. How insurance business is organized in Germany under the Segregation Principle



Source: own compilation

2. Insurance Regulation in the UK

The British insurance market has been historically relevant and today, London is one of the biggest insurance clusters in the world. “The London insurance market continues to be the largest global centre for commercial and speciality insurance risks, controlling more than US$91 billion in gross written premiums.”[17]

The main regulatory framework for insurance and reinsurance in the UK is based in the Financial Services and Markets Act 2000 (FSMA) as amended, and the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (RAO). The PRA Rulebook and FCA Handbook complement these. On the European side, Directive 2016/97/EU on insurance distribution (Insurance Distribution Directive), regulates authorisation, passporting and regulatory requirements for intermediaries/distributors. The regulatory bodies are PRA, FCA and Lloyds (Lloyd's brokers and members' agents are regulated by Lloyd's and FCA.)[18]

Schedule 2, FSMA states “Contracts of insurance” are regulated activities. By contracts of insurance, the schedule means “Rights under a contract of insurance, including rights

[15] Section 120 Insurance Supervision Act
[16] FSB 2016 list of global systemically important insurers (G-SIIs) http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-insurers-G-SIIs.pdf
[17] J. Hill, and E. Ligere, “Insurance and reinsurance in the UK (England and Wales): overview” (Thomson, 2018)
[18]Ibid.

under contracts falling within head C of Schedule 2 to the Friendly Societies Act 1992." Also, it is a regulated activity "In the case of an investment which is a contract of insurance, which includes carrying out the contract."[19]

Chapter III 10 of the RAO specify regulated activities as of section 22 of FSMA (Regulated Activities): "1) effecting a contract of insurance as principal is a specified kind of activity. (2) Carrying out a contract of insurance as principal is a specified kind of activity."[20] There are certain exclusions such as Community Co-insurers and certain types of vehicle accident.[21] According to the General part of RAO, a "contract of insurance" means "any contract of insurance which is a contract of long-term insurance or a contract of general insurance".[22] Contracts of General insurance are: Accident, Sickness, Land vehicles, Railway rolling stock, Aircraft, Ships, Goods in transit, Fire and natural forces, Damage to property, Motor vehicle liability, Aircraft liability, Liability of ships, General liability, Suretyship, Miscellaneous financial loss, Legal expenses and Assistance.[23] Contracts of long term insurance include: Life and annuity, Marriage and birth, Linked long term, Permanent health, Tontines, Capital redemption contracts, Pension fund management, Collective insurance, Social insurance. [24]

However, the FSMA and RAO do not define what an insurance contract is. FCA Handbook refers to the case of *Prudential v. Commissioners of Inland Revenue* [1904] 2 KB 658. The case

> "treats as insurance any enforceable contract under which a 'provider' undertakes: (1) in consideration of one or more payments; (2) to pay money or provide a corresponding benefit (including in some cases services to be paid for by the provider) to a 'recipient'; (3) in response to a defined event the occurrence of which is uncertain (either as to when it will occur or as to whether it will occur at all) and adverse to the interests of the recipient."[25] According to the FCA, "Any contracts that fall outside that description are unlikely to be contracts of insurance."[26]

Any firm willing take part in the insurance and reinsurance business in the UK must file a Part IVA FSMA authorization with the PRA, with the exception of those relying on the EU's passporting regime.[27] PRA regulates insurers that are both subject to Solvency II and those who are not. Solvency II exclude certain insurance undertakings from the Directive. These are those insurance undertaking which fulfils all the following conditions:

> "(a) the undertaking's annual gross written premium income does not exceed EUR 5 million; (b) the total of the undertaking's technical provisions, gross of the amounts recoverable from reinsurance contracts and special purpose vehicles... does not exceed EUR 25 million; (c) where the undertaking belongs to a group,

[19] FSMA, Schedule 2
[20] The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Chapter III, 10
[21] Ibid, Chapter III, 11 and 12.
[22] Ibid, Part I, 3.
[23] Ibid, Schedule 1, Part1
[24] Ibid, Schedule 1, Part1
[25] FCA Handbook, PERG 6.3.4G
[26] FCA Handbook, PERG 6.5.1.
[27] FSMA, Part IVA

> the total of the technical provisions of the group defined as gross of the amounts recoverable from reinsurance contracts and special purpose vehicles does not exceed EUR 25 million; (d) the business of the undertaking does not include insurance or reinsurance activities covering liability, credit and suretyship insurance risks, unless they constitute ancillary risks … (e) the business of the undertaking does not include reinsurance operations exceeding EUR 0,5 million of its gross written premium income or EUR 2,5 million of its technical provisions gross of the amounts recoverable from reinsurance contracts and special purpose vehicles, or more than 10 % of its gross written premium income or more than 10 % of its technical provisions gross of the amounts recoverable from reinsurance contracts and special purpose vehicles."[28]

Insurer firms subject to Solvency II Directive are restricted to pursuit certain activities, described in article 18: "The home Member State shall require every undertaking for which authorisation is sought: (a) in regard to insurance undertakings, to limit their objects to the business of insurance and operations arising directly therefrom, to the exclusion of all other commercial business; (b) in regard to reinsurance undertakings, to limit their objects to the business of reinsurance and related operations; that requirement may include a holding company function and activities with respect to financial sector activities within the meaning of Article 2(8) of Directive 2002/87/EC"[29].

The UK implemented this directive through PRA and FCA. PRA Rulebook and FCA Handbook states (1) "A firm other than a pure reinsurer must not carry on any commercial business other than insurance business and activities directly arising from that business.(2) (1) does not prevent a friendly society which was on 15 March 1979 carrying on long-term insurance business from continuing to carry on savings business. A pure reinsurer must not carry on any business other than the business of reinsurance and related operations."[30]

Also, Solvency II states "Insurance undertakings shall not be authorised to pursue life and non-life insurance activities simultaneously". However, it permits undertakings authorised to pursue life insurance activity to obtain authorisation for non-life insurance activities for the risks of accident and sickness, and it permits undertakings authorised solely for accident and sickness to obtain authorisation to pursue life insurance activity.[31] Additionally, FCA Handbook states "Insurers cannot carry on an insurance mediation activity in respect of a third party's products unless they can show a natural fit or necessary connection between their insurance business and the third party's products".[32]

Article 17 of Solvency II requires "every undertaking for which authorisation is sought …to adopt one of the legal forms set out in Annex III. This Annex require in the case of the United Kingdom: "companies limited by shares or by guarantee or unlimited, societies

[28] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), Art. 4
[29] Solvency II Directive, Art. 18.
[30] FCA Handbook, INSPRU 1.5.13; PRA Rulebook Conditions Governing Business 9.1. These rules only apply to UK Solvency II firms, Lloyd's societies and management agents. PRA Rulebook 9.1.
[31] Solvency II, Art. 74 (1).
[32] FCA Handbook, ICOBS 4.2.6

registered under the Industrial and Provident Societies Acts, societies registered under the Friendly Societies Acts, the association of underwriters known as Lloyd's".[33]

FSMA Section 55A establishes "An application for permission to carry on one or more regulated activities may be made to the appropriate regulator by—(a) an individual, (b) a body corporate, (c) a partnership, or (d) an unincorporated association."[34] Additionally, Schedule 6 state that "if someone is seeking to pursue regulated activities "which consist of or include a PRA-regulated activity relating to the effecting or carrying out of contracts of insurance" it must be (a)a body corporate (other than a limited liability partnership), (b)a registered friendly society, or (c)a member of Lloyd's.[35]

UK approves pursuing insurance and non-insurance activities via different companies of the same group.[36] According to the Joint Committee, there are 11 financial conglomerates with head of group in the EU/EEA with UK as Coordinator. Most of them include insurance as one of the regulated activities:

- Baillie Gifford & Co: "Baillie Gifford is unique in the UK in being a large-scale investment business that has remained an independent private partnership." Mitsubishi UFJ Baillie Gifford Asset Management Limited ('MUBGAM') is a joint venture company between Mitsubishi UFJ Trust & Banking Corporation and Baillie Gifford Overseas Limited. MUBGAM is authorised and regulated by the Financial Conduct Authority.[37]
- Integrated Financial Arrangements Legal & General Investment Management (Holdings) Limited "Legal & General Investment Management, one of Europe's largest asset managers and a major global investor".[38]
- Invesco Group: Invesco is an independent investment management firm headquartered in Atlanta, dedicated to delivering an investment experience that helps people get more out of life. Invesco Perpetual Life Limited, is an insurance company.[39]
- Goldman Sachs: "The Goldman Sachs Group, Inc. is a leading global investment banking, securities and investment management firm that provides a wide range of financial services".[40]
- Barclays is the second banking group measured by assets in the UK. It includes the insurance company "Barclays Insurance Services Company Limited".
- HSBC is the biggest banking group by total assets in the UK. It includes HSBC Life (UK) Ltd. Which offers Life insurance.

[33] Solvency II, Annex III.
[34] FSMA Article 55A.
[35] FSMA Schedule 6.
[36] J. Smethurst and S. Rudin "Confining insurers to insurance business" (Lexology, 2018) https://www.lexology.com/library/detail.aspx?g=583c5504-11d8-461b-a97c-5023992a4dc1 Accessed 28 February 2019.
[37] Baillie Gifford & Co https://www.bailliegifford.com/en/uk/about-us/literature-library/our-shared-beliefs/our-shared-beliefs/ Accessed 28 February 2019.
[38] Integrated Financial Arrangements Legal & General Investment Management (Holdings) Limited http://www.lgim.com/ch/en/ Accessed 28 February 2019.
[39]Annual report 2017 https://www.invesco.com/corporate/dam/jcr:0da968cd-32b0-4625-92dd-c305b6dbcd4c/IVZ-AR-2017-1.pdf Accessed 28 February 2019.
[40]Goldman Sachs https://www.goldmansachs.com/our-firm/index.html

- Lloyds Banking Group "The Group's main business activities are retail and commercial banking, general insurance and long-term savings, provided under well recognised brands including Lloyds Bank, Halifax, Bank of Scotland and Scottish Widows".[41]
- Old Mutual: A South African group which provide "product solutions, addressing both protection and savings needs, as well as short term insurance solutions through Old Mutual Insure, as well as asset management through the Old Mutual Investment Group or the selection of funds for customers to invest in through multi-managers."[42]
- Sanlam: a South African financial services group, which pursues insurance, investment banking and consulting solutions. [43]
- Schroders: a UK asset manager firm "Schroders is an asset manager operating from 29 countries across Europe, the Americas, Asia and the Middle East"[44] It owns Burnaby Insurance (Guernsey) Limited, an insurance company.[45]
- The Carlyle Trust Group: "The Carlyle Group is a global investment firm with $216 billion of assets under management across 343 investment vehicles. Founded in 1987 in Washington, DC, Carlyle has grown into one of the world's largest and most successful investment firms".[46] It owns

According to the 2016 GSII list, which is the last published by FSB, Aviva plc and Prudential plc are the only British GSIIs, along with Aegon N.V, Allianz SE, American International Group, Inc., Axa S.A., MetLife, Inc. Ping An Insurance (Group) Company of China, Ltd. Prudential Financial, Inc.[47]

3. Insurance regulation in the US

State law regulates insurance in the USA since the McCarran-Ferguson Act of 1945.[48] In 1868, SCOTUS in *Paul v Virginia* held that insurance was not "interstate commerce" and it was not in conflict with the US Constitution that states "the citizens of each State shall be entitled to all the privileges and immunities of citizens in the several States".[49] For 75 years the federal government could not regulate the insurance business. In 1944, SCOTUS reversed *Paul v Virgina* in *US v South-Eastern Underrwiters Ass´n* where it

[41] Lloyds 2018 Annual Report. Accessed 28 February 2018

[42]Old Mutual https://www.oldmutual.com/about/who-we-are Accessed 28 February 2018

[43] Sanlam https://www.sanlam.co.za/Pages/default.aspx Accessed 28 February 2018

[44] Schroeders https://www.schroders.com/en/about-us/welcome-to-schroders/

[45]Schroeders Annual report 2017 https://www.schroders.com/en/sysglobalassets/global-assets/global/annual-report/documents/Schroders-AR17.pdf?1 Accessed 28 February 2018.

[46] The Carlyle Group https://www.carlyle.com/corporate-overview Accessed 28 February 2018.

[47] FSB 2016 list of global systemically important insurers (G-SIIs) http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-insurers-G-SIIs.pdf Accessed 28 February 2018

[48] R. Lastra, *International Financial and Monetary Law* (OUP 2015), p. 135; S. Randall "Insurance regulation in the United States: regulatory Federalism and the National Association of Insurance Commissioners" 26 Florida State University Law review 625 (1999); A. Abramovsky, I. Mason, R. Tischner and S. Bessman "Enforcement: a survey of three approaches to insurance regulatory enforcement: the USA, the UK and Sweden" in J. Burling, and K. Lazarus, (Eds) *Research handbook on International insurance law and regulation* (Edward Elgar 2012); J. Macey and G.. Miller, "The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation", 68 N.Y.U. L. Rev. 13 (1993).

[49] *Paul v Virgina* 75 US (8 Wall) 168 (1868).

held that insurance may be a matter of federal regulation.[50] In 1945, Congress passed the McCarran-Ferguson Act that provided "the business of insurance, and every person engaged therein, shall be subject to the laws of the several states which relate to the regulation or taxation of such business". 15 USC § 1012 state that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance". The same act specifies that certain acts (Sherman Act, Clayton Act, and Federal Trade Commission Act), "shall be applicable to the business of insurance to the extent that such business is not regulated by State Law".[51] SCOTUS in *Sec v National Securities Inc.* explained the scope of the State powers over the business of insurance and other activities. SCOTUS stated:

> "The statute did not purport to make States supreme in regulating all the activities of insurance companies, its language refers not to the persons or companies who are subject to state regulation, but to laws "regulating the business of insurance". Insurance companies may do many things which are not subject to paramount deferral regulation; only when they are engaged in the business of insurance does the statue apply (….)
>
> Congress was concerned with the type of state regulation that centres on the contract of insurance, the transaction which Paul v. Virginia held was not "commerce." The relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement - these were the core of the "business of insurance." Undoubtedly, other activities of insurance companies relate so closely to their status as reliable insurers that they too must be placed in the same class. But whatever the exact scope of the statutory term, it is clear where the focus was - it was on the relationship between the insurance company and the policyholder. Statutes aimed at protecting or regulating this relationship, directly or indirectly, are laws regulating the "business of insurance."[52]

In order to centralise and give cohesion to this decentralised state system, the National Association of Insurance Commissioners (NAIC) was created. NAIC has expanded its "initial advisory and model law drafting functions until it resembled a federal agency in many ways".[53] Insurance regulation is very similar in each state due to the efforts of NAIC. The goals of insurance regulation in most states include fair trading, protection of insurance company´s solvency, prevention of unfair practices and assuring insurance coverage.[54]

As stated above, Banks were not generally permitted to underwrite insurance under the same roof. However, "the primary routes for banks to sell insurance were under state laws for state-chartered banks, but national banks were allowed to provide credit-related

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[50] *US v South-Eastern Underrwiters Ass´n,* 322 U.S. 533 (1944).
[51] 15 USC § 1012.
[52] Marshall, T. & Supreme Court Of The United States. (1968) U.S. Reports: SEC v. National Securities, Inc., 393 U.S. 453. [Periodical] Retrieved from the Library of Congress, https://www.loc.gov/item/usrep393453/.
[53] S. Randall, above note 48, p. 628-629.
[54] Ibid. See also, S. L. Kimball, The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law, 45 Minn. L. Rev. 471 (1960).

insurance and operate insurance agencies in small towns where they had bank offices”.[55] In 1998 Citicorp, a large bank holding company, announced intentions of merging with Travelers Insurance, in order to form Citigroup. While this was not permissible, the move was made in anticipation of Congress discussions.[56] GLBA did not change the restriction of security and insurance underwriting and sales by depository institutions. However, banks could form conglomerates, which involved those activities.[57] This is a momentous change in the history of US financial evolution, together with DFA and determination of SIFI.

The four largest US banking conglomerates[58], JPMorgan, Wells Fargo, Bank of America and Citigroup took advantage of the new regulations. However, most of them divested their insurance underwriting business to focus on other businesses. Indeed, JPMorgan Chase sold its insurance underwriting business to Protective Life in 2006, while continuing meeting customers’ needs through third party providers.[59] In a similar vein, Wells Fargo announced the sale of its crop insurance business, Rural Community Insurance Services, to Zurich American Insurance Company. By 2018, Wells Fargo divested the personal insurance business because its contribution was not material. [60] On the other hand, Bank of America sells Insurance and annuity products through Merrill Lynch Life Agency Inc., a licensed insurance agency and wholly owned subsidiary of BofA Corp.[61]Citigroup owned Travelers until 2002 when the group span off its Travelers Property and Casualty insurance underwriting business.[62] In 2005 Citigroup announced the sale of Citigroup's Travelers Life & Annuity, “and substantially all of Citigroup's international insurance” businesses, to MetLife for $11.5 billion.[63]

According to the 2016 GSII list, three of the six listed GSIIs are American: American International Group, Inc. MetLife, Inc. and Prudential Financial, Inc.[64]

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[55] Federal Reserve History “Financial Services Modernization Act of 1999, commonly called Gramm-Leach-Bliley” <https://www.federalreservehistory.org/essays/gramm_leach_bliley_act Accessed19 > Accessed 12 September 2019. .

[56] M. Mitchell "Citicorp and Travelers Plan to Merge in Record $70 billion Deal". The New York Times. (7 April 1998).

[57] Ibid.

[58] Federal Reserve Statistical Release https://www.federalreserve.gov/releases/lbr/current/default.htm Accessed 23 September 2019.

[59]JPMorgan Chase “JPMorgan Chase completes sale of insurance underwriting business to Protective Life” <https://jpmorganchaseco.gcs-web.com/news-releases/news-release-details/jpmorgan-chase-completes-sale-insurance-underwriting-business.> Accessed 23 September 2019.

[60] A. Simpson “Wells Fargo Closing Down Its Personal Insurance Business” Insurance Journal 28 November 2017.

[61] Bank of America “Our business” https://about.bankofamerica.com/en-us/who-we-are/our-businesses.html#fbid=RCbxrcbm5AU, Accessed 23 September 2019

[62] Citigroup, Form 8-K, Current Report". U.S. Securities and Exchange Commission. 18 July 2002; P.Beckett “Citigroup to Split Off Travelers Unit In an IPO Expected Early Next Year” Wall Street Journal 20 December 2001.

[63] "Citigroup, Form 8-K, Current Report". U.S. Securities and Exchange Commission. 31 January 2005.

[64] FSB 2016 GSII list https://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-insurers-G-SIIs.pdf Accessed 27 September 2019.

ANNEX 4 Case Studies: Deutsche Bank, Credit Agricole, Barclays, Citi, and Santander

1. Case Study: Deutsche Bank

1.1. Deutsche Bank History

Deutsche Bank (DB) is the most important bank in Germany and it is viewed as a leading financial institution in Europe. DB was founded in 1870 under the leadership of Adelbert Delbrück. According to its statue "The object of the company is to transact banking business of all kinds, in particular to promote and facilitate trade relations between Germany, other European countries and overseas markets". The first two decades the DB contributed to the development of German electrical, iron and steel industries, as well as other overseas projects such as the Baghdad Railway. DB was the first bank in Germany that relied in retail deposits to finance banking, which was an important innovation at the time.[1] DB rapidly expanded into Asia and in 1914 the "Frankfurter Zeitung" announced that DB was "the biggest bank in the world".[2] From 1914 to 1932 Germany was ruled by the Weimar Republic, which turned Germany into an inflationary process. DB merged with Disconto-Gesellschaf, its most important rival in 1929, increasing German bank concentration. From 1933- 1945 DB had to live with the Nazi regime. As the DB official History Chronicle state, "Hitler's seizure of power in 1933 marked the beginning of the darkest chapter in the history of Deutsche Bank. By 1945, after twelve years of National-Socialist rule and six years of war, not only was the bank itself on the brink of the abyss; it had also allowed itself to become a tool of the Nazi state".[3]

After the war over, DB was divided into ten banks[4] and the name "Deutsche Bank" was forbidden. In 1952 the 10 banks were regrouped in three: Rheinisch-Westfälische (Düsseldorf), Süddeutsche Bank (Frankfurt and Munich), and Norddeutsche Bank (Hamburg). In 1957 they merged in DB again. From 1958 to 1988 a stage of internationalization begun for the bank. In the national front, the bank focused on retail banking, while on the international side, it expanded owing banks in Italy, Spain, the UK, and the United States.[5] In 1989, DB acquired the British merchant bank Morgan Grenfell and the New York investment bank Bankers Trust, which opened the American market for DB. DB is today a leading institution in Germany and Europe. However, in 2018 the Fed announced the DB US subsidiary failed the Fed stress test: "Concerns include material weaknesses in the firm's data capabilities and controls supporting its capital planning process, as well as weaknesses in its approaches and assumptions used to

[1] T. Guinnane "Delegated Monitors, Large and Small: Germany´s Banking System, 1800-1914" [2002] Journal of Economic Literature, vol. 40, p. 102

[2] Deutsche Bank History. Chronicle 1870 until today. Available at <https://www.db.com/company/en/media/Deutsche-Bank-History--Chronicle-from-1870-until-today.pdf>accessed 27 August 2020

[3] Ibid

[4] E. Owen Smith The German Economy (Taylor & Francis Group 2002), p. 324

[5] Deutsche Bank History. Chronicle 1870 until today, above note 2.

forecast revenues and losses under stress".[6] After the announcement, Standard and Poor's downgraded the bank´s Credit Rating (Long-Term) to BBB-.[7]

Additionally, DB is the only German G-SIB according to FSB G-SIB List, classified in Bucket 3 with Bank of America, Citigroup and HSBC.[8] In 2016, the IMF announced that DB "Deutsche Bank is also a major source of systemic risk in the global financial system. The net contribution to global systemic risk is captured by the difference between the outward spillover to the system from the bank and the inward spillover to the bank from the system based on forecast error variance decomposition. Deutsche Bank appears to the most important net contributor to systemic risks in the global banking system, followed by HSBC and Credit Suisse"[9]

In March 2017, DB has announced a restructuring plan in order to take

> "a decisive step forward to become stronger and grow again. Decisions agreed by the Management Board and Supervisory Board on Sunday aim to reinforce the bank's roots in its home market of Germany and its position as a leading European bank with global reach. The bank plans to combine Postbank and Deutsche Bank's Private & Commercial client's business, float a minority stake of Deutsche Asset Management and create an integrated corporate and investment bank.".[10]

Three years later, in the 2020 Annual Report DB declared

> "In July 2019, we announced a strategic transformation of Deutsche Bank, designed to significantly improve sustainable returns to shareholders. This strategy is underpinned by four specific objectives. First, to refocus Deutsche Bank around four core businesses, focusing on key areas of strength and on more predictable revenue sources while exiting business areas unlikely to produce adequate returns. Second, to reduce our adjusted costs and improve the efficiency and effectiveness of our infrastructure. Third, to reinvigorate the leadership and spirit of the bank by enabling faster decision-making, increasing discipline in execution and unleashing Deutsche Bank's entrepreneurial culture. Finally, we established the Capital Release Unit to liberate capital consumed by low return assets and businesses that earn insufficient returns or that are no longer core to our strategy, by winding those down in an economically rational manner".[11]

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[6] M. Price, D. Henry "Deutsche Bank fails Fed stress test while three U.S. lenders stumble" (Reuters, June 28, 2018) <https://www.reuters.com/article/us-usa-fed-stresstests/deutsche-bank-fails-fed-stress-test-while-three-u-s-lenders-stumble-idUSKBN1JO33U> accessed 27 August 2019.

[7] Deutsch Bank Ratings, available at https://www.db.com/ir/en/current-ratings.htm, accessed 27 August 2018. For 2021 ratings see <https://www.db.com/ir/en/current-ratings.htm >

[8] FSB 2017 list of global systemically important banks (G-SIBs) http://www.fsb.org/wp-content/uploads/P211117-1.pdf, FSB 2018 list https://www.fsb.org/wp-content/uploads/P161118-1.pdf>, FSB 2019 list https://www.fsb.org/wp-content/uploads/P221119-1.pdf and FSB 2020 List <https://www.fsb.org/wp-content/uploads/P111120.pdf> accessed 24 April 2021.

[9] IMF Country Report No. 16/191, Germany, June 2016.

[10] DB Media release (March 5, 2017), available at https://www.db.com/newsroom_news/2017/medien/deutsche-bank-refines-strategy-and-announces-capital-increase-en-11483.htm accessed 27 August 2018.

[11] DB 2020 Annual Report <https://www.db.com/ir/en/download/Annual_Report_2020.pdf> Accessed 29 April 2021.

1.2 Deutsche Bank Group

DB has its Headquarters in Frankfurt am Main, Germany, and it is the largest bank in Germany and one of the largest financial institutions in Europe, with total assets of € 1,475 billion as of 2018. DB employs 97,535 people, operates in 60 countries out of 2,425 branches. DB "provide(s) services in commercial and investment banking and retail banking as well as wealth and asset management products to corporations, governments, institutional investors, small and medium-sized businesses, and private individuals."[12] DB comprises three corporate divisions, which are supported by infrastructure functions: Corporate & Investment Bank (CIB); Private & Commercial Bank (PCB); and, Deutsche Asset Management (Deutsche AM).[13] DB operates with customers in most countries in the world, through: 1) subsidiaries and branches; 2) representative offices and or representatives assigned to serve customers.

As of 2019 "The Group consists of 628 consolidated entities, thereof 242 (2019: 249) consolidated structured entities. 420 (2019: 459) of the entities controlled by the Group are directly or indirectly held by the Group at 100 % of the ownership interests (share of capital). Third parties also hold ownership interests in 208 (2019: 207) of the consolidated entities (noncontrolling interests). As of December 31, 2020, and 2019, one subsidiary has material non-controlling interests. Non-controlling interests for all other subsidiaries are neither individually nor cumulatively material to the Group"[14]

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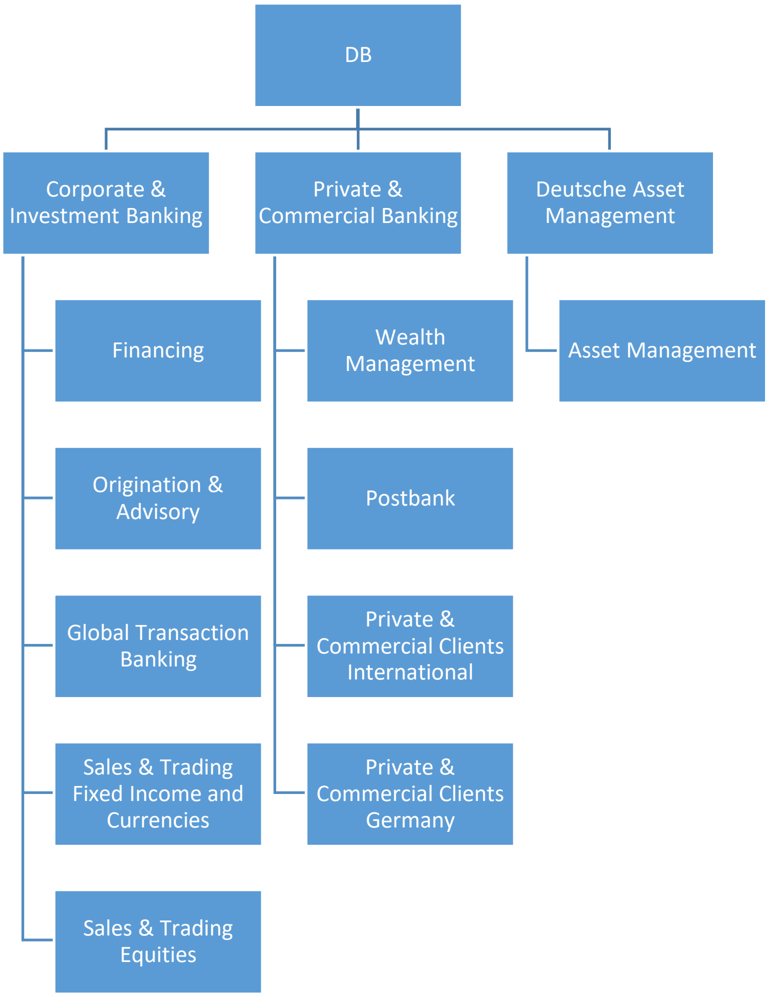
[12] DB Annual Report 2017 <https://annualreport.deutschebank.com/2017/ar/servicepages/downloads/files/dbfy2017_entire.pdf > accessed 20 April 2019.

[13] Ibid.

[14] DB 2020 Annual Report above note 11.

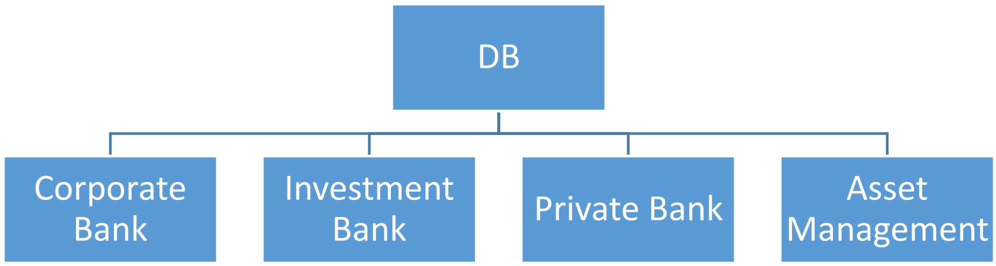
Figure 1. DB Internal Divisions 2017



Source: DB[15]

[15] DB Annual Report 2017 , available at: https://annualreport.deutschebank.com/2017/ar/servicepages/downloads/files/dbfy2017_entire.pdf accessed 27 August 2018.

Figure 2. DB Internal Divisions 2021



Source: DB[16]

According to 2020 Annual Report

> Our strategic transformation is designed to refocus our Core Bank around market leading businesses, which operate in growing markets with attractive return potential. Our Core Bank comprises our four core operating divisions, namely the Corporate Bank, the Investment Bank, the Private Bank, and Asset Management, together with the segment Corporate & Other.[17]

1.3. DB as "House Bank"

DB acted as House Bank of many companies for many years. The house bank would not only own shares of the company, it would take up of Director positions in supervisory boards and rely on "relationship lending". A "classic example" of a house bank relationship is that of DB and Daimler Benz. DB has guided the mergers of Mercedes Benz along time. Until 1994, Daimler Benz president was a senior DB official. Other example was the house bank relationship between DB and Volkswagen.[18]

1.4. Deutsche Bank and Insurance

In 1989 the DB formed the Lebensversicherungs-AG der Deutschen Bank, an insurance company: "Since September 1989 we have been offering life insurance in the Group through a newly-established company, Lebensversicherungs-AG der Deutschen Bank,

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[16] DB Annual Report 2020 above note 13.
[17] Ibid.
[18] J. Canals. *Universal banking: International Comparisons and Theoretical Perspectives* (1997) p. 169; Automotive News "German cross-shareholding system unwinds as Deutsche Bank exits <http" ://www.autonews.com/article/20091101/ANE02/311019997/german-cross-shareholding-system-unwinds-as-deutsche-bank-exits> accessed 12 October 2018.

Wiesbaden. Marketing is carried out mainly via our branches".[19] In 1992 DB "acquired a majority interest in Deutscher Herold AG, Bonn. Deutscher Herold is an insurance group with a long tradition and a good market positioning. Its activities are centred on life insurance business with private individuals and commercial clients. It also offers a wide range of composite insurance products. In addition, we took a 30% stake in GerlingKonzern Versicherungs-Beteiligungs-AG, Cologne" [20]

As of 1995 the DB owed Deutscher Herold Allgemeine VersicherungsAG der Deutschen Bank, Deutscher Herold Lebensversicherungs-AG der Deutschen Bank, Deutscher Herold Rechtsschutzversicherungs-AG der Deutschen Bank, Globale Krankenversicherungs-AG (Germany), DB Vida – Companhia de Seguros de Vida, S.A.(Portugal) DB Vida Compañía de Seguros y Reaseguros, S.A, and DB Vita Compagnia di Assicurazioni e Riassicurazioni sulla Vita S.p.A.(Italy).[21] In 1996 the insurance companies were regrouped under the Retail and Private Client Division.[22]

In May 2014, DB "completed the sale of a 20.2 % stake in Deutsche Herold AG to Zürich Beteiligungs AG, a subsidiary of Zurich Insurance Group AG. We acquired the 20.2 % stake from a third party immediately ahead of selling it to Zurich."[23] In December 2016 DB completed the sale of 100 % of the shares of Abbey Life Assurance Company to Phoenix Group Ltd. As a consequence of this sale all of the Group's insurance contracts business and the majority of the investment contract business were disposed of leaving only € 592 million in a remaining program."[24]

In 2018 DB and the digital insurance broker Friendsurance announced a partnership in order for DB to offer insurance products through the broker. In order "to drive this Deutsche Bank will integrate Friendsurance's digital products into its online banking portal." [25]By doing this, DB is "resurrecting" the concept of Allfinanz or bacassurance" by way of selling insurance products. While the 2016 strategy was to sell its equity in Abbey Life Insurance, the new strategy is to use its digital bank platform to offer insurance to its customers.[26]

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[19] DB Annual Report 1989 available at <http://www.bankgeschichte.de/en/docs/1989.pdf> accessed 27 August 2018.
[20] DB Annual Report 1992, <http://www.bankgeschichte.de/en/docs/1992.pdf> accessed 27 August 2018.
[21] DB Annual Report 1995 available at: <http://www.bankgeschichte.de/en/docs/Annual_Report_1995_(Group).pdf> accessed 27 August 2018.
[22] DB Annual Report 1996 available at <http://www.bankgeschichte.de/en/docs/Annual_Report_1996_(Group).pdf> accessed 27 August 2018.
[23] DB Annual Report 2016, available at https://www.db.com/ir/en/download/Deutsche_Bank_Annual_Report_2016.pdf accessed 27 August 2018.
[24] Ibid. Therefore, DB improved the Bank's CET1 ratio by approximately 10 basis points.
[25] DB Media Release "Deutsche Bank strengthens its insurance business" (January 16, 2018) available at <https://www.db.com/newsroom_news/2017/deutsche-bank-strengthens-its-insurance-business-en-11763.htm> accessed 27 August 2018.
[26] D. Delamaide, Y. Osman, C. Schnell "Deutsche Bank partners with tech firm to offer online insurance product" Handelsblatt Global 16 January 2018 available at <https://global.handelsblatt.com/finance/deutsche-bank-partners-with-tech-firm-to-offer-online-insurance-product-875857> accessed 27 August 2018.

1.5. Investment Banking Business Model

The business model for DS has changed from mainly commercial banking to investment banking from the 1980s and 1990s. "The larger for-profit banks, particularly the Deutsche Bank and Dresdner Bank. Throughout the postwar period, these banks had made most of their profits from the interest rate spread…and the interest they received on loans (most of these were made to the company sector). As has been well documented the slowing of economic growth in the 1980s and 1990s (and thus slowing demand for bank loans from companies) and increased competition among banks led to a narrowing of this interest rate spread. The main alternative to interest-based income for banks is fee-based income, such as investment banking and asset management. These activities are, however, primarily market based, and thus require growing financial markets to increase income. These banks thus became the main supporters of strengthening markets within the German financial system."[27]

Historically, DB has been able to raise money at a rate similar to that of the sovereign since it was seen as "an extension of the German state". However, after the GFC even senior bondholders may be "bailined" if a bank fails, making funding costs increase. "Paying more than big rivals such as France's BNP Paribas and JPMorgan Chase in the US leaves Deutsche's investment bank vulnerable to being priced out of business for its most important institutional clients, which would exacerbate market share declines in key trading and lending businesses, analysts say".[28]

While some think, creating a "National Champion" via a merger with Commerzbank[29] would be a possible solution for DB, in 2019 that chance did not materialise[30].

1.6. Recovery and Resolution Planning

According to DB 2020 Annual Report "We work closely with the Single Resolution Board (SRB) and the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin") who establish the Group resolution plan for Deutsche Bank, which is currently based on a single point of entry (SPE) bail-in as the preferred resolution strategy. Under the SPE bail-in strategy, the parent entity Deutsche Bank AG would be recapitalized through a write-down and/or conversion to equity of capital instruments (Common Equity Tier 1, Additional Tier 1, and Tier 2) and other eligible liabilities in order to stabilize the Group. Within one month after the application of the bail-in tool to recapitalize an institution, the BRRD (as implemented in the SAG) requires such institution to prepare a business reorganization plan, addressing the causes of failure and aiming to restore the institution's long-term viability."[31] (See generally Chapter 6).

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[27] S. Vitols "Changes in Germany's bank-based financial system: A varieties of capitalism perspective" [2004], WZB Discussion Paper, No. SP II-03 p.5
[28] S. Morris, R. Smith and Olaf Storbeck, "Deutsche Bank struggles with rising funding costs" *Financial Times*, (London, September 10, 2018).
[29] Lex "Commerzbank: waiting for Deutsche Bank" *Financial Times*, (London, August 7, 2018).
[30] "Germany's Deutsche Bank and Commerzbank end merger talks" *DW* (Berlin, 15 April 2019) <https://www.dw.com/en/germanys-deutsche-bank-and-commerzbank-end-merger-talks/a-48474225> accessed August 15 2020.
[31] DB Annual Report 2020 above note 13.

2. Case Study: Crédit Agricole

2.1 Universal Banking in France

"Saint Simonian banks" played an important role in the development of the Universal banking model during the Second Empire period due to the persistence and leadership of the Pereire brothers and *Crédit Mobilier*. Contrary to what happened in Germany, in France from 1880 to 1914 "universal banks gave up their universal bank- pattern to be turned into deposit banks (designed to serve exclusively as a source of short-term capital)".[32] Universal banks faced "massive withdrawals" at the time of war in 1870 and following crisis from 1873-1896. In order to prevent further loses, some banks such as *Crédit Lyonais*, *Crédit Industriel et Commercial*, and *Societé Générale* limited the business to short-term loans. "The deposit banks thereby came to specialize in discounting operations as well as advances on securities and loans on securities on the stock carried over"[33] Small and mid-size manufactory firms tended not to use these joint stock banks. Levy-Leboyer and Lescare state that universal banks did not develop in France because: i) Long-term investment come from firms themselves or family and friends; ii) the stock market provided new financing opportunities for large firms; and iii) local banks played an important role.[34] When universal banks were permitted to capture individual´s deposits, they left the business "of investment banking to institutions especially created for that purpose, trustee banks, investment banks, and the stock market… The outcome was specialised banking."[35] The principal investment banks in the nineteenth century were *Banque de Paris et des Pays-Bas* (1872), the *Banque de l´ Indochine* (1875) and the *Banque de l´ Union Parisienne.*[36]

In 1945 De Gaulle nationalised *Banque de France* and the four most important banks, *Crédit Lyonnais, Société Générale*, *Comptoir National d´Escompte de Paris* and *Banque National pour le Commerce et l´Industrie.* Under Chirac government, major banks were privatised including *Société Générale*, *Crédit Commercial de France*, *Paribas* and *Suez. Crédit Lyonnais* was privatised in 1999. [37] *Caisse National de Crédit Agricole* was transformed into a stock company in 1988, which gave it independence from the State, and it was listed in 2001.[38]

Verdier explains that universal banking is commonly believed to exist before 1913 in Belgium, Germany, Austria, Italy, whereas specialised banking "was mostly encountered in France and the Anglo-Saxon countries".[39] While the development of the universal banking model in Germany and France in the nineteenth and almost all of the twentieth

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[32] M. Levy- Leboyer and M. Lescure Chapter 8. "France" in R. Sylla and G. Toniollo *Patterns of European Industrialization* (Rout- ledge, Chapman, and Hall, 1991) p. 164
[33] A. Plessis "The History of banks in France" (Elgar 2003). <http://www.fbf.fr/en/files/888HK2/History_banks_france_EN.pdf4 >accessed 30 October 2018.
[34] Idid, p. 166
[35] D. Verdier "Explaining cross-national variations in universal banking in nineteenth-century Europe, North America and Australasia" in D. Forsyth and D. Verdier *The Origins of National Financial Systems: Alexander Gerschenkron Reconsidered* (Routledge 2002), p. 29
[36] A. Plessis, above note 33, p. 5
[37] Idid, p, 6
[38] Histoire Du Groupe Crédit Agricole (Crédit Agricole, 2018) < https://www.Crédit-agricole.com/le-groupe/histoire-du-groupe-Crédit-agricole >accessed 22 November 2018.
[39]D. Vedier, above note 192, p. 23.

century was different, after 1984, French Banking Act "defined the concept of universal banking". As the *Federation Bancaire Française* affirm "French groups were subsequently able to expand to all business in the banking industry: namely, retail banking as well as corporate and investment banking"[40].

Scholars argue that France shifted from a government-based financial system to a market-based one. The change involved patterns of ownership and financing. State ownership was transferred to "cross-shareholding networks in newly privatised firms" at a first stage, and after de late 90´s, to foreign shareholders[41]. O´Sullivan explains this change as follows. First, there was a contraction of the role of the state in the allocation of funds. Second, the role of financial markets in funding firms "experienced a market expansion" -from 27% of GDP in 1975 to 186% by 2001-. Third, the relevance of the banking sector decayed in comparison to other sources of funding. French deregulation started in 1984. Some believe this movement was a reaction to the "growing integration of financial markets" on the one side, and the pressure for the move to a single currency and the integration of the monetary policy in Europe, on the other.[42]

French deregulation, among other drivers, led to a new phenomenon in the financial industry called "Bancassurance".

2.2. Bancassurance

Bancassurance phenomenon first appeared in France in 1980.[43] There is not a single definition of "bancassurance" since it depends on the strategy adopted by financial institutions. Bancassurance "in its simplest form is the distribution of insurance products through a bank´s established distribution channels. The result is a banking corporation that can offer banking, insurance, lending and investment products to its customers". [44] In general terms, it "refers primarily to banks entering the insurance sector by offering insurance products to their retail customers".[45] According to the Cambridge Dictionary, Bancassurance is "a business activity in which banks sell services and products usually sold by insurance companies" or "the combination of banking and insurance services that is offered by many banks".[46] Oxford Dictionary defines Bancassurance as "[t]he selling of life assurance and other insurance products and services by banking institutions".[47] The Financial Times Lexicon define the term as "The combining of banking and

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[40] Federation Bancaire Francaise "The French Banking System" (2008) p. 1.
[41] M. O´Sullivan "Acting out institutional change: understanding the recent transformation of the French Financial System" [2017] Socio-economic Review p. 396.
[42] M. O´Sullivan, ibid, p. 400; M. Loriaux France *After Hegemony: International Change and Financial Reform* (Cornell university Press 1991).
[43] P. Artikis, S. Mutenga and S. Staikouras "A practical approach to blend insurance in the banking network" The Journal of Risk Insurance, Vol 9 Issue 2, (2008) p. 107; F. Fiordelisi and O. Ricci *Bancassurance in Europe, Past, Present and Future*, p. 1
[44] M. Nurullah and S. Staikouras "The separation of Banking from insurance: Evidence from Europe" Multinational Finance Journal 2008, vol 12, p. 159.; E. Clipici and C. Bolovan "Bancassurance-Main insurance distribution and sale channel in Europe, Scientific Bulletin- Economic Sciences, Volume 11 (2012), p. 54.
[45] T. Hoschka *Bancassurance in Europe* (St. Martin´s Press, 1994), p.1.
[46] Cambridge Dictionary <https://dictionary.cambridge.org >accessed 12 November 2018.
[47] Oxford Dictionary <https://en.oxforddictionaries.com/definition/bancassurance >accessed 12 November 2018.

insurance activities in one organization".[48] While originally the term was adopted to define a distribution phenomenon, today it is used to define "all kinds of relationships between banking and insurance industries".[49] The "assurfinance" phenomenon refers to insurance companies selling financial products.[50]

Gonulal, Goulder and Lester explain that bancasurance is "the process of using a bank´s branches, sales network, and customer relationships to develop sales or insurance products…It is not simply a sales technique. It is a development channel." Bancassurance is the "development channel" and there is no requisite for the insurance company to be wholly owned by the bank. There is "nothing intrinsic" in Bancassurance that require ownership linkages between the bank and the insurance company.[51]

The French financial sector is "concentrated and connected through cross- shareholdings" between the banking and insurer´s sectors. A majority of French banks hold insurance company subsidiaries, such as:

Table 1. French BBFCs with insurance company subsidiaries

Bank	Life Insurance	Nonlife Insurance
BNP Paribas	Cardif	Avanssur (AXA subsidiary)
Groupe Banque populaire Caisse d'Epargne (BPCE)	Assurance Banque Populaire vie, prévoyance et non-vie	Assurance Banque Populaire vie, prévoyance et non-vie
Groupe Crédit Agricole	Predica	Pacifica
Groupe Crédit Mutuel Proposes	Groupe Crédit Mutuel Proposes	Groupe Crédit Mutuel Proposes
HSBC France	HSBC Assurances	HSBC Assurances
Banque Postale	Banque Postale Prévoyance	Banque Postale Prévoyance
Société Générale	Sogecap	Sogessur

Source: IMF[52]

[48] Financial Times Lexicon <http://lexicon.ft.com/Term?term=bancassurance> accessed 12 November 2018. In a similar way, Elkington defines bancassurance as the provision of and selling of banking or insurance products by the same organization under the same roof. W. Elkington *Bancassurance* [1993] Chartered Building Societies Institutions Journal (1993) p.2.
[49] F. Fiordelisi and O. Ricci, above note 43.
[50] L. Van den Berghe and K. Verweire "Convergence in the Financial Services Industry" [2001] The Geneva Papers on Risk and Insurance Vol 26 No. 2 p. 175.
[51] S. Gonulal, N. Goulder and R. Lester "Bancassurance- A Valuable Tool for Developing Insurance in emerging Markets" [2012] Policy Research Working paper 6196, The World Bank, ps. 9-10.
[52] IMF "France: Financial Sector Assessment Program— Detailed Assessment of Observance of Insurance Core Principles" [2013[p. 14.

2.3. Models of Bancassurance

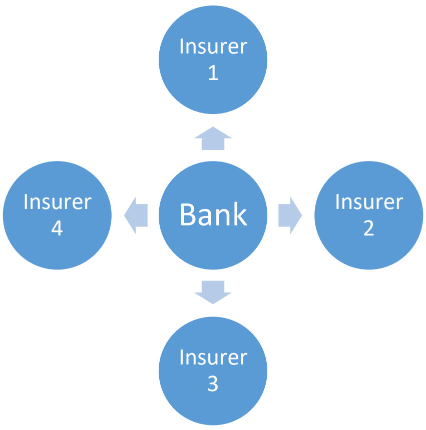
There are different models of bancassurance according to the degree of integration of insurance and banking.

The first mode of entry is called "multi-tie or referral" where banks distribute insurance products for a fee. [53]Its aim is to bypass the middle agent and take advantage of the bank customer database to offer products. After the introduction of the Freedom of Services Directive in Europe, insurers avoided setting up offices but use bank branches to offer their products. These products are offered via branches, internet, apps and other supports.[54] The bank may choose more than one alliance. Generally, both parties remain autonomous.[55] Figure 3 describes the first model, in which a single bank holds four commercial agreements with four different insurers.

The second mode of entry relies on joint ventures, where both insurers and bankers put resources together and form a separate entity (Figure 4), which will have to "blend cultures" and share risks.[56]

The third mode of entry is through financial conglomerates[57]. This type of bancassurance model is the most integrated one, since it involves an "extended capital commitment" and "adequate pool of skilled professionals" and a strong brand. This model is the most widespread in France.[58]

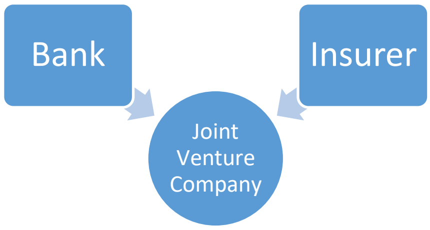
Figure 3. Model 1. Multi-tie or Referral



Souce: own complilation

[53] P. Artikis, S. Mutenga and S. Staikouras, above note 43, p. 107; M. Teunissen "Bancassurance: Tapping into the Banking Strength" [2008] The Geneva Papers 33, p. 409; P. Trainar "La Bancassurance: Generalization ou déclin du modèle? [2008] Revue déconomie financière p. 53.
[54] P. Artikis, S. Mutenga and S. Staikouras, above note 43, p. 107.
[55] S. Staikouras "Business Opportunities and Market Realities in Financial Conglomerates". The Geneva Papers, (2006) 31, p. 139
[56] Ibid, p. 119; E. Clipici and C. Bolovan, above note 44, p. 54; M. Teunissen, above note 53, p. 409.
[57] See Chapter 2.
[58] Ibid, p. 119; M. Teunissen, above note 53, p. 409.

Figure 4. Joint Venture



Souce: own complilation

2.4. Drivers of Bancassurance

Teunissen explains there are a number of drivers that underpin the development of bancassurance. In the first place, regulation permits banks to owe insurance companies and to distribute insurance products through banking networks. Second, insurers may use the bank databases as new a channel for sales, while international insurers may use local banks to enter new markets. Third, bancassurance is a new source of revenue in times of deregulation and more competition in the financial sector. Fourth, "positive fiscal" treatment of long-term saving products fosters the sale of bancassurance products. Fifth, experience shows bancassurance products are more desirable if they are simple and standardised. Sixth, the bancassurance model proved to be successful in markets where there is no strong alternative distribution channel, such as independent brokers. Seventh, the more integrated the model is, in terms of IT, product development, sales and remuneration, the more successful bancassurance would be.[59]

Particularly in France, there are certain factors that supports the bancassurance model. First, the liberalization of bank´s scope of actives permitted banks to expand into insurance. Second, the French tax system encourages savings, fostering the sale of certain insurance products. In the case of life insurance products, they are exempted for tax on the proceeds if they are held for a minimum period. Third, banks take advantage of the marginal cost of distributing insurance because their fixed overheads are covered by the banking activities. Fourth, banks and life insurers extend the term of their liabilities "through the creation of longer term contracts". Fifth, Solvency I permitted a "degree of regulatory arbitrage", though it was "diluted" by the Financial Conglomerates Directive.[60]

2.5 Mutual or Cooperative Banks

The *Code Monetaire et Financier* or Money and Financial Code is the main code regulating financial institutions in France. Book V regulate Financial Service Providers. The French banking sector is composed by:

- Banks (Book V, Chapter 1),

[59] M. Teunissen, above note 53, ps. 412-413.
[60] S. Gonulal, N. Goulder and R. Lester, above note 51 p. 9; Similar causes listed by G. Morgan, A. Sturdy, J. Daniel and D. Knights "Bancassurance in Britain and France: Innovating Strategies in the Financial Services."[1994] The Geneva Papers on Risks and Insurance p. 178.

- Mutual or Cooperative Banks (Book 5 Chapter II: *Banques Populaires, Crédit Agricole, Crédit Mutuel, Crédit Mutuel Agricole et Rural, Sociétés Cooperatives de banque, Crédit Maritime Mutuel, Caisses D´espargne* (Saving Banks)),
- Municipal Credit Banks (Book 5 Chapter IV), which "are local public lending and welfare institutions. Their role is to prevent usury through the granting of loans secured by pledge, in respect of which they have a monopoly. They may execute any transaction with the Credit institutions, accept funds from individuals and legal entities make means of payment available to them and effect related transactions".[61]
- Finance Companies (Book 5 Chapter V)
- State- owned banks:

  -*Caisse des Depôts et Consignations*, which is a "public group in the service of the country's general interest and economic development. Said group fulfils public interest duties in support of the public policies pursued by the State and the local authorities and may engage in competitive activities."[62]
  -*Trésor Public*, which is a public institution with responsibilities in collection of taxes, execution of state budget, with regulation prerogatives in banking and financial issues.[63]
  -*Banque de France,* which is the French Central Bank: "The Banque de France is the French pillar of the Eurosystem, a federal system formed by the European Central Bank and the national central banks of the euro area. Its three main missions are monetary strategy, financial stability and the provision of economic services to the community."[64]
  -Others: *La Banque Postale*, the *Institut d´emission des departaments d´autre – mer* and *Bpifrance* are also public institutions that perform banking activities.

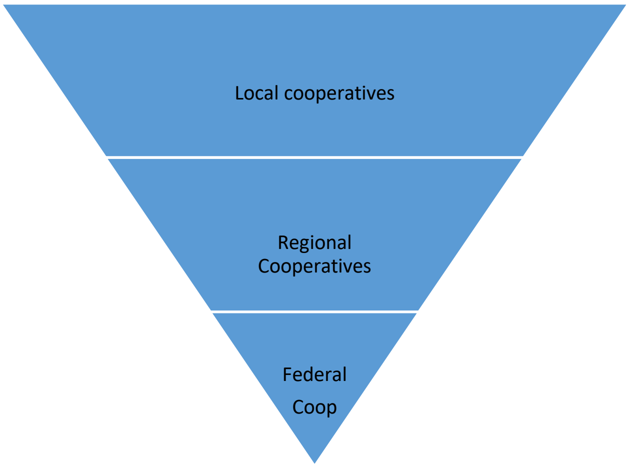
A second category consists of the Mutual or Cooperative Banks. Contrary to Germany, where Saving Banks and Cooperatives are two different categories, in France, the Monetary and Financial Code regulate both institutions under the same chapter. The first saving banks were founded in Paris in 1818 as a private initiative; while in the 19th century, they were recognised as institutions of public utility. From 1950, several laws permitted saving banks to widen their scope of permitted activities, which were restricted to collect savings until then. From 1999, saving banks were induced to use the legal form of cooperative banks. As of today, saving banks exist under the *Banque Populaire Caisse d´Espargne* (BPCE), but are not organised as publicly owned banks anymore.[65]

[61] Monetary and Financial Code, Art. 514-1
[62] Monetary and Financial Code, Art 518-2
[63] O. Hubert and A. Pince, D, Banking regulation in France: overview (Practical Law).
[64] Banque de France< https://www.banque-france.fr/en/banque-de-france/about-banque-de-france/missions >accessed 20 November 2018
[65] D. Bûlbul, R. Reinhard, H. Schmidt and U. Schuwer "Saving Banks and Cooperative Banks in Europe" [2013] White Paper Series No. 5 Center of Excellenece Sustainable Architecture for Finance in Europe, ps 11-12.

The first cooperative bank in France was *Banque Poulaire* in the 1870s. Two rural Credit cooperatives were founded in the following years, *Crédit Mutuel* in the Alsace-Lorraine region, and *Crédit Agricole*, founded in 1890s. The cooperative banks multiplied and grew until after the Second World War, where the banking sector was nationalised. In the 80s, 90s and 2000s the law changed permitting the privatization of major French banking institutions. *Crédit Agricole* has transformed into one of the largest financial institutions in France and internationally.[66]

French banking cooperatives also commit to cooperative principles, similar to German banking cooperatives. French cooperatives have set up networks comprised by different levels of entities, conforming an "inverted pyramid structure". Local cooperatives are independent entities owned by members. These local cooperatives own regional cooperative banks, than in turn own federal or national body cooperatives.

Figure 5. Inverted Pyramid French Cooperative structure



Source: own compilation

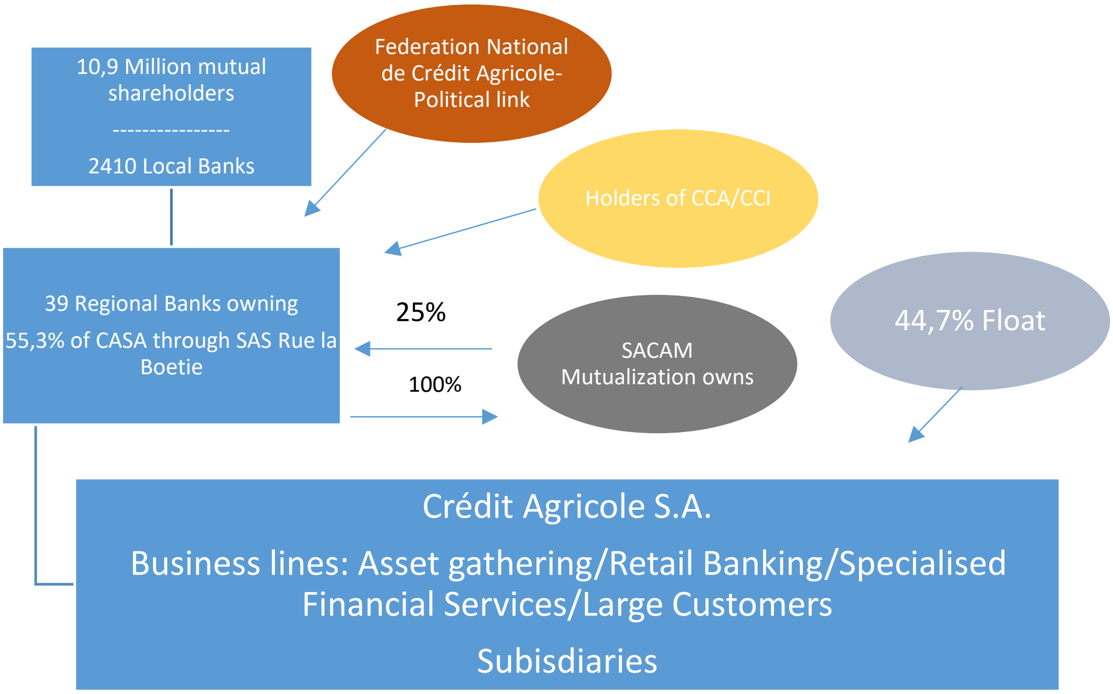
The French cooperatives have evolved into complex structures, where the simple inverted pyramid is no longer the standard. Now, a central institution generally holds interests in different "conventional subsidiaries" turning the cooperative network into hybrid banking groups. [67] For *Crédit Agricole, Caisse d`Espargne* and *Banque Populaire*, the central institution has become a joint stock company, where regional/local banks have remained cooperatives.[68] A second change in cooperative structures was the introduction of two innovative cooperative instruments called Associate Cooperative Certificates (CCA) and Investment Cooperative Certificate (CCI), which mix cooperative principles with capitalist ones. For instance, CCI are subscribed freely, they grant no voting rights, they may be sold in the market, they allow free interest withdrawals, and they act as stocks in liquidation. CCA give subscription rights to associates only, they do not grant voting

[66] R. Ayadi, D. T. Llewellyn, R. H. Schmidt, E. Arbak, W. Pieter De Groen *Investigating Diversity In The Banking Sector In Europe Key Developments, Performance And Role Of Cooperative Banks* (Centre for European Policy Studies, 2010) ps. 66-67.
[67] J. Ory, E. Gurtner, and M. Jaeger "The Challenges of Recent Changes in French Cooperative Banking Groups"[2006] RECMA Revue Internationale de L´Economie Sociale" No. 301, p. 44.
[68] J. Ory and Y Lemezeri "The French Co-Operative Banking Group Model: Too Good to be True? [2010] XIXème Conférence de l'AIMS, p.10

rights, they grant free dividends, but in order to sell them an "order book" is required. As with CCI, CCA act as stock in liquidation.[69]

Figure 6 describes the 2020 *Crédit Agricole* structure, which includes a listed central body, and relationships via CCA and CCI instruments.

Figure 6: Crédit Agricole



Source: *Crédit Agricole 2020-2021 Integrated Report*[70]

The role of the Central bodies is regulated by Article 511-31 para 2: "They are responsible for ensuring the cohesiveness of their network and the correct functioning of the institutions affiliated with them. To this end, they shall take all necessary measures to ensure the liquidity and solvency of each said institution and of the entire network. They may also decide to prohibit or limit the distribution of dividends to the shareholders or the remuneration of the shares of the Credit institutions or investment firms affiliated with them."[71]

In general, local cooperatives have delegated functions such as treasury, risk management, mutual support, investment activities, debt issuance, and back office IT services to central institutions.[72] Regarding mutual support, *Crédit Agricole* has a "legally

[69] S. Nivoix "Specificities of the French Cooperative Banking Groups Facing the 2007-2012 Crisis" [2016] China-USA Business Review Vol 15, p.381
[70] Credit Agricole 2020-2021 Integrated Report <https://www.credit-agricole.com/en/pdfPreview/188402> accessed 23 April 2021.
[71] Monetary and Financial Code Art. 511-31
[72] R. Ayadi, et al, above note 223, p 66.

binding cross-guarantee system" that enables the use of the group resources to serve the debt of regional cooperatives.[73]

2.6 The case of Crédit Agricole

Crédit Agricole is an interesting case because it is one of French SIFIs, it is a Cooperative network, and one of the most successful cases of cross-border BBFC.

Crédit Agricole S.A, (CASA) headquartered in Montrouge, is the central body of the "Crédit Agricole Network", which includes 2447 local banks, 39 regional banks, and all the CASA business lines and subsidiaries. The *Crédit Agricole Group* has a net income group share (NIGS) of €3,649 million, presence in 49 countries, and it is the number 1 bancassurer in Europe.[74]

Business line contribution to NIGS is:

-15% Specialised financial services

-17% Retail banking

-29% Large customers

-39% Asset gathering

Table 2: Crédit Agricole Business Lines

Asset Gathering	**Retail Banking**	**Specialised Financial Services**	**Large Customers**
Insurance: "Crédit Agricole Assurances (CAA) is the largest bancassurer in Europe by premium income."	**LCL: "**LCL is the only domestic network bank in France to focus exclusively on retail banking and insurance. It covers all markets: individual customers, small businesses, private and corporate banking."	**Consumer finance "**Crédit Agricole Consumer Finance offers multi-channel range of financing and insurance solutions and services"	**Corporate and investment banking**: Crédit Agricole Corporate and Investment Bank serve corporates and financial institutions, in France and internationally"
Asset Management "Amundi provides	**Crédit Agricole's international retail**	**Leasing , factoring and finance for**	**Asset servicing** "CACEIS, a

[73] R. Ayadi et al, above note 223 p. 67; D. Blanche "The regulation of French financial co-operatives: From local co-operatives to global banking groups subject to the Post-Crisis regime for banking resolution" 11th Strasbourg European Meeting – European Parliament (2016).
[74] Crédit Agricole Annual Financial Report Registration Document 2017.

both individual customers and institutional and corporate customers with innovative savings and investment solutions that cater for their needs, performance targets and specific risk profiles."	**banks (IRB)** "are primarily located in Europe (Italy, Poland, Serbia, Romania, Ukraine), and in selected countries of the Mediterranean basin (Morocco, Egypt), where they serve individual and corporate customers (SMEs and large corporates), mainly in the agriculture and food processing sector."	**energies and regions** "Crédit Agricole Leasing & Factoring (CAL&F) provides solutions for businesses of all sizes for their investment plans and the management of their trade receivables."	specialist back-office banking group, supports management companies, institutional investors, banks, sovereign asset funds, brokers and companies in the execution of their orders, including custody and management of their financial and physical assets."
Wealth Management "Indosuez Wealth Management comprises Crédit Agricole Group's wealth management activities in Europe, the Middle East, Asia-Pacific and the Americas… It has a presence in 14 countries worldwide."			

Source: Crédit Agricole Annual Financial Report Registration Document 2017

Additionally, CA comprises four "Specialised businesses and subsidiaries": *Crédit Agricole Immobilier*; *Crédit Agricole Capital Investissement & Finance* (IDIA CI, SODICA CF) (€1.5 billion assets under management); *Crédit Agricole Payment Services* (France's leading payment solutions provider with a market share of almost 30%); and *Uni-Éditions (*11 market-leading publications with nearly 2 million subscribers).[75]

[75] Crédit Agricole Annual Financial Report Registration Document 2017

2.7 Resolution of Crédit Agricole

Directive 2019/879 of 20 May 2019 ("BRRD2") was transposed into French law and is applicable since 28 December 2020. The law provides requisites for French cooperative banking groups. According to CA "The resolution authorities will treat the Central Body and its affiliated entities ("Network") as a whole when assessing the conditions to enter in resolution… In case of a bail-in, write-down or conversion measures will apply simultaneously to all entities within the Network".[76]

Analysing the four indicators detailed in Chapter 6, it can be concluded that:

1. *Crédit Agricole* Group is a highly complex group, which comprises not only CASA and its subsidiaries and branches, but also local and regional cooperatives.
2. CASA perform many functions delegated by local and regional cooperatives, such as management liquidity, risk management, IT services, etc. Therefore, *Crédit Agricole* may be included in the "centralised business model" category, even though as a central body it is located at the bottom of the inverted pyramid structure.
3. *Crédit Agricole* retail business amounts to 17% of its NIGS, while Large Customers and Asset gathering amounts to 68% of its NIGS. Therefore, it may be labelled as a "no retail business model" although historically it was based on retail banking, aligned with the cooperative solidarity movement.
4. France has a universal approach to resolution: "The French court tends to consider an insolvency estate as a whole (*universalité de patrimoine*). This means that the court that has jurisdiction to open insolvency proceedings also has jurisdiction over all the company's assets, whether located in France or abroad. There are some exceptions to this for assets located in EU member states, which apply when secondary proceedings are opened with respect to a company's branch(es) operating in another EU member state."[77]

While theoretically the four indicators discussed above show the SPOE strategy would be the most appropriate for *Crédit Agricole Group*, its corporate structure presents some challenges. As its structure remains a hybrid-inverted pyramid, a pure SPOE strategy would not be achievable without changing the group´s nature. Applying SPOE at the central body would mean a split of the group, which would present similar effects as a MPOE.

If an pure SPOE strategy bail in tool would be applied primary to ordinary shares (most of them in hands of the regional banks) and then to holders of bail-in able debt (generally issued by the central body), so the regional banks would lose their shares in the central

[76] Credit Agricole Credit Update, available at <https://www.credit-agricole.com/pdfPreview/186516>
[77] P. Talbourdet , J. Gumpelson, D. Brocas Maffei "Restructuring and insolvency in France: overview" (Thomsen Reuters, 2018) <https://uk.practicallaw.thomsonreuters.com/1-501-6905?transitionType=Default&contextData=(sc.Default) >accessed 21 November 2018.

body[78]. The result would be splitting the cooperative group via a de facto "demutualization"[79] of part of the group. CASA would have new shareholders, while local and regional cooperatives will continue to exist as cooperatives.

Second, *Crédit Agricole* as a consolidated group has mutual guarantee schemes in place, which ensure the transfer of funds and liquidity within the group at any moment.[80] According to the FSB, "The existence of intra-group transactions and exposures, including the use of intra-group guarantees (IGGs) …increases interconnectedness and may impede separability of firms' transactions and legal entities. ..The existence of IGGs makes it challenging for a firm to transfer positions or portfolios from guaranteed entities to third parties as client consent would be required to not only transfer the trade but also to release the firm from the guarantee. Obtaining the release from the guarantee can add time and cost, e.g., price concessions or alternative Credit support. The use of IGGs also increases the likelihood that financially sound entities are caused to fail due to contagion. The insolvency of a guarantor, especially a parent, may hasten the insolvency of any guaranteed subsidiaries, thereby increasing the potential disruption to financial stability."[81] The existence of IGGs in French cooperative networks is part of its nature, so the resolution of cooperative networks would be more challenging than other banking groups with no IGGs in place.

Is it possible to apply the bail in tool to the regional or local banks? While theoretically possible since the bail in tool is legally applicable to cooperative banks in France, bail-inable debt is not issued at the local or regional levels. [82]

Considering the above-mentioned elements, a pure SPOE resolution strategy applied to the current structure, would imply the split of the CA group due to the hybrid inverted pyramid structure. However, SPOE has certain advantages described in Table 2.

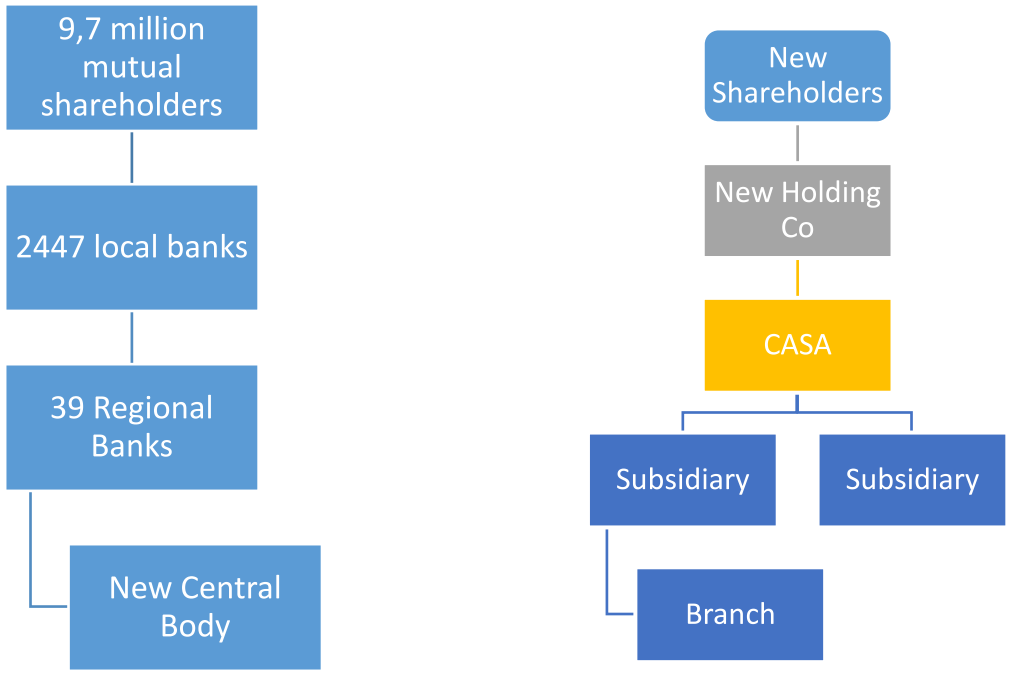
Table 2. Advantages and challenges of SPOE for CA

[78] D. Blanche, above note 73.
[79] Demutualization according to Fulton and Girard is "Demutualisation is the conversion of a cooperative, Crédit union or mutual into an alternative organisational form (usually one owned by investors). Demutualisation can occur through the conversion of equity into investment shares, or it can occur via a merger, takeover or buyout involving companies that are not cooperatives or mutuals. Regardless of the form it takes, demutualisation involves the transfer to private investors of the capital that has been built up in the cooperative over the years. M. Fulton and J. Girard "Co-operatives and Mutual Canada, Demutualization of Co-operatives and Mutuals, (COOP, 2015) http://canada.coop/sites/canada.coop/files/files/documents/en/2015_coop-dcm_report_eng_final_web.pdf accessed 21 November 2018.
[80] European Association of Co-Operative Banks "Consultative Document "Effective Resolution of Systemically Important Financial Institutions. Recommendations and Timelines" (2011).
[81] FSB "Consultative Document Effective Resolution of Systemically Important Financial Institutions Recommendations and Timelines" (2011).
[82] In the hypothetical case that regional or local banks issue bail-inable debt, a number of challenges would be present: a) how to harmonize the "one member-one vote" principle with the conversion of debt into cooperative shares, b) how to harmonize the need of approval of new members by other members. IADI Resolution issues for Financial Cooperatives-Overview of Distinctive Features and Current resolution Tools" (2017).

Advantages of SPOE as a preferred resolution strategy CA	**Challenges of the SPOE strategy CA**
Efficiency: SPOE strategy allows cross-jurisdictional transfers and needs less loss absorbing capacity needed as a group	Need to have ex ante agreements with other resolution authorities
Critical functions assured	Doubtful that foreign jurisdictions would respect French`s universal approach to resolution. Special case of the US insolvency approaches.
Flexibility: allows a flexible legal structure through branches and or subsidiaries	Need to change legal and operational structure to include a holding company on top of current parent company
Fast process: through a “liquidation weekend”	Split of the Cooperative Network. Demutualization of part of the Group.
Enhances transparency	
French Resolution authority would be is in control of the process	
France applies the Universal Approach to resolution	

In order to apply a proper SPOE strategy, the inverted pyramid structure would have to be turned upside down. This would mean the end of the cooperative structure, via a demutualization of the local and regional banks, and posing CASA at the top of the pyramid. In order to apply a “pure” SPOE resolution strategy a non-operative holding company would have to be created on top of CASA. While this option is non-viable from a practical point of view, there is room for applying a SPOE strategy taking CASA as the point of entry. This option would mean at least that the local and regional banks might continue to be cooperatives (and would need to create a new central body), while the structure below CASA would split into a banking group with CASA or a holding company as the apex. Figure 8 shows the result of applying a SPOE at CASA/New holding Co. level.

Figure 8. Result of applying SPOE at CASA/New Holding Co. Level



Source: own compilation

As in the case of Deutsche Bank, an alternative scenario would be to take advantage of SPOE in Europe, and to analyse a MPOE strategy for foreign subsidiaries such as Asian, African and Latin American units.

2.8. Concluding remarks

Unlike Germany, France has not engaged in universal banking throughout its history, although the *Crédit Financier* and Saint Simon ideas were precursors of the universal banking model in Europe, and particularly in Germany. After 1980´s, French financial system has changed from a governed-centred model to a market-centred one, and it has embraced universal banking model. This has underpinned the insurgence of Bancassurance, a term that was first used in France, and which emerged because of deregulation and competition. Contrary to the German banking system, in France there is no "three-pillar system", since Saving banks are regulated "in tandem" with cooperative banks, and there is no clear distinction in its legal form, as in Germany. One of the most impressive developments of the French banking system is the evolution of the Cooperative banking system, which has created one of the French SIFIs, *Crédit Agricole.*

The Cooperative Network inverted pyramid structure is designed to fulfil the cooperative principles of solidarity, mutual support and democracy. While this structure has proved to assure the mentioned principles, certain challenges appear when the structure confronts a distress situation. The new resolution toolbox was designed to tackle traditional join stock banking groups. The bail in tool is planned for entities that are able to issue bail-inable debt freely and that allow the write down of shares and the conversion of debt into equity. While the traditional inverted pyramid is no longer the standard since the central body is generally a listed entity, there are still some challenges ahead. These challenges pose difficulties to maintain the cooperative network standing as a whole after the bail in is applied.

There are three theoretical options for *Crédit Agricole*. First, to change the structure, turning the inverted pyramid upside down, demutualizing both local and regional cooperatives, and changing the ownership structure to mimic a join stock universal bank as Deutsche Bank. The "pure" SPOE strategy would imply also to set up a holding company on top of CASA. This option is practically infeasible since it would denaturalise the cooperative and would be politically unattainable. A second option would be to apply the SPOE strategy at the CASA level. This option would maintain the local and regional cooperatives as such, splitting the network since the regional banks would lose their equity in CASA. The benefits of this option are that the international side of the group would remain united, and the local cooperatives would survive. The costs of this option are that unlike in a traditional SPOE strategy, the consequence will be the split of the group, which resembles the result of a MPOE strategy in this respect. A third option for *Crédit Agricole* would be a hybrid resolution strategy, whereby a SPOE resolution strategy would be applied to certain jurisdictions (E.g. the EU, USA and Japan) and a MPOE would be applicable for developing countries. This option would not be as efficient as a SPOE strategy, but would assure there is no uncoordinated "ring-fenced" type of resolution.

3. Case Study: Barclays

3.1. Barclays History

"Barclays traces its ancestry back to two goldsmith bankers, John Freame and Thomas Gould, who were doing business in Lombard Street, London in 1690. In 1736, Freame's son, Joseph took his brother-in-law, James Barclay on as a partner, and the name has remained a constant presence in the business ever since."[83] Foxwell states "The economist Storch said in 1815 that Great Britain was the only country in Europe in which there were any private banks. The statement requires qualification; but there is certainly no other country in which such private firms, half- bankers and half traders, can be more profitably studied, or have given rise to such remarkable developments. Nor is there any English bank better suited through all the stages of its long history than Barclays to illustrate the most characteristic features of these developments".[84]

As the Saint Simonians shaped the Credit Mobilier and the Universal banking system, Quaker religious movement shaped Barclays. "The Quakers have played a great part in English banking, nowhere more than in the Barclay group: the Huguenots may rank next; but a certain pietistic and mystical form of religious feeling seems to have characterised nearly all the original Barclay banker"[85]

In 1888 Barclay, Bevan, Tritton & Co., and Ransom, Bouverie & Co.- London agents of several country banks- united. In 1896, twenty country banks, including the Gurneys of Norwich and Backhouse of Darlington also united. In 1915, Barclays amalgamated with

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[83] Barclays "Our history" <https://home.barclays/who-we-are/our-history/> Accessed 7 March 2019.
[84] H. Foxwell "A History of Barclays Bank" [1927] The Economic Journal, Vol. 37, No. 147, ps. 411-417
[85] Idid; M. Larson, G. Schnyder, G. Westerhuis and J. Wilson "Strategic responses to global challenges: The case of European banking, 1973–2000" [2011] Business History, 53:1, ps. 40-62.

large centralised branch-banks of a different type. [86] In 1916, Barclays acquired the United Counties Bank, which "enabled Barclays to become one of the 'Big Five' clearing banks, with national coverage."[87]

In the 1920s Barclays gained control of the following banks: i) the Colonial Bank, with branches in the Caribbean and West Africa; ii) the Anglo-Egyptian Bank, with branches in Palestine, Egypt, Malta and Cyprus; and iii) the National Bank of South Africa. In 1925, these banks were merged into the newly formed "Barclays Bank (Dominion, Colonial and Overseas), "Barclays Bank DCO", and later "Barclays Bank International". In 1968, Barclays acquired Martins Bank. In 2000, Barclays acquired The Woolwich, a former building society. In 2003, it acquired Banco Zaragozano, a Spanish bank. In 2005, it acquired a majority stake in ABSA, a leading South African bank.[88] In 1986 Barclays established an investment banking operation known as Barclays Capital. Barclays Capital is now part as Barclays International. In 1995 the fund manager Wells Fargo Nikko Investment Advisers was acquired by Barclays and "was integrated with BZW Investment Management to form Barclays Global Investors". In 2008 Barclays acquired the investment banking and capital markets businesses of Lehman Brothers. In 2009, BGI was sold to BlackRock[89].

In 2016 Barclays "announced a new strategy, designed to build on its strengths as a diversified transatlantic consumer and wholesale bank, anchored in the UK and US home markets, with global reach." In 2018, the Barclays "underwent its biggest structural changes for over 30 years, in accordance with regulatory requirements introduced by the UK government as a result of the financial crisis of 2008. The main objective was to separate or 'ring-fence' the domestic retail and business bank from the international and investment bank. Barclays PLC continues as the holding company, supervising three operational subsidiaries: Barclays Bank UK PLC, comprising the UK Retail Bank, UK Barclaycard, UK Wealth and Investments, and Corporate Banking for smaller UK businesses; Barclays Bank PLC comprising Corporate and Investment Banking, non-UK Barclaycard, Wealth International, the Private Bank, and Overseas Services; and Barclays Services Ltd, which includes support services such as Group Functions, Operations and Technology"[90].

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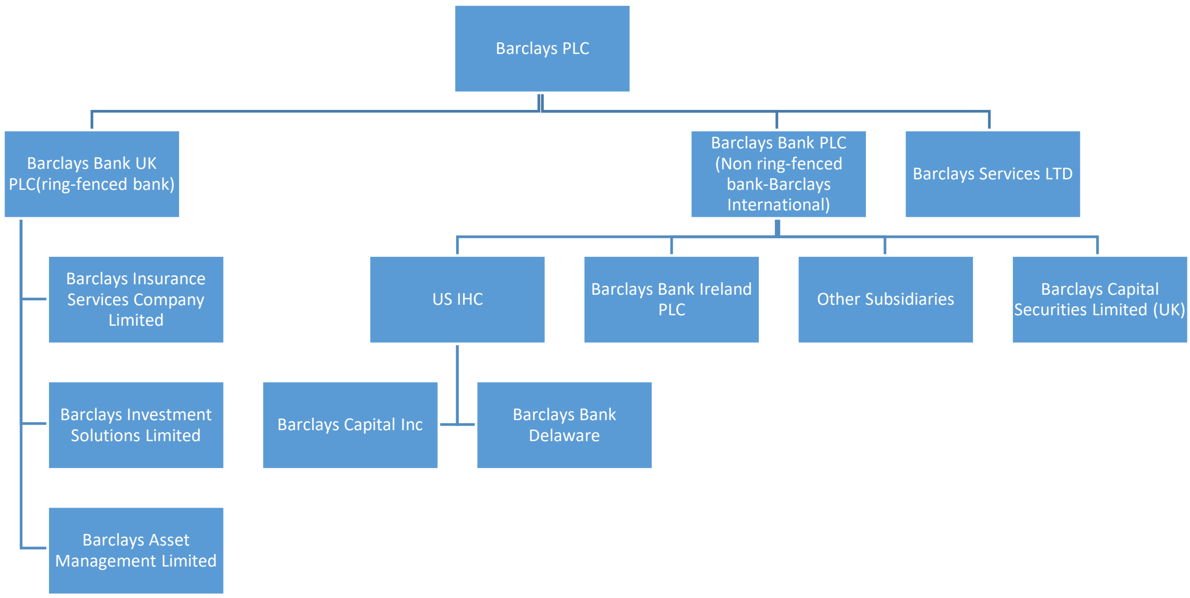
[86] Ibid
[87] Barclays "Our history, above note 83.
[88] Barclays "A quick history" <https://www.archive.barclays.com/items/show/5419> Accessed 7 March 2019.
[89] Ibid.
[90] Ibid.

Figure 9. Simplified Barclays´ Structure



Source: S&P Global Ratings, November 19, 2018, and "Important Information about Barclays Insurance Services", 2018; Barclays Bank UK PLC Annual Report, 2018.

Table 3. Barclays wholly owned subsidiaries and related undertakings

	Wholly owned subsidiaries	Related undertakings	Main Branches
United Kingdom	157	23	
Argentina	2		
Brazil	3		
Canada	3		Barclays Bank PLC (Canada Branch)
Caymans	32	5	
China	3		
France	1	2	Barclays Bank PLC (France Branch)
Germany	2		Barclays Bank PLC (Germany Branch)
Guernsey	2		Barclays Bank PLC (Guernsey Branch)
Hong Kong	4		Barclays Bank PLC (Hong Kong Branch)

India	4		Barclays Bank PLC (India Branch)
Indonesia	2		
Ireland	6		Barclays Bank PLC (Ireland Branch)
Isle of Man	2		Barclays Bank PLC (Isle of Man Branch)
Israel			Barclays Bank PLC (Israel Branch)
Italy			Barclays Bank PLC (Italy Branch)
Japan	3		Barclays Bank PLC (Japan Branch)
Jersey	11		Barclays Bank PLC (Jersey Branch)
Korea	1	2	
Luxembourg	22	4	
Malta		2	
Mauritius	4		Barclays Bank PLC (Mauritius Branch)
Mexico	4		
Monaco	1	1	Barclays Bank PLC (Monaco Branch)
Netherlands	1	1	
Nigeria	1		
Philippines	1		
Portugal			Barclays Bank PLC (Portugal Branch)
Saudi Arabia	1		
Singapore	5		Barclays Bank PLC (Singapore Branch)
South Africa		1	
Spain	2		Barclays Bank PLC (Spain Branch)
Switzerland	3		
UAE			Barclays Bank PLC (UAE Branch)

USA	61	38	Barclays Bank PLC (United States Branch)
Zimbabwe	1		

Source: Barclays 2018 Annual Report and Country Snapshot 2017[91]

3.2. Barclays Insurance

In the UK, Barclays Bank UK PLC arranges home insurance via Barclays Insurance Services Company Limited, a wholly owned subsidiary of Barclays Bank UK PLC. Barclays Bank UK PLC and Barclays Insurance Services Company Limited are both insurance intermediaries. Barclays Bank UK PLC is authorised by PRA and regulated by PRA and FCA. Barclays Insurance Services Company Limited is authorised and regulated by the FCA.[92]

3.3. Barclays Investment banking

After the Big Bang, in 1985, the Bank merged its merchant bank with Zoate & Bevan and Wedd Durlacher to form BZW. A decade after, it sold its division to Credit Suisse. In 2008, Barclays purchased the US operations of Lehman Brothers under the leadership of Bob Diamond. Today, the corporate and investment banking division amounts to a 70% of total risk weighted assets of the group, while the retail bank amounts to the remaining 30%. [93] Barclays ranks on the seventh position on the world´s top investment banks, being the first British bank to rank in it, before HSBC (position 9). (See Table 2).

Table 4. World`s top investment banks

1	JPMorgan
2	Goldman Sachs
3=	Citi
3=	Morgan Stanley
5	Bank of America Merryll Lynch
6	Deutsch Bank
7	Barclays
8	Credit Suisse

[91] 2017 List of Barclays main entities <https://home.barclays/content/dam/home-barclays/documents/citizenship/our-reporting-and-policy-positions/Final-2017-LE-listing-CBC-disclosure.pdf >Accessed 23 September 2018.

[92] Barclays Important Information about Barclays Insurance Services <https://www.barclays.co.uk/content/dam/documents/premier/BAR_9914957_Cropped.pdf>Accessed 8 March 2019

[93] D. Crow and S Morris "Investment Banking: the battle for Barclays" *Financial Times*, (London, 20 January 2019).

9=	UBS
9=	HSBC

Source: Coalition and Financial Times[94]

While some believe Barclays would be better without the investment-banking unit[95], Barclays CEO Staley states: "I believe in universal banks…I believe in having a diversified portfolio of consumer and wholesale businesses. I believe you've got to have the team to execute and deliver strong returns for your shareholders. And I believe in scale. What I don't believe is this notion that only an American bank can be a bulge-bracket investment bank. That is flawed."[96]

3.4. Resolution planning

According to the Annual Report 2020 "The BoE's preferred approach for the resolution of the Group is a bail-in strategy with a single point of entry at Barclays PLC. Under such a strategy, Barclays PLC's subsidiaries would remain operational while Barclays PLC's capital instruments and eligible liabilities would be written down or converted to equity in order to recapitalise the Group and allow for the continued provision of services and operations throughout the resolution. The order in which the bail-in tool is applied reflects the hierarchy of capital instruments under CRD IV and otherwise respecting the hierarchy of claims in an ordinary insolvency. Accordingly, the more subordinated the claim, the more likely losses will be suffered by owners of the claim.[97] (See Chapter 6).

4. Citibank Case

4.1. Historical Overview

The case of Citibank is illustrative and archetypical of the US banking system. From its inception in 1870, it has grown to become the biggest bank in the US. However, the GFC turned the US authorities to implement one of the biggest bailouts in US history. Nowadays, a decade after the GFC, Citibank is again in the hands of private owners and continues to be one of the most important banking groups in the world. As Huertas states:

> In 1870 the firm was an owner-managed entity with few employees. It operated from a single location, had a restricted customer base and a single product. Its share of the total banking industry was by any measure small. By 1920 the picture had changed dramatically. Citibank had become the largest commercial bank in the country and a leading investment banking house. It had put a managerial

[94] Ibid

[95] Ed Firth, an equity analyst at Keefe, Bruyette & Woods Inc believes: "Barclays has some truly wonderful consumer businesses, but the problem is the big investment bank. It's impossible to predict earnings in the division, which you'd accept if from time to time you made 20 to 25 percent return on equity. But we don't even have that anymore." E. Robinson Jes Staley Stakes Barclays's Future on Investment Banking <https://www.bloomberg.com/news/features/2018-09-26/jes-staley-stakes-barclays-s-future-on-investment-banking> *Bloomberg*, (New York, 26 September 2018) , Accessed 11 March 2019.

[96] Ibid.

[97] Barclays. Annual Report 2020 <https://home.barclays/content/dam/home-barclays/documents/investor-relations/reports-and-events/annual-reports/2020/Barclays-PLC-Annual-Report-2020.pdf >accessed 20 April 2021.

> hierarchy in place and was in the process of separating ownership from management. It was on the verge of becoming the nation's first truly modern bank.
>
> [98]

On June 16, 1812, City Bank of New York was chartered by the NY authorities with the purpose of competing with other states such as Philadelphia and Baltimore.[99] In 1865 the bank gained a national charter and changed his name to "National City Bank of New York". By then, Moses Taylor was his president, principal owner and principal customer. In 1891, Stillman was created president and changed the business model of Citibank. From being a specialised small bank, it changed the bank in terms of size and product diversification. Stillman wrote

> I firmly believe ... that the most successful banks will be the ones that can do something else than the mere receiving and loaning of money. That does not require a very high order of ability, but devising methods of serving people and [of• attracting business without resorting to unconservative or unprofitable methods, that opens limited fields for study, ability and resourcefulness and few only will be found to do it.[100]

The bank was organised through commercial, investment and trust affiliates and commenced an era of geographical expansion. In 1920, with the incorporation of Mitchel as Manager, a special compensation scheme was introduced consisting of 20% share of profits over those needed to pay dividends. This scheme separated the ownership from managerial positions and helped the expansion of the bank during that decade. In 1929 Citibank was the largest in the world.[101]

After the creation of the Federal Reserve Act in 1913, the previous perception that banks were "quasi-public entities" changes because of the creation of the central bank. The new Act permitted banks to expand through international branching.[102] National City Bank took the opportunity. In terms of geographical expansion, it established offices in London, Shanghai, Manila, Yokohama and Singapore in 1902. In 1914, it opened its first South American office in Buenos Aires, followed by, Rio de Janeiro, Montevideo and Santiago de Chile. By 1917, Citibank had 35 branches and in 1998, it has expanded over 100 countries.[103]

By 1965

> "Fortune magazine was describing First National City Bank as the "wave of the future" for American banking. It had surpassed its rivals in terms of local branch network; with 150 branches, it was the leading bank in the New York metropolitan area. In terms of assets, it was now America's second-largest bank after Bank of

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98 T. Huertas "The Rise of the Modern Business Enterprise: The Case of Citibank" [1985] Business and economic history, p. 146
99 Citibank: Timeline <https://www.citigroup.com/citi/about/timeline/> Accessed 14 May 2019.
100 James Stillman, Letter to Frank A. Vanderlip, 12 February 1907, Vanderlip MSS, Columbia University, cited by T. Huertas, above note 1, p. 146.
101 T. Huertas, above note 256, p. 152.
102 T. Huertas, above note 256, p. 149.
103 D. Baron and D. Besanko "Strategy, Organization and Incentives: Global Corporate Banking at Citibank" Journal of Industrial and corporate change (2001) p. 12

> America. It was the top bank overseas, with 163 branches and affiliates in 55 countries and territories."[104]

In 1968, following McKenzie advice, Citibank took a series of measures to reorganise the business. First, a holding company "First National Citi Corporation" was created, who acquired the bank as a wholly owned subsidiary. Second, a new management structure was established, focusing on the types of customers (individuals, small and mid-sized customers, national or multinational businesses, overseas customers and high net wealthy individuals).[105]

The GFC hit Citigroup. By November 2008, Citigroup had receipt $25 billion in taxpayer-funded federal Troubled Asset Relief Program funds. On November 2018 Shares of Citigroup common stock traded below $1.00 on the New York Stock Exchange. In November 2018 Citigroup was bailout by the Treasury and the FDIC by "approximately $306 billion of loans and securities backed by residential and commercial real estate and other such assets, which will remain on Citigroup's balance sheet." Additionally, the Treasury would invest "$20 billion in Citigroup from the Troubled Asset Relief Program in exchange for preferred stock with an 8% dividend to the Treasury." In 2010, the Treasury sold its Citigroup shares denationalizing the bank again.[106]

According to its Annual Report, "Citigroup is a global diversified financial services holding company whose businesses provide consumers, corporations, governments and institutions with a broad, yet focused, range of financial products and services, including consumer banking and credit, corporate and investment banking, securities brokerage, trade and securities services and wealth management. Citi has approximately 200 million customer accounts and does business in more than 160 countries and jurisdictions."[107]

Additionally, Citigroup is one of the US bank-based conglomerates included in the FSB G-SIB List (2020), classified in Bucket 3 with Bank of America, DB and HSBC.[108]

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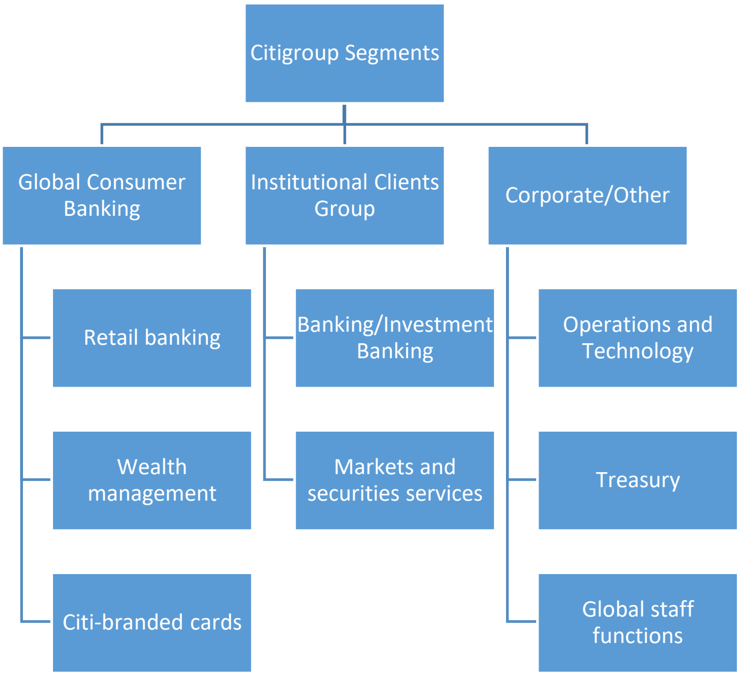
[104] Citibank: Timeline, above note 257.
[105] Ibid.
[106] T. Braithwaite and F. Guerrera "US Treasury sells remaining Citi share" Financial Times, December 7, 2010. <https://www.ft.com/content/f8d42e04-0181-11e0-9b29-00144feab49a> Accessed 23 September 2019
[107] Citigroup 2018 Annual Report. <www.citi.com/annualreport> Accessed 23 September 2019.
[108] FSB GSIB list 2020.< https://www.fsb.org/wp-content/uploads/P111120.pdf > Accessed 23 April 2021.

Figure 10. Citigroup Segments



Source: 2018 Citigroup Annual Report.

According to Second Quarter 2019 Results and Key Metrics, Global Consumer Banking represents 45% of total revenues, while Institutional Clients Group represents 52% and Corporate/Other a 3%.[109]

Citi has a strong presence in Latin America and the Caribbean through branches: Argentina,[110]Bahamas,[111]Ecuador,[112]Salvador,[113]Guatemala,[114]Haiti,[115]Jamaica,[116]

[109]Citigroup Second Quarter 2019 Results and Key Metrics <https://www.citigroup.com/citi/news/2019/second-quarter-2019-earnings.htm> Accessed 23n September 2019

[110] Citi Argentina<https://www.citibank.com/icg/sa/latam/argentina/institutional-info/ >Accessed 15 April 2020

[111]Citi Bahamas< https://www.citibank.com/icg/sa/latam/bahamas/institutional-info/about.html >Accessed 15 April 2020

[112] Citi Ecuador <https://www.citi.com/icg/sa/latam/ecuador/institutional-info/ >Accessed 15 April 2020

[113] Citi El Salvador<https://www.citibank.com/icg/sa/latam/el-salvador/institutional-info/branch.html> Accessed 15 April 2020

[114] Citi Guatemala<https://www.citibank.com/icg/sa/latam/guatemala/institutional-info/ >Accessed 15 April 2020

[115]Citi Haiti <https://www.citibank.com/icg/sa/latam/haiti/institutional-info/branch.html> Accessed 15 April 2020

[116]Citi Jamaica< https://www.citibank.com/icg/sa/latam/jamaica/institutional-info/branch.html> Accessed 15 April 2020

Panamá,[117]Paraguay,[118]Puerto Rico,[119]República Dominicana,[120]Uruguay,[121]and Venezuela[122]; and through subsidiaries in: Aruba,[123] Barbados,[124]Brazil,[125]Chile,[126]Colombia,[127]Costa Rica,[128]Honduras,[129] México,[130]Perú,[131] and Trinidad and Tobago.[132]

In Canada Citi operates through both subsidiaries and a branch.[133]

In Africa, Citi operates through branches in: Algeria,[134] Cameroon, Democratic Republic of Congo, Egypt, Gabon, Ghana (Representative Office), Kenya, South Africa, Tanzania,

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[117]Citi Panama< https://www.citibank.com/icg/sa/latam/panama/institutional-info/ >Accessed 15 April 2020

[118]Citi Paraguay< https://www.citibank.com/icg/sa/latam/paraguay/institutional-info/about.html >Accessed 15 April 2020

[119] Citi Puerto Rico<https://www.citigroup.com/citi/about/countries-and-jurisdictions/puerto-rico.html >Accessed 15 April 2020

[120] Citi Dominican Republic<https://www.citibank.com/icg/sa/latam/dominican-republic/institutional-info/ >Accessed 15 April 2020

[121]Citi Uruguay < https://www.citibank.com/icg/sa/latam/uruguay/institutional-info/> Accessed 15 April 2020

[122] Citi Latin America <https://www.citibank.com/citi/about/countries-and-jurisdictions/latin-america/data/franchise_profiles_es.pdf >Accessed 15 April 2020

[123] Citibank Aruba N.V accessed <www.citibank.com> Accessed 15 April 2020

[124] Citicorp Merchant Bank Limited (Barbados) <https://www.citigroup.com/citi/about/countries-and-jurisdictions/barbados.html >Accessed 15 April 2020

[125] Banco Citibank S.A. <https://corporateportal.brazil.citibank.com/nossos-balancos.htm >Accessed 15 April 2020

[126] Banco Edwards Chile <https://www.bancoedwards.cl/wps/wcm/connect/BancoEdwardsCiti/Portal/Inicio >Accessed 15 April 2020

[127] Citibank Colombia S.A. <https://www.citibank.com/icg/sa/latam/colombia/institutional-info/ >Accessed 15 April 2020

[128]Citibank Costa Rica S.A. <https://www.citigroup.com/citi/about/countries-and-jurisdictions/costa-rica.html> Accessed 15 April 2020

[129] Banco de Honduras S.A <https://www.citibank.com/icg/sa/latam/honduras/institutional-info/about.html >Accessed 15 April 2020

[130] Citibanamex (Banco Nacional de México S.A.) <https://www.citigroup.com/citi/about/countries-and-jurisdictions/mexico.html >Accessed 15 April 2020

[131] Citibank Perú S.A.< https://www.citibank.com/icg/sa/latam/peru/institutional-info/about.html >

[132] Citi (Trinidad & Tobago) Limited <https://www.citibank.com/icg/sa/latam/trinidad-tobago/institutional-info/ >Accessed 15 April 2020

[133]<https://www.citibank.com/tts/insights/eSource_academy/docs/country_profiles/north_america/1442257821-Citi-TTS-Canada-Country-Profile-2014.pdf >Accessed 15 April 2020

[134] <https://www.citigroup.com/citi/about/countries-and-jurisdictions/emea.html >Accessed 15 April 2020

Tunisia, Uganda, Zambia,[135]and subsidiaries in: Ivory Coast,[136] Morocco,[137]Nigeria,[138] and Senegal.[139]

In Europe, Citi chose to operate mainly through subsidiaries. The only country where Citi functions through a branch is Italy.[140]It acts through subsidiaries in: Austria,[141] Belgium,[142]Bulgaria,[143]Czech Republic,[144]Denmark,[145]Finland,[146]France,[147]Germany,[148]Greece,[149]Hungary,[150]Ireland

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[135] https://www.citigroup.com/citi/about/countries-and-jurisdictions/emea.html >Accessed 15 April 2020

[136] Citibank Côte d'Ivoire SA, and the brokerage vehicle, Citicorp Securities West Africa, <https://www.citigroup.com/citi/about/countries-and-jurisdictions/ivory-coast.html> Accessed 15 April 2020

[137] Citibank Maghreb S.A. < https://www.citigroup.com/citi/about/countries-and-jurisdictions/morocco.html >Accessed 15 April 2020

[138] Citibank Nigeria Limited <https://www.citibank.com/tts/insights/eSource_academy/docs/country_profiles/africa/1442254739-Citi-TTS-Nigeria-Country-Profile-Sep2015.pdf >Accessed 15 April 2020

[139] Citibank Senegal SA <https://www.citigroup.com/citi/about/countries-and-jurisdictions/senegal.html >Accessed 15 April 2020

[140]<https://www.citigroup.com/citi/about/countries-and jurisdictions/data/italy_disclosure_2013.pdf?ieNocache=276 >

[141] Citibank International Plc - Austria <www.citigroup.com/citi/about/countries-and-jurisdictions/austria.html >

[142] Citibank Europe Plc, Belgium< www.citigroup.com/citi/about/countries-and-jurisdictions/austria.html; http://www.amcham.be/company/citibank-international-plc >accessed 25 May, 2020

[143] Citibank Europe plc, Bulgaria< https://www.citigroup.com/citi/about/countries-and-jurisdictions/bulgaria.html >accessed 25 May, 2020

[144] Citibank Europe plc, Czech < www.citigroup.com/citi/about/countries-and-jurisdictions/czech-republic.html >accessed 25 May, 2020

[145] Citibank Europe Plc, Denmark< www.citigroup.com/citi/about/countries-and-jurisdictions/denmark.html >accessed 25 May, 2020

[146] Citibank International plc <https://www.citibank.com/tts/insights/eSource_academy/docs/country_profiles/western_europe/1442258168-Citi-TTS-Finland-Country-Profile-Sep2015.pdf> accessed 25 May, 2020

[147] Citibank Europe Plc, France and Citigroup Global Markets Ltd Paris Branch <https://www.citigroup.com/citi/about/countries-and-jurisdictions/france.html >accessed 25 May, 2020

[148] Citigroup Global Markets Deutschland AG <https://www.citigroup.com/citi/about/countries-and-jurisdictions/germany.html accessed 25 May, 2020

[149] Citibank Europe Plc, Greece <https://www.citigroup.com/citi/about/countries-and-jurisdictions/data/Greece_Privacy-Statement-Corporate-Institutional-Clients-English.pdf?ieNocache=440 >accessed 25 May, 2020

[150] Citibank Europe plc Hungary <https://www.citigroup.com/citi/about/countries-and-jurisdictions/hungary.html >accessed 25 May, 2020

[151]Luxembourg,[152]Monaco,[153]Netherlands,[154]Norway,[155]Poland,[156]Portugal,[157]Romania [158]Russia,[159]Slovakia,[160]Spain,[161]Sweden,[162]Switzerland,[163]Turkey,[164] Ukraine,[165] and the United Kingdom.[166]

In the Middle East Region, Citi acts through branches and subsidiaries. In Bahrein, Citi operates via a branch, and has erected a subsidiary called Citi Islamic Investment Bank E.C.[167] In Iraq it operates through a branch,[168] as well as in Israel,[169]

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[151] Citibank Europe plc and Citibank Holdings Ireland Ltd <https://www.citigroup.com/citi/about/countries-and-jurisdictions/ireland.html >accessed 25 May, 2020

[152] Citibank Europe plc, Luxembourg Branch< https://www.citigroup.com/citi/about/countries-and-jurisdictions/data/citilux_complaintpolicy.pdf?ieNocache=127 >accessed 25 May, 2020

[153] Citi Global Wealth Management SAM< https://www.citigroup.com/citi/about/countries-and-jurisdictions/monaco.html >accessed 25 May, 2020

[154] Citibank International plc, Netherland<s https://www.citigroup.com/citi/about/countries-and-jurisdictions/netherlands.html >accessed 25 May, 2020

[155] Citibank Europe plc, Norway< https://www.citigroup.com/citi/about/countries-and-jurisdictions/norway.html >accessed 25 May, 2020

[156] Citi Handlowy Bank Handlowy w Warszawie S.A. < https://www.citigroup.com/citi/about/countries-and-jurisdictions/poland.html accessed 25 May, 2020

[157] Citi Europe Plc, Portugal <https://www.citigroup.com/citi/about/countries-and-jurisdictions/portugal.html >accessed 25 May, 2020

[158] Citibank Europe plc <https://www.citigroup.com/citi/about/countries-and-jurisdictions/romania.html> accessed 25 May, 2020

[159] AO Citibank Russia< https://www.citibank.com/commercialbank/network/emea/russia/en/index.html >accessed 25 May, 2020

[160] Citibank Europe plc, Slovakia< https://www.citigroup.com/citi/about/countries-and-jurisdictions/slovakia.html >accessed 25 May, 2020

[161] Citibank España S.A<. https://www.citigroup.com/citi/about/countries-and-jurisdictions/spain.html accessed 25 May, 2020

[162] Citibank Europe plc, Sverige filial< https://www.citigroup.com/citi/about/countries-and-jurisdictions/sweden.html >accessed 25 May, 2020

[163] Citibank (Switzerland) AG< https://www.citigroup.com/citi/about/countries-and-jurisdictions/switzerland.html >accessed 25 May, 2020

[164] Citibank A.S. <https://www.citigroup.com/citi/about/countries-and-jurisdictions/turkey.html >accessed 25 May, 2020

[165] Citi Ukraine (JSC Citibank) < https://www.citigroup.com/citi/about/countries-and-jurisdictions/ukraine.html >accessed 25 May, 2020

[166] Citibank UK Limited <https://www.citibank.co.uk/personal/home.do?lid=UKWTM1CUKCUKL1 >accessed 25 May, 2020

[167] Citi Islamic Investment Bank E.C. < https://www.citi.com/icg/sa/emea/bahrain/ >accessed 25 May, 2020

[168] Citi Iraq< https://www.citigroup.com/citi/about/countries-and-jurisdictions/iraq.html> accessed 25 May, 2020.

[169]Citi Israel< https://www.citigroup.com/citi/about/countries-and-jurisdictions/israel.html> accessed 25 May, 2020.

Jordan,[170]Kuwait,[171]Lebanon,[172]Pakistan,[173]Qatar,[174] United Arab Emirates,[175]and through subsidiaries in: Kazakhstan,[176] and Saudi Arabia.[177]

In the Asia Pacific region, Citi operates through branches in: Australia,[178]Bangladesh,[179]Hong Kong,[180]India,[181]Indonesia,[182]Macau,[183] Mauritius,[184] New Zealand,[185]Sri Lanka[186] and Vietnam;[187]and through subsidiaries in China,[188]Korea,[189]Malaysia,[190] and Taiwan.[191]

In Japan, Philippines, Singapore, and Thailand Citi operates through branches and subsidiaries. [192]

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[170] Citi Jordan<https://www.citigroup.com/citi/about/countries-and-jurisdictions/jordan.html >accessed 25 May, 2020

[171]Citi Kuwait< https://www.citigroup.com/citi/about/countries-and-jurisdictions/kuwait.html >accessed 25 May, 2020

[172]Citi Lebanon< https://www.citigroup.com/citi/about/countries-and-jurisdictions/lebanon.html> accessed 25 May, 2020

[173] Citi Pakistan<https://www.citi.com/icg/sa/emea/pakistan/about/branches.html> accessed 25 May, 2020

[174]Citi Qatar <https://www.citigroup.com/citi/about/countries-and-jurisdictions/qatar.html >accessed 25 May, 2020

[175] Citi Emirates<https://www.citigroup.com/citi/about/countries-and-jurisdictions/united-arab-emirates.html >accessed 25 May, 2020

[176]Citibank Kazakhstan JSC <https://www.citigroup.com/citi/about/countries-and-jurisdictions/kazakhstan.html> accessed 25 May, 2020

[177]Citigroup Saudi Arabia (CSA) <https://www.citigroup.com/citi/about/countries-and-jurisdictions/citigroup-saudi-arabia.html >accessed 25 May, 2020

[178] <https://www.citi.com/australia/aboutus/history.html >accessed 25 May, 2020

[179]< https://www.citigroup.com/citi/about/countries-and-jurisdictions/bangladesh.html >accessed 25 May, 2020 accessed 25 May, 2020

[180] Citi Honk Kong<https://www.citibank.com.hk/english/info/pdf/CTBHK_FinDisc_12_2017_English.pdf >accessed 25 May, 2020

[181]Citi India< https://www.citigroup.com/citi/about/countries-and-jurisdictions/india.html >accessed 25 May, 2020

[182]Citi Indonesia< https://www.citibank.co.id/english/footer/about-us.htm >accessed 25 May, 2020

[183] Citi Macau<https://www.citigroup.com/citi/about/countries-and-jurisdictions/macau.html >accessed 25 May, 2020

[184]Citi Mauritius< https://www.citigroup.com/citi/about/countries-and-jurisdictions/mauritius.html> accessed 25 May, 2020

[185]Citi New Zealand< https://www.citigroup.com/citi/about/countries-and-jurisdictions/new-zealand.html >accessed 25 May, 2020

[186] Citi Sri Lanka<https://www.citigroup.com/citi/about/countries-and-jurisdictions/sri-lanka.html >accessed 25 May, 2020

[187]Citi Vietnam< https://www.citigroup.com/citi/about/countries-and-jurisdictions/vietnam.html >accessed 25 May, 2020

[188] Citibank (China) Co., Ltd< www.citigroup.com/citi/about/countries-and-jurisdictions/china.html> accessed 25 May, 2020

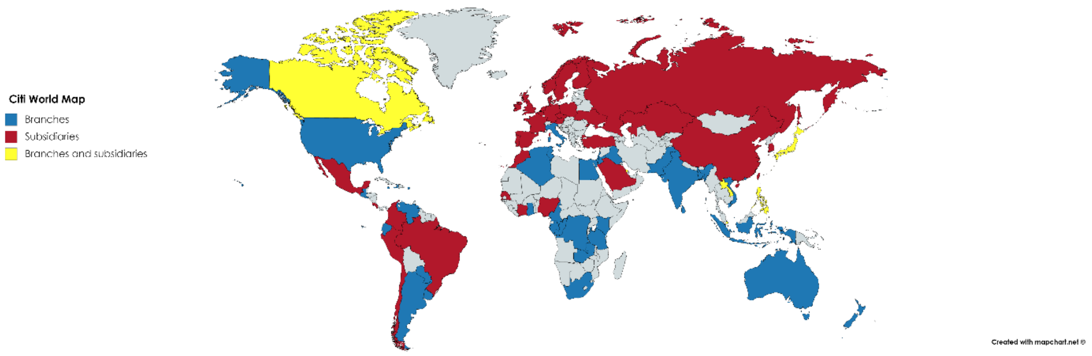
[189] Citibank Korea Inc. < https://www.citigroup.com/citi/about/countries-and-jurisdictions/korea.html> accessed 25 May, 2020

[190] Citibank Malaysia (Labuan) Limited< https://www.citigroup.com/citi/about/countries-and-jurisdictions/malaysia.html >accessed 25 May, 2020

[191] Citibank Taiwan Ltd (CTL) < https://www.citigroup.com/citi/about/countries-and-jurisdictions/taiwan.html accessed 25 May, 2020

[192]< https://www.citigroup.com/citi/about/countries-and-jurisdictions/thailand.html >accessed 25 May, 2020

Figure 11 Citi World presence



Source: own elaboration based on www.citigroup.com

4.2. Citi Resolution Planning

Under Citigroup 2019 Resolution´s Plan the preferred resolution strategy is still SPOE.

> "Citigroup's preferred resolution strategy is "single point of entry" under the U.S. Bankruptcy Code. Citi's preferred Resolution strategy remains a single point of entry strategy (SPOE Strategy) under which Citigroup Inc. (Citigroup Parent) would enter bankruptcy, but Citi's material legal entities (MLEs) would continue operating for the benefit of the Citigroup Parent bankruptcy estate. Specifically, under the SPOE Strategy, Citi's Operating MLEs - which are MLEs that contain operating businesses and include Citibank, N.A. (CBNA), Banco Nacional de Mexico, S.A. (Citibanamex), and certain broker dealers, among others -would be recapitalized so that they would continue operating throughout Citi's Resolution. In addition, Citi's Service MLEs - which are MLEs that house shared service functions - are prefunded with at least six months of working capital, enabling their continuity during Resolution."
>
> The SPOE Strategy is designed to (i) minimize the impact of Citi's Resolution on the U.S. and global financial systems, depositors, clients, and counterparties, (ii) maintain continuity of Citi's core business lines (CBLs), critical operations (COs), and material legal entities (MLEs), and (iii) maximize the value of Citi's businesses for the benefit of the Citigroup Parent bankruptcy estate. Citi believes that neither the Citi 2019 § 165(d) Resolution Plan Public Section U.S. government nor the Federal Deposit Insurance Corporation (FDIC) deposit insurance fund would incur losses under the SPOE Strategy. Rather, shareholders and unsecured creditors of Citigroup Parent would absorb any losses."[193] (See Chapter 6).

[193]Citigroup Inc. 2019 Resolution Plan Public Section July 1, 2019 <https://www.federalreserve.gov/supervisionreg/resolution-plans/citigroup-1g-20190701.pdf > Accessed 15 April 2020

5. Banco Santander Case

Banco Santander is a *rara avis* in the world of G-SIBs. Not only because of its origins in a northern province of Spain, but because of its history of internationalization, focus on retail business and family leadership for more than three generations. The Botin family, despite holding less than 3% of the shares of the bank has led the bank with intermittences since 1907, when Emilio Botin López was appointed president of the bank. Emilio Botin III who took office as president of the bank in 1986 made Banco Santander rise from the 152nd to number 10 in 2008. [194]Santander is the only Spanish G-SIB by 2020. [195]

Banco Santander was founded in 1857 in Santander, Spain. By then, Spain's economy was approximately one fourth of UK's economy and on third the size of Germany. The population of the city of Santander by 1857 was 28.907 inhabitants.[196] Competition among banks in Spain between 1874 and 1892 was intense and the main banks were Barcelona, Bilbao, Santander and Crédito Mobiliario Español. After the repatriation of capital due to the colonial crisis of 1898 when Spain lost Cuba, the Philippines and Puerto Rico, three banks were formed: Banco Guipuozcoano, Banco Hispano-Americano, Banco de Vizcaya and Banco Español de Crédito (Banesto).[197] Banco Santander grew during the 1940s because of acquisition of Spanish banks. In 1946, Santander acquired Banco Mercantil and a year later, it opened representative offices in Cuba, Argentina, Mexico and Venezuela and a London office.[198]

During the 1960s, Emilio Botin II opened new branches taking advantage of the banking deregulation in Spain. In 1965, Santander bought *Banco del Hogar Argentino*, the first wholly owned Latin American subsidiary, and in the same year it founded Banco Intercontinental Español (Bankinter).[199] From 1977 to 1982 Santander launched subsidiaries in different Latin American locations: Santo Domingo, Costa Rica, El Salvador (1978), Nassau, Sao Paulo, Uruguay and Chile (1982).[200]

In 1976, Santander bought First National Bank of Puerto Rico, and in 1982, Banco Español-Chile. At the end of the 1980s, Santander acquired German CC-Bank. In 1988, Santander acquired shares of Banco de Comércio e Indústria (Portugal) and it started a partnership with The Royal Bank of Scotland. [201] In 1987, Metropolitan Life and Santander constitute a company, Santander-Met S.A, to operate in the insurance business. [202]

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[194] A. Tschoegl and M.F. Guillen *Building a global bank: the transformation of Banco Santander* (Princeton University Press, 2008), p. 2
[195] 2020 list of G-SIBs above note 108.
[196] A. Tschoegl and M.F. Guillen, above note 194 p.2.
[197] A. Tschoegl and M.F. Guillen, above note 194, p.2.
[198] Santander: Our History <https://www.santander.com/en/about-us/our-history#1856-1950 > Accessed 2 March 2020.
[199] Santander: Our History; above note 198.
[200] Archivo Histórico Santander< http://www.archivohistoricosantander.com/historia.php > Accessed 2 March 2020.
[201] Santander: Our History; above note 198
[202] Archivo Histórico Santander, above note 198. J. Cacho "Metropolitan Life y Banco de Santander crean una compañía de seguros con un capital inicial de 5.000 millones de pesetas" *El Pais (*Madrid, 7 July 1987).

In 1989, Santander launched the "supercuenta" a high-interest check account, (11% on balances of USD 4000 or more, when the average was 6,8%) which started the so called "Guerra del pasivo" or deposits war. By 1992, it started the "Guerra del activo" or loans war with the launch of a "superhipoteca", a mortgage loan of 12% (2% less than its competitors did).

An important milestone in Santander History was the acquisition of Banesto in 1994, which made Santander the biggest bank group in Spain.[203] Another big milestone took place in 1999 when Santander merge with Banco Hispanoamericano in a USD 11,35 billion deal.[204] The new bank became the 8th largest Eurozone bank.[205] The same year Santander bought Totta e Açores financial group and Crédito Predial Português.[206]

Santander Group continued with its acquisition strategy in Latin-America. It acquired Banespa in Brazil[207], Serfín in Mexico[208] and Banco Santiago in Chile, which strengthened its position in the subcontinent.[209]

A third important milestone in Santander history was the acquisition of Abbey, the UK's sixth-largest bank.[210] It was then Europe´s biggest cross border acquisition.[211] Santander integrated Abbey to IT and training activities and was efficient in terms of cost reduction (25% by 2008). Botin reported that the "new Abbey" showed "proportionately more deposits than the English Banking System, lower costs, more provisions, a better credit portfolio and higher profits, and all while increasing market share".[212]

In 2007, Santander was recognised as "the twelfth largest bank in the world by market capitalisation and the seventh by profit and we boasted the largest retail network in the

[203] Santander, Our History, above note 196; "El Santander adquiere Banesto por 313.476 millones" *El Pais*, (Madrid, 24 April 1994 <https://elpais.com/diario/1994/04/26/economia/767311228_850215.html> accessed 16 July, 2020. In 2012, Santander absorbed, Banesto. E. Segovia "Santander se come Banesto tras no encontrar socios al precio exigido por Botín" *El Confidencial*, (Madrid 18 Dec 2012). <https://www.elconfidencial.com/economia/2012-12-18/santander-se-come-banesto-tras-no-encontrar-socios-al-precio-exigido-por-botin_374757/ >accessed 16 July, 2020.
[204] C. Vitzthum and C. Rhoads "Hispanoamericano, Banco Santander Agree to Merge in $11.35 Billion Deal" *The Wall Street Journal*, (New York 18 January 1999). <https://www.wsj.com/articles/SB916407621616738500> Accessed 16 July 2020.
[205] E. Nash "Spanish banks in pounds 20bn merger" *Independent* (London, 16 January 1999), (1999) <https://www.independent.co.uk/news/business/spanish-banks-in-pounds-20bn-merger-1074255.html> Accessed 16 July 2020.
[206] Santander, Our History, above note 196.
[207] J. Karp and K. Johnson "Banco Santander Wins Banespa Sale, Topping Rivals With $3.6 Billion Bid" *Wall Street Journal* (New York, 21 November 2000)<https://www.wsj.com/articles/SB974737464734107847 >Accessed 16 July 2020.
[208] P. Druckerman "Santander Buys Serfin for $1.56 Billion, Taking Lead in Mexican Banking Market" *Wall Street Journal* (New York 9 May 2000) <https://www.wsj.com/articles/SB957822014671100477 >Accessed 16 July 2020.
[209] Santander, Our History, above note 196.
[210] Santander, Our History, above note 196. "Banco Santander's European Dreams" Wharton, 8 September 2004 <https://knowledge.wharton.upenn.edu/article/banco-santanders-european-dreams/> Accessed 16 July 2020; M. Mulligan and P. J Davies "Santander profits driven by Abbey acquisition" *Financial Times*, (London 27 July, 2005). <https://www.ft.com/content/b0eae68c-fe85-11d9-94b4-00000e2511c8 >Accessed 16 July 2020.
[211] P. Parada, L. Alemany and M. Planellas "The Internationalization of Retail Banking: Banco Santander´s Journey towards Globalisation" Long Range Planning 42 (2009) 654-677
[212] P. Parada et al, above note 211.

Western world: 10,852 branches."[213] That same year Sir Fred Goodwin, RBS CEO invited Santander to join RBS and Fortis in the bid of Dutch ABN AMRO bank. This was the first time three banks joined to make a hostile takeover bid (ABN AMRO was in negotiations with Barclays at the time). The deal was closed, Fortis took the Dutch business, RBS the Asian division and Santander took Banco Real in Brazil and Antonveneta in Italy.[214]

Next year Santander acquired Alliance & Leicester and Bradford & Bingley in the UK, therefore reaching 1,300 branches in the country positioning as third-largest bank by deposits.[215]

In 2010, another phase of Santander internationalization process took place with the acquisition of Sovereign Bankcorp for USD 1,9 billion.[216] In 2011, Santander acquihired a Polish bank, Bank Zachodni WBK. [217]

In 2012, Santander floated 25% of the shares of Santander Mexico, which was the third largest in the world that year. In 2014 Ana Botin succeeded his father Emilio Botin III, and became the family member of the third generation to lead the bank, even though they do not have a majority stake in Santander.

In 2017, Santander acquired Banco Popular Español, S.A. after the ECB announced it to be "failing of likely to fail". The ECB then informed the Single Resolution Board (SRB), which adopted a resolution scheme entailing the sale of Banco Popular Español S.A. to Banco Santander S.A.[218]The final price was a symbolic €1.[219]

5.1. A Retail bank "subsidiary governance model"

According to Santander's Annual Report

> "Santander is a retail bank operating in 3 geographies (Europe, North America and South America) and in 10 main markets. Furthermore, we have global businesses like Santander Corporate & Investment Banking; Wealth Management & Insurance; or Santander Global Platform. Our purpose as a company is to help people and businesses prosper. Our aim is to be the best open financial services platform, by acting responsibly and earning the lasting loyalty of our people, customers, shareholders and communities". Santander also describe itself by having a "geographic and business diversification and our subsidiaries' model, which make us more resilient under adverse circumstances".[220]

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[213] Santander, Our History, above note 196.
[214] P. Parada et al, above note 211.
[215] Santander, Our History, above note 196.
[216] "Spain's Santander Buys Sovereign for $1.9 Billion" *New York Times* (New York, 3 October 2018) <https://dealbook.nytimes.com/2008/10/13/spains-santander-buys-sovereign-for-19-billion/ >Accessed 20 July, 2020.
[217] Santander, Our History, above note 196.
[218] ECB "ECB determined Banco Popular Español S.A. was failing or likely to fail" https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170607.en.html Accessed 20 July, 2020.
[219] "Banco Popular fails and is bought by Santander" The Economist (10 June 2017)
[220] Santander 2019 Annual Report, p. 114

"The structure of the Santander Group is a model of legally independent subsidiaries whose parent is Banco Santander, S.A… The Group has established a Group-Subsidiary Governance Model (GSGM) and good governance practices for its main subsidiaries..."

The main features that underpin this model are: 1) each subsidiary is governed prudently to ensure its economic solvency; 2) management of subsidiaries is led by local management with local experience; 3) subsidiaries are subject to local regulation and supervision, under global supervision of ECB; 3) customer funds are secured by local deposit insurance; 4) "Subsidiaries finance themselves autonomously when it comes to both capital and liquidity; 5) "Intra-group exposure is limited and transparent and any such transactions are invariably arranged under arm's length conditions"; 6) Each subsidiary has its own recovery plan.[221]

Santander believes this subsidiarity model best fits their retail business model. First because retail banking requires proximity to customer. Second, because it provides the "right incentives" for local management, since they are hold accountable for the performance in their respective unit. Third, because the structure provides "greater transparency" to the market, particularly when the stock is partially listed and subject to local stock exchange disclosure requirements.[222]

The Spanish BBFC also considers it structure has "considerable benefits" from a supervisory perspective since in "peace time" locally managed subsidiaries are easy to supervise by the local authorities and in crisis times the subsidiaries act as a "firewall" to reduce contagion and hence systemic risk. It is also possible to cut off a subsidiary if necessary.[223]

Santander main markets are Europe -47% weight of profit/operating areas- (Spain, Portugal, United Kingdom, Poland), Latin America -37% weight of profit/operating areas- (Brazil, Chile, Argentina, Uruguay, Colombia and Peru) and North America -16 % weight of profit/operating areas- (USA and Mexico).

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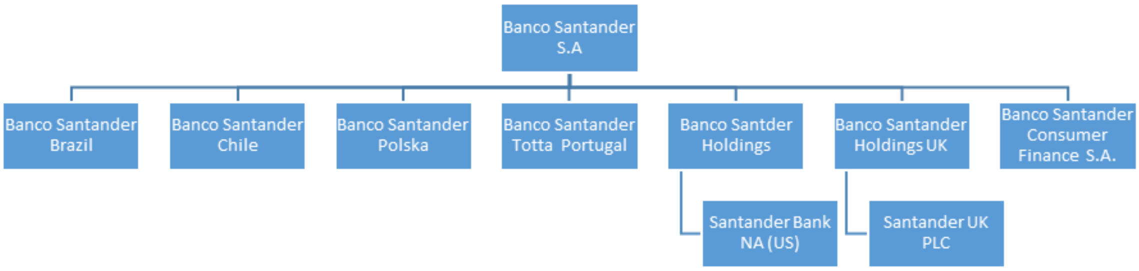
[221] Santander 2019 Annual Report, p. 236

[222] UK Parliament "Supplementary written evidence submitted by Santander." Santander's response to the Treasury Select Committee's request (dated 18 January 2011) for supplementary evidence on the Santander Group's subsidiaries structure.
https://publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/writev/banking/m42.pdf

[223] UK Parliament above note 222.

Figure 12 Simplified Santander Group Corporate Chart



Source: Santander Annual Report 2019, SEC Form 20-F[224]*and S&P Rating 2019*[225]

5.2. Banco Santander Resolution Strategy

Santander reassures that "The Single Resolution Board's preferred resolution strategy for the Group contemplates multiple points of entry for the resolution of the entire Santander Group. Given the potential adverse effects the liquidation of the Group's European-based banks could have on the real economies in which it operates, a bail-in resolution is expected, thus allowing operating entities to continue business activities. Outside of Europe, the SRB defers identification of an appropriate resolution strategy to each of the relevant resolution authorities in their respective jurisdictions. This includes Santander's US operations which would be resolved under U.S Bankruptcy Code (SHUSA and SC) and by the FDIC (SBNA)."[226]

Regarding the points of entry, "The Single Resolution Board identified nine different points of entry for the Santander group, which will be subject to a separate resolution process from that of the parent. Those separate points of entry are: Spain (which is the largest as it also includes the European operations of Santander Consumer Finance as well as all equity holdings in subsidiaries abroad), Portugal, the U.K., Poland, the U.S.,

[224] SEC Form 20-F <https://sec.report/Document/0000891478-20-000017/a20-f2019.htm#s3367C386059B5A05A845293A827B00D0 >accessed 20 April 2020.
[225] S&P Global Ratings, September 2019 <https://www.santander.com/content/dam/santander-com/es/contenido-paginas/accionistas-e-inversores/informacion-economico-financiera/ratings/do-rating-Standard%20&%20Poors-septiembre-2019.pdf > accessed 20 April 2020.
[226] FDIC "Banco Santander, S.A. Resolution Plan for U.S. Operations Public Section December 31, 2018"<https://www.fdic.gov/regulations/reform/resplans/plans/santander-165-1812.pdf > accessed 20 April 2020.

Mexico, Brazil, Chile, and Argentina. Each point of entry would be required to build up its own cushions of bail-in-able instruments to face a potential resolution scenario, provided that it is required to do so by host authorities."[227]

The application of the four-indicator matrix pointed out in Chapter 6 show Santander is a typical case where MPOE strategy would apply swiftly. As examined above, Santander is a Retail focused institution, structured mainly through subsidiaries, and described as a decentralised bank. All these would suffice for regulators to choose the MPOE strategy. Almost all the advantages of MPOE pointed out by the doctrine are present in the Santander structure.

First, Santander has proven in the Argentine financial crisis of 2001 that the subsidiary model did not foster contagion to other subsidiaries of the group. The same may be said from the Eurozone financial crisis of 2007-9, which did not gravely affect Latin American subsidiaries.

Second, MPOE´s outcome would not probably become "non-cooperative", since the resolution is ring fenced in a territory and cross-border cooperation is not as essential as in SPOE resolution scenario. In most jurisdictions where Santander operates, the bank leads in national rankings. Hence, a failure of any of such subsidiaries would have a huge impact in the national financial system, and the need of local authorities' intervention would be much needed.[228]

Third, the corporate structure based in subsidiaries and a decentralised model make the group less complex, and hence easier to resolve for resolution authorities. Additionally, this resolution strategy may foster the development of capital markets in the territories where the subsidiary operates.

Finally, the fourth indicator (territorial approach to resolution) would not be a problem since feasible and efficient cross border resolution would be possible even if the different jurisdictions apply different legal resolution regimes. Contrary to a SPOE resolution-strategy where a home authority will have to carry and coordinate the whole resolution process, in MPOE each authority will apply resolution tools under local law. [229]

As in the case of the German Model and British Model, a hybrid model would be feasible, applying a SPOE resolution strategy for the Eurozone and a MPOE for the other subsidiaries. In the Eurozone BBRD and SRM simplify the process and blur national banking barriers. In the rest, a MPOE would be feasible and will determine a swift resolution process.

As the doctrine recognises, MPOE strategy has its own costs in terms of using more loss absorbing capacity, in terms of a possible splitting of the group after the resolution process is done, and in terms of organising independent critical shared services that would assist subsidiaries of the group.

[227] S&P Global Ratings, September 2019 above note 225.
[228] S. Eirea Álvarez and M. Ordás Fernández "A multiple resolution scheme for Spanish global systemically important banking groups". [2014] Estabilidad Financiera No. 27, Banco de España, p.82
[229] S. Fernandez de Liz, J. Pardo, V. Santillana, G. Martin "Regulation Outlook: Compendium on resolution strategies: a multiple-point-of-entry view" [2014] BBVA Research, p.28

Advantages of MPOE as a preferred resolution strategy for Santander	**Challenges of the MPOE strategy**
Firewalls to contagion: Argentine 2001 Crisis and Eurozone 2007-9 financial crisis	Need of independent critical share services
Smooth resolution with no problems of "non-cooperative" resolution outcomes	Need of more loss absorbing capacities
Less complex structure, easy to resolve	A possible outcome is a splitting group
Foster local capital markets	
Feasible and efficient cross border resolution would be possible even if different jurisdictions apply different legal resolution regimes	

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