Legal **Houdini** Academy

Understanding
Legal Hocus Pocus

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The bail-in tool as proposed by the EU

In June 2012 the EU Framework for bank recovery and resolution as proposed by the Commission came out[1]. The draft text is now available[2].

Bail-in power

I am especially interested in the bail-in tool to the extent that tool is used to recapitalise a financial institution, thereby breaking the implicit state guarantee. Or, as Michel Banier has said it: "Banks should pay for banks" and "We are going to break the link between banking crises and public budgets."

Section 5 of the proposal deals with that, more specifically article 37.2.a pursuant to which the bail-in tool may be used:

> "to recapitalise an institution that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation and to carry on the activities"

However, article 37.3 limits the bail-in power:

> "Member States shall ensure that resolution authorities may apply the bail-in tool for the purpose referred to in point (a) of paragraph 2 only if there is a realistic prospect that the application of that tool, in conjunction with measures implemented in accordance with the business reorganisation plan required by Article 47 will, in addition to achieving relevant resolution objectives, restore the institution in question to financial soundness and long-term viability."

In other words, only if the financial institution is viable at a long run and there is a possibility to restore the financial soundness. Furthermore, such a bail in should be accompanied (within a certain period) with a business reorganisation plan showing restoration of the long term viability within a time horizon of maximum two years (article 46 and 47). This business reorganisation plan should also diagnose the causes of the difficulties of the institution.

Non Bail-inable Debt

Article 38 makes clear that the bail-in tool should apply to all liabilities, unless such liabilities are exempted in article 38.2. Exempted liabilities are: guaranteed deposits and secured liabilities (but only to the extent guaranteed or secured, so if these liabilities are partly out of the money, they are also bailed in), liabilities related to the holding of assets or clients money, very short term liabilities (i.e. original maturity less than a month), claims of

[1] See press release in Appendix for short description of Commission of bail-in instrument: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/570&format=HTML&aged=0&language=EN&guiLanguage=en See also video conference of press conference: http://ec.europa.eu/avservices/player/streaming.cfm?type=ebsvod&sid=204551

[2] http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

employees (other than variable remuneration), commercial or trade creditor (to the extent essential to the daily functioning of its operations) and preferred tax and social security claims. Exemption of certain derivatives claims is optionable (article 38.3, see also article 44 re derivatives).

Implementation of Bail-in tool

In order to assess whether or not the bail-in tool will be exercised and if so, how much debt will be bailed in, a preliminary valuation will take place by a independent third party[3]. Article 30 deals with this valuation. Valuation should be done at market value, unless in circumstances "where the market for a specific asset or liability is not functioning properly the valuation may reflect the long term economic value of those assets or liabilities " (see article 30.2). The valuation should also deal with priorities of creditors: "The valuation shall indicate the subdivision of the creditors in classes in accordance with their priority level under the applicable insolvency law and an estimate of the treatment that each class could be expected to receive in winding up proceedings. (article 37.4)".

The minimum amount of debt which is bailed shall – inter alia, see article 39.3 - be determined on the following factors:

- to ensure that, if the bail in tool were to be applied the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to sustain sufficient market confidence in the institution[4];
- the size, the business model and the risk profile of the institution; and
- the extent to which the failure of the institution would have an adverse effect on financial stability, including, due to its interconnectedness with other institutions or with the rest of the financial system through contagion to other institutions.

Financial institutions are required to maintain a sufficient amount of bail-inable debt (see article 39 and 41).

Treatment of shareholders

In case of a bail in existing shareholders should be either exited (through a cancellation of their shares) or severely diluted (see article 42.1), provided however that the amount old shareholders get is based on what they should have gotten in case of a wound up (article 42.3):

> "When considering which action to take in accordance with paragraph 1, resolution authorities shall have regard to the likely amount of losses relative to assets before the exercise of the bail-in tool, with a view to ensuring that the action taken in respect of shareholders is consistent with that reduction in equity value; the valuation carried out in accordance with Articles 30 and 31 and in particular to the likelihood that shareholders would have recovered any value if the institution had been wound up on the basis of that valuation".

[3] Unless article 30.5 is applicable (in short: urgency of circumstances).

[4] See also article 51 e.f. re write down of capital instruments

Waterfall
The proposal also deals with the waterfall of claims of different creditors, the so called waterfall. Article 43 deals with this issue and makes clear that first equity, thereafter subordinated debt and only if that is not enough, senior debt is bailed in (and in any case on a so called pro rate parte basis, see article 43.2). The amount of bail in will be diminished if and to the extent the institutions has issued instruments that contain the following terms:

- terms that provide for the principal amount of the instrument to be reduced on the occurrence of any event that refers to the financial situation, solvency or levels of own funds of the institution; or
- terms that provide for the conversion of the instruments to shares or other instruments of ownership on the occurrence of any such event.

In other words, the famous cocos will be taken into account.
If a debt to equity conversion takes place, the ranking of different claims which are converted should be taken into account (see article 45). Further details still to be provided (see article 45.4).

Ancillary provisions
The new bail-in mechanism need to be facilitated, both through company and contractual law, article 48 and 49 (company law) and article 50 (contractual law) deals with these issues. See f.e. article 50.2 which limits the possibility of a financial institution to try to escape bail in dent by choosing a non EU law on the relevant debt.

Comments
My preliminary conclusion (as stated in my blog of January 14, 2011: "Irish Haircut is wrong, are Brussels and Basel doing a better job) was already that the Commission was on the right track. Just looking at bail-in debt, I still think the Commission gets it right. To put in plain English, get rid of the out of the money shareholders, dilute shareholders (heavily) if still in the money and write down capital instruments and convert into equity (relevant amount of equity to be decided pursuant to ranking) the creditors. The decision to exclude certain non-secured and non-preferred creditors is debatable but understandable.
The CEO of Rabobank Bert Bruggink reacts in the FD of June 7, 2012 that he worries about the fact that only EU banks are obliged to have this sort of debt.
The FT reacts on June 5, 2012 that the weal spot in the rules is that still regulators at an notional level and not at EU level remain in charge[5]. See also WSJ June 7, 2012: EU Offers Rescue Plan With Onus on Investors[6]

[5] FT June 5, 2012: National Interest threathen EN bank reforms: http://www.ft.com/intl/cms/s/0/50028acc-af28-11e1-a8a7-00144feabdc0.html#axzz1xOOBljBV and FT June 6, 2012: Brussels looks to bank investors not taxpayers, http://www.ft.com/intl/cms/s/0/f94b6432-afeb-11e1-ad0b-00144feabdc0.html#axzz1xOOBljBV
[6] http://professional.wsj.com/article/TPWSJEE00020120607e86700007.html

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Appendix

FAQ EU Commission dated June 6, 2012
http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/12/416&format=HTML&aged=0&language=EN&guiLanguage=en

The following short description of bail-in is taken from the FAQ:

V. BAIL-IN

19. What is the proposal to write down creditors ('bail in') and how would it work?

The mechanism would stabilise a failing institution so that it can continue to provide essential services, without the need for bail-out by public funds. Recapitalisation through the write-down of liabilities and/or their conversion to equity would allow the institution to continue as a going concern, avoid the disruption to the financial system that would be caused by stopping or interrupting its critical services, and give the authorities time to reorganise it or wind down parts of its business in an orderly manner – an 'open bank resolution'. In the process, shareholders should be severely diluted or wiped out, and culpable management should be replaced.

Open bank bail-in would be helpful in cases where other resolution tools may not deliver the best outcome as regards financial stability (e.g. banks where it may not be possible to find a private sector acquirer and transfer of systemically important functions to a bridge bank may be complex or destabilising).

In a 'closed bank resolution' the bank would be split in two, a good bank or bridge bank and a bad bank. The good bank-bridge bank is a newly created legal entity which continues to operate, while the old bad bank is liquidated. Bank creditors that are not systemic can either be left with the old bank and participate in the liquidation or be transferred to the new bank either reducing their claims or converting them into equity.

20. What instruments would bail-in apply to and in what order?

Bail-in would potentially apply to any liabilities of the institution not backed by assets or collateral, and not to deposits protected by a deposit guarantee scheme, short-term (e.g. inter-bank) lending, client assets, or liabilities such as salaries, pensions, or taxes. Member States can also choose to exclude other liabilities on a case-by-case basis if necessary to ensure the continuity of critical services.

The write down would follow the ordinary allocation of losses and ranking in insolvency. Equity should absorb losses in full before any debt claim is subject to write-down. After shares and other similar instruments, it would first, if necessary, impose losses evenly on holders of subordinated debt and then evenly on senior debt-holders.

The Deposit Guarantee Scheme (but not covered depositors who would remain unaffected) to which the institution is affiliated would rank alongside other unsecured creditors and be liable to assume losses, up to the amount of covered deposits, for the amount that it would have had to bear if the bank had been wound up under normal insolvency proceedings.

21. Are you proposing to require institutions to maintain a minimum level of liabilities that is subject to write down?

If debt write-down is to be a credible resolution tool, it is necessary to ensure that there are sufficient 'in-scope' liabilities when a resolution authority determines that an institution meets the conditions for resolution and that writing down the debt of an institution would be in line with the objectives of resolution. In other words, sufficient bail-in capacity should be provided for in all cases when the insolvency of a distressed institution would be detrimental for financial stability and taxpayers.

By definition, this will only be likely in the case of systemic institutions. Still, depending on their risk profile, complexity, size, interconnectedness etc., all banks should maintain (subject to on-going verification by supervisors), a percentage of their liabilities in the form of shares, contingent capital and other liabilities not explicitly excluded from bail-in. In this context, institutions could issue specific subordinated debt instruments which would absorb losses after regulatory capital but before any senior debt. The Commission would specify criteria to ensure similar banks are subject to the same standards.

The crisis has shown that a level of loss-absorbing capacity (own funds, subordinated debt and senior liabilities) at 10% of total liabilities (exclusive of regulatory capital) could broadly represent a threshold at which most recent bank failures could have been resolved with bail-in, and one which is largely consistent with the composition of banks' liabilities today. This is indicative however, and is not a proposed legal requirement.

22. Would the bail-in tool apply immediately to all outstanding debt or only after a transitional period?

The proposal states that the tool should apply as of 1 January 2018 to all outstanding and newly issued debt. This provides the relevant institutions and resolution authorities with a period of time (additional to the entry into force of the rest of the framework) during which to ensure required levels of eligible liabilities.

23. How much would bail-in cost banks, and ultimately the real economy?

The costs should be moderate, and by far outweighed by the expected macro-economic benefits associated with a far-reduced likelihood of systemic financial crises and economic disruption. The average increase in funding costs for banks is expected to be around 5-15 basis points. Subtracted from the expected benefit in terms of GDP of a lower probability of systemic crises, this translates into a net yearly benefit of 0.34-0.62% of EU GDP.

This is set out in the impact assessment accompanying this proposal. This assessment is based on the fact that: (i) bail-in would be better for creditors than normal insolvency, (ii) it would principally apply only to cross-border and other systemic institutions, (iii) these could satisfy the minimum requirement with new subordinated debt instruments if cheaper for them, and (iv) that there would be a sufficient degree of ex-ante funding for supporting the costs of resolution (whether via the Deposit Guarantee Scheme or a separate Resolution Fund).