MORRISON | FOERSTER

News Bulletin

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Possible Structures to Address Bail-In Proposals

Background

One important aspect of the international response to the financial crisis is the ongoing work in relation to proposals that banks and other financial institutions be required to issue debt with "bail-in" features, i.e. debt that is subject to write-down or conversion into equity in certain circumstances. The Financial Stability Board and Basel Committee for Banking Suspension are continuing to consider proposals in this regard, particularly in relation to institutions regarded as systemically important. A recent working document published by the DG Internal Market and Services of the EU Commission (the "EU Paper") set out various technical details of a possible EU framework for bank recovery and resolution. Amongst the more controversial aspects of the EU Paper is a proposal that a mechanism be introduced allowing relevant regulatory authorities of member states to require a bank to write down or convert to equity some or all of the debt owed to its unsecured creditors (subject to certain exemptions) upon the occurrence of specified trigger events.

Feedback to the EU Paper so far, including from the European Central Bank, has highlighted that such approach is likely to have a significant impact on the way banks obtain funding and should not be introduced without a full impact assessment being carried out. The EU Paper is therefore subject to development and change and the EU Commission may make significant changes to its approach following completion of the consultation process. We understand that concerns in relation to the EU proposals and the other international initiatives referred to above are already leading some investors away from unsecured senior bank debt and towards covered bonds.

As referred to above, the EU Paper envisages that certain debt might be excluded from the write-down and conversion powers including (i) swaps, repos and other derivative transactions, (ii) trade creditors, (iii) short term debt, (iv) retail and wholesale deposits (v) secured debt (including covered bonds) and (vi) claims covered by master netting arrangements. These exemptions will be critically important in structuring any debt instruments designed to fall outside any statutory bail-in power and are likely to be subject to considerable scrutiny and debate. If the EU Commission proceeds with the proposals, it may therefore seek to tighten-up or reduce the exemptions it currently envisages. The extent of some of these exemptions is also unclear including whether secured debt that is under collateralised will be fully or only partially exempt from the requirements.

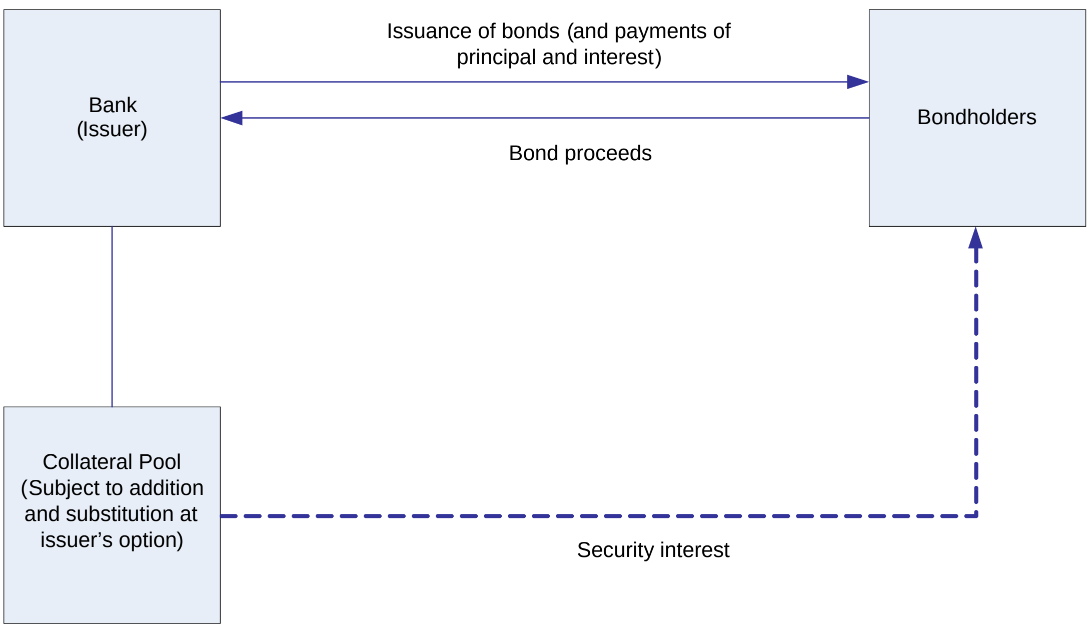
Although covered bonds and asset backed securities (including rmbs and cmbs) are an available source of funding for banks, and would be likely to fall within any exemption there are limitations and cost implications of such structures. We understand that some banks are considering "quasi" securitisation or covered bond structures that offer greater flexibility to issuers whilst offering investors senior debt of the bank that is not likely to be subject to write-down or conversion into equity once the bail-in legislation is finalised. We set out below our thoughts as to possible structures that could meet these objectives.

Possible Structures

In light of the above, we have set out some preliminary thoughts below as to how senior debt could be structured so as to not be subject to any statutory bail-in power of a regulatory authority to require the debt to be subject to write-down or conversion into equity upon the occurrence of specified trigger events. We have sought to avoid structures likely to be regarded too complex by investors or which have multiple tranches of debt. We have also sought to develop structures which could be structured as fixed income products. Such structures would need considerable further analysis, particularly in respect of relevant insolvency laws, tax legislation and laws impacting upon the validity of the security granted by the issuer.

1. *Secured Bonds*

If secured debt is exempt from any statutory bail in provisions, a bank could issue full recourse secured bonds directly to investors. The collateral could comprise residential or commercial mortgages or other assets. To achieve flexibility for the bank and to enable replenishment of the pool enabling longer maturities, it is envisaged that the issuer would have the ability to add further collateral to the pool as existing collateral amortises or matures subject to meeting specified criteria. Such a structure could also be developed as a continual issuance programme with all debt issued under the programme sharing in the collateral pool and would therefore be very similar to many covered bonds. It would not however be subject to the same collateral tests and other requirements of a statutory covered bond.

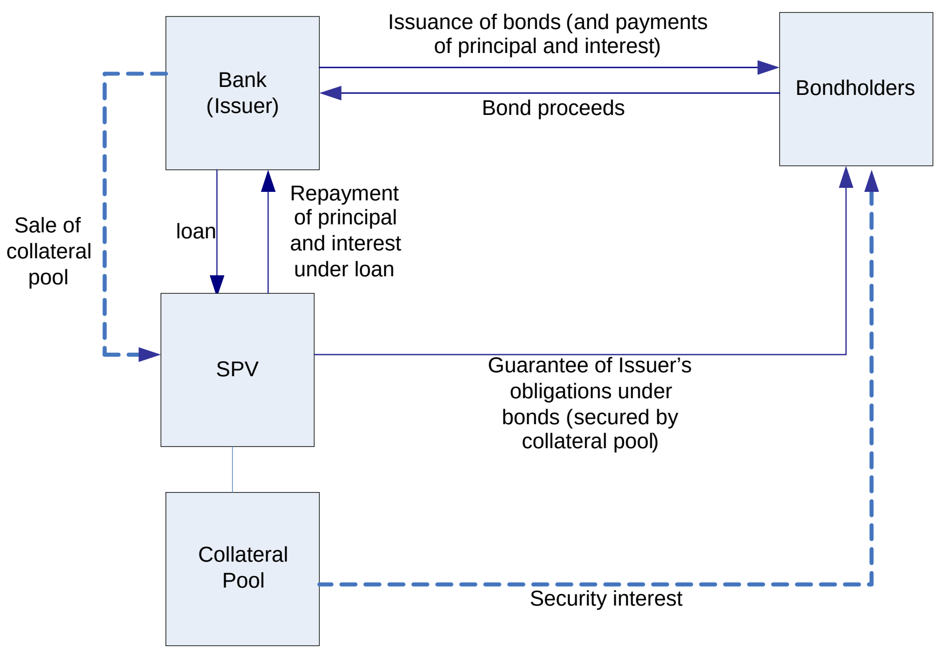


As with covered bonds, such a structure would not be off balance sheet funding for the bank and the collateralised assets would remain on its balance sheet for accounting and regulatory purposes. Any rating of the bonds is likely to be closely linked to the rating of the issuer.

Possible drawbacks to this structure include the fact that allowing substitutions of the collateral pool is likely to mean it would not be treated as first fixed collateral (although such arrangements should still constitute a valid security interest and therefore potentially defeat any mandatory bail-in provisions). Direct ownership of the pool by the issuer may also increase the risk of the collateral being sought to be clawed back by an administrator or other insolvency officer of the bank or, depending upon the rules of the jurisdiction where the bank is located, being subject to a moratorium against enforcement or liable to transfer to a third party under relevant statutory resolution or recovery powers. Such concerns may be alleviated by using a structure along the lines set out under heading 2 below. It is also likely that under any such structure, upon an insolvency of the issuer, the bonds would need to be accelerated and the collateral realised reasonably shortly after the insolvency of the issuer. This would therefore mean that, unlike many covered bond structures, the noteholders would not be able to continue to receive scheduled principal and interest following a default of the issuer.

2. *Secured Bonds with Collateral Transferred to Third Party*

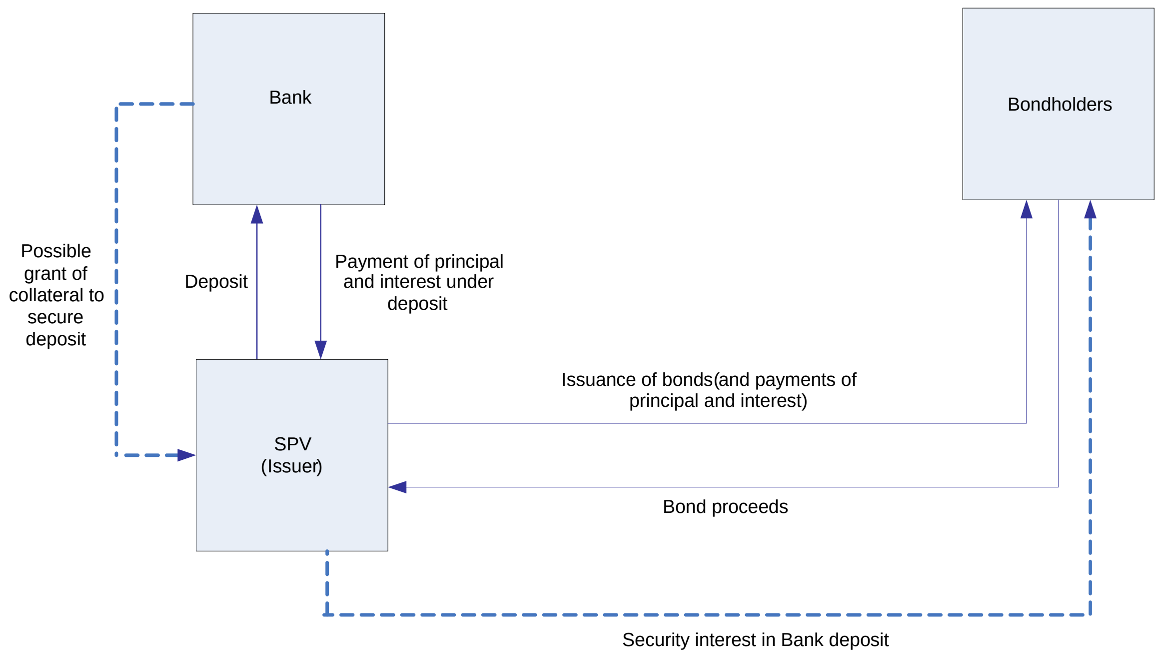
To deal with some of the possible legal issues identified in structure 1 above, an alternative would be for the bank to issue full recourse secured bonds directly to investors but with the issuer transferring the collateral to a third party entity (possibly a subsidiary). Although there are various ways the collateral arrangement could be structured, one possibility would be an approach similar to that in UK covered bonds with, the issuer issuing bonds (which could be under a continuous issuance structure) and lending the proceeds to a subsidiary SPV company or LLP. The SPV would then use the loan proceeds to purchase the collateral from the issuer and guarantee the issuer's obligations under the bonds (which guarantee would be secured by the collateral). Another possibility would be for the collateralised assets to be transferred to a trust to be held for the benefit of bondholders.



Such structures could also provide for additions and substitutions to the original collateral pool subject to the satisfaction of specified criteria. As with structure 1 above, the issuer would not be subject to the same collateral tests and other legislative requirements of a statutory covered bond although the collateralised assets and the bond liabilities are likely to remain on the issuer group's balance sheet for accounting and regulatory purposes. Having the collateral pool held outside the issuer makes it less likely the collateral arrangements could be immediately disrupted following an insolvency of the issuer. It is also possible that the arrangements could be structured so the underlying bonds do not accelerate on the issuer's insolvency and the bondholders continue to receive scheduled payments from the guarantor. This would only be practicable if arrangements could be made for the continued servicing of the collateral assets other than by the issuer in these circumstances.

3. *Wholesale Deposit Repackaging Structure*

The EU Paper also envisages that retail and wholesale deposits would be exempt from the statutory bail-in power. It might be possible to take advantage of this exemption by utilising a deposit repackaging structure under which a special purpose vehicle could be used to make a deposit at a bank. To fund the deposit, the spv would issue bonds to investors. The spv could then provide security over the deposit in favour of the bondholders. The bonds would therefore have the benefit of the credit of the bank. If desirable, the bank could also provide collateral to secure its obligations under the deposit in one of the ways set out under structures 1 and 2 above.

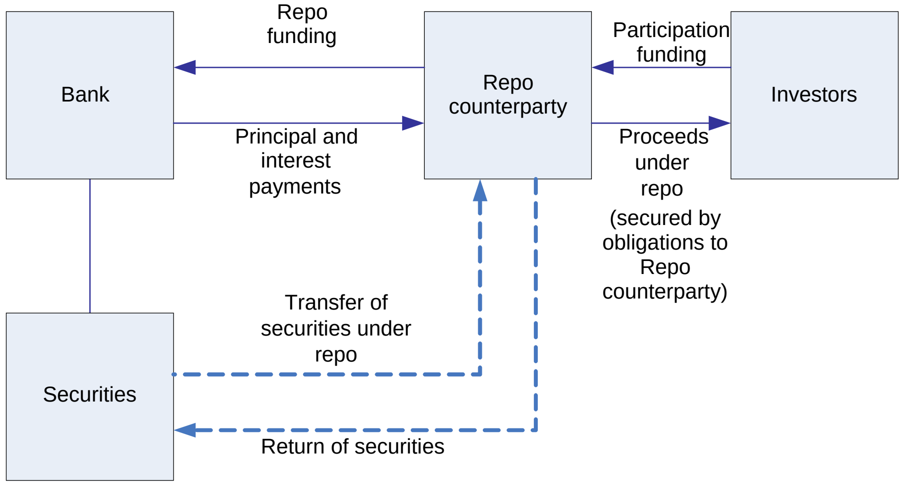


For this structure to be effective, it would need to be ensured that the deposit meets any applicable requirements to be exempt from the statutory bail-in power (and in view of the relative ease of using deposits in such structures it is likely that the EU will seek to draw an exemption for deposits narrowly). The more complex the deposit, the more likely it would not be regarded as a deposit for the purpose of the relevant statutory provision. There is, however, no reason in principle why a deposit could not be designed as a long term deposit with interest payments structured to match the payment obligations on the bonds. If any detailed structuring of the cash flows under the bonds was necessary, it might also be possible to supplement the deposit with a swap between the spv and the bank (the EU Paper also currently envisaged that swaps would fall outside the statutory write-down power).

4. *Repo Type Arrangements*

It may also be possible to structure a financing structure to take advantage of the carve-out from the statutory write-down power in relation to repos. If a bank had securities available to be used for repo transactions, it could enter into repo arrangements with a counterparty. It could also repackage assets of the bank into transferable securities which could be used for such repo activities.

To obtain funding from a greater range of investors, a bank could enter into a repo facility with a counterparty (which could be a SPV or subsidiary) which could syndicate the repo funding with other investors either directly or through a participation in the repo activities. So that investors have the benefit of the credit of the bank, the repo counterparty would collateralise its obligations to investors by granting security over the obligations of the bank to it under the repo.

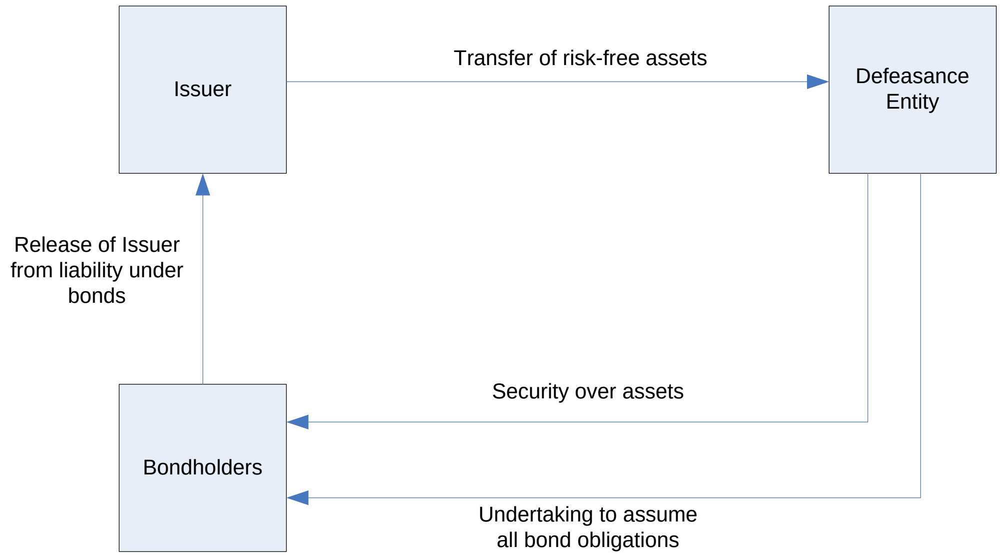


5. *Call Option/Put-Option*

In cases where it is not possible to structure a bond so as to fall within any exemptions to the bail-in requirements, it may be necessary to consider building in either or both of a call option or put option. Such option(s) could be designed to be exercisable well before any exercise of bail-in powers was likely to be applied by the relevant supervisor. This could be difficult to design with any degree of certainty, particularly for situations where the financial situation of an entity deteriorates quickly. The possible shortened maturity of the bond would also have a significant impact on the pricing of the bond. One possible way of minimising the pricing impact of a bond exit would be to consider a defeasance structure.

6. *Defeasance*

Defeasance is the process of (i) releasing the issuer from its bond obligations without redeeming/repurchasing the bond by (ii) substituting for the issuer a risk-free third party to assume the bond obligations. One way this could be achieved, illustrated below, is by the issuer transferring low risk assets, such as US Treasuries, to a special purpose vehicle (the “defeasance entity”), which then assumes the primary obligation to make required payments under the bonds and grants a first priority security interest to the bondholders over transferred assets, to secure its bond obligations.



The terms and conditions of the bonds will provide for the issuer to be released from its payment obligations provided certain criteria are satisfied which are likely to include matters such as (i) the limited corporate purpose of the defeasance entity, (ii) the permitted types of risk-free assets and minimum levels of collateralisation and (iii) legal opinions confirming the validity of the asset transfer and the enforceability of the bond obligations and the security arrangements against the defeasance entity.

After the defeasance takes effect, any bail-in affecting the issuer should have no effect on bondholders as the bonds are no longer obligations of the original issuer. Any insolvency of the issuer should not affect the bondholders, so long as the transfer of assets to the defeasance entity took place at fair value, prior to the onset of insolvency and the defeasance entity is not a creditor of the original issuer. The defeasance entity could be structured so as to be "bankruptcy-remote" in that the rights of the bondholders against the defeasance entity are expressed to be limited in recourse to the value of the pledged risk-free assets, and since the defeasance entity is structured as a single purpose entity there should be no realistic likelihood of the defeasance entity's insolvency.

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