EU BAIL-IN POWERS AND TRANSACTION STRUCTURING

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Background to EU Bail-In Powers

- During Financial Crisis many failing banks bailed out by public sector funds – considered “too big to fail” e.g. Citigroup, RBS, Lloyds
- Some failing banks allowed to fail e.g. Lehmans, Icelandic banks
- Became apparent that existing insolvency regimes not suited to bank/financial institution failures
- Some jurisdictions, including UK, drew up legislation to implement “resolution” regimes for banks and certain financial institutions
Bank Resolution

- Restructuring of a failing institution by a regulator through use of resolution “tools” and ancillary powers, to:
  - ensure continuity of critical functions
  - preserve financial stability
  - restore viability of all or part of the institution
  - any remaining non-viable parts to be placed into normal insolvency proceedings
- Aim is to be able to effect all resolution actions over a “resolution weekend” to minimise uncertainty and loss of market confidence/financial contagion
International Response

• G-20 summit in Seoul, November 2010 agreed that no firm should be too big/complicated to fail and taxpayers should not bear costs of bank resolution

• Summit endorsed Financial Stability Board’s policy framework designed to reduce moral hazard risks posed by systemically important financial institutions (SIFIs)

• Reaffirmed its commitment to national implementation of Basel Committee’s cross-border resolution recommendations and asked FSB to develop key attributes of effective resolution regimes

• November 2011, FSB published its Key Attributes for Effective Resolution Regimes for Financial Institutions
UK and EU Responses

• UK Banking Act 2009 introduced Special Resolution Regime for banks and some other financial institutions

• Applies to banks, building societies, certain investment firms, recognised CCPs and bank holding companies

• 3 pre-insolvency stabilisation options for banks:
  ➢ transfer to private sector purchaser
  ➢ transfer to bridge bank
  ➢ transfer to temporary public sector ownership

• Bank Insolvency Procedure – the default option unless in public interest to use a stabilisation option
UK and EU Responses (cont.)

- Bank Administration Procedure – for use in a partial transfer in conjunction with private sector purchase or bridge-bank tool

- PRA responsible for triggering SRR in respect of a bank, if satisfied that:
  - bank is failing, or likely to fail, to satisfy PRA’s threshold conditions, and
  - not reasonably likely (having regard to timing and other circumstances) that action will be taken by or for the bank that will enable it to satisfy threshold conditions


- BRRD finally entered into force on 2 July 2014

- Most complex and controversial provisions for legislators to agree on were bail-in provisions
UK and EU Responses (cont.)

• Member States must implement into national laws by 1 January 2015, except for bail-in provisions which must be implemented by 1 January 2016

• UK has indicated it will enact legislation to implement bail-in provisions also by 1 January 2015
BRRD – Key Features

• Appointment of national resolution authority for each EU member state

• Single Resolution Board replaces national resolution authorities for banks subject to supervision by ECB under Single Supervision Mechanism – broadly banks in member states that are participating in Eurozone and some others

• Bank of England is resolution authority for UK

• Main objectives of bank resolution (Article 31):
  - continuity of critical functions
  - avoid significant adverse effect on financial system by preventing contagion and maintaining market discipline
  - protect public funds by minimising reliance on extraordinary public support
  - protect depositors and investors covered by a guarantee scheme
  - protect client funds and client assets
• Recovery plan to be prepared by each institution and submitted to national competent authority for review. Plan must detail measures to be taken by institution to restore its financial position following significant deterioration of its financial situation

• Resolution authority must draw up resolution plan for each institution in consultation with national competent authority and resolution authorities in all jurisdictions where any significant branches are located. Resolution plan must provide for resolution actions to be taken where institution meets conditions for resolution
BRRD – Key Features (cont.)

- Resolution plan must assess resolvability of institution without extraordinary public support (other than permitted resolution financing) or central bank liquidity assistance on emergency or non-standard terms
- Institution must provide all required information and assistance needed to prepare resolution plan
- Resolution authority must also identify material impediments to resolvability, including actions to address the impediments
BRRD – Key Features (cont.)

• Intra-group financial support
  - parent institutions must be permitted to enter into financial support agreements with their subsidiaries in other member states or third countries where those entities are part of the same consolidated supervision

• Where the conditions for early intervention are satisfied, any party to that agreement may provide financial assistance (loans, guarantees, use of assets as collateral, or any combination) to another party

• Member states must remove any national legal impediments to such financial support arrangements
BRRD – Key Features (cont.)

• Early intervention measures to be available to national competent authorities in cases of rapidly deteriorating financial condition, including where one of the following measures:
  
  ➢ deteriorating liquidity
  ➢ increasing leverage levels
  ➢ increasing non-performing loans
  ➢ increasing concentration of exposures

  is likely to infringe prudential requirements, including CRD4/CRR
BRRD – Key Features (cont.)

• Measures include:
  ➢ requiring management to implement measures contained in the recovery plan
  ➢ requirement management and/or shareholder meeting to approve/implement an action plan for recovery
  ➢ removing management if found unfit to perform duties
  ➢ requiring management to draw up debt restructuring plan to negotiate with creditors
  ➢ requiring changes to business strategy and/or to legal or operational structures

• Where above measures insufficient to reverse deterioration, competent authorities may require removal of senior management, in whole or in part and, where this is considered insufficient to remedy the situation, competent authorities may appoint a temporary administrator
BRRD - Resolution

• Where the above recovery plan and other early intervention measures are insufficient to stop the financial deterioration, resolution authorities must consider whether conditions to resolution actions have been met

• Resolution authority must consider that all of following conditions are met, before taking resolution action:
  ➢ competent authority or resolution authority has determined, after consulting the other authority, that the institution is failing or likely to fail
  ➢ having regard to timing and other relevant circumstances, there is no reasonable prospect that alternative private sector measures or supervisory action (including early intervention measures and/or write down or conversion of capital instruments) would prevent failure
  ➢ resolution action is necessary in public interest
BRRD – Resolution (cont.)

- Institution shall be deemed to be failing or likely to fail in any of the following circumstances:
  - the institution infringes or will, in the near future, infringe the requirements for continuing authorisation, so as to justify a competent authority from withdrawing authorisation – including but not limited to the incurral of losses that will deplete all or a significant amount of its own funds
  - the institution's assets are or will in the near future be less than its liabilities
  - the institution is or will in the near future be unable to pay its debts or other liabilities as they fall due
  - extraordinary public financial support is required (except that the following extraordinary public financial support is discounted):
    - a state guarantee to back central bank liquidity facilities in accordance with the central bank’s conditions
    - a state guarantee of newly issued liabilities
    - an injection of own funds or purchase of capital instruments on terms that do not confer an advantage upon the institution
• The European Banking Authority shall, by 3 July 2015, issue guidelines regarding the interpretation of the different circumstances when an institution shall be considered to be failing or likely to fail – draft guidelines published in September 2014

• These resolution powers apply not only to credit institutions and MiFID investment firms, but also to other EU financial institutions that are subsidiaries of the foregoing and are subject to the same consolidated supervision, or subsidiaries of financial/mixed financial/mixed activity holding companies established in the EU
• When applying resolution tools and powers, resolution authorities must have regard to following resolution objectives and choose tools/powers that best achieve the objectives relevant to the particular circumstances:
  - to ensure continuance of critical functions
  - to maintain financial system stability
  - to protect public funds by minimising reliance on public sector support, e.g. bailouts
  - to protect guaranteed deposits
  - to protect client funds/ assets
BRRD – Resolution general principles

- Resolution authorities must ensure resolution action taken in accordance with following principles:
  - the shareholders of the institution must bear first losses
  - creditors of the institution bear losses after the shareholders in accordance with the priority of their claims under normal insolvency proceedings, except as expressly provided otherwise
  - the management body and senior management of the institution are replaced except where their retention is considered necessary to achieve the resolution objectives
  - except where otherwise provided, creditors of the same class are treated in an equitable manner
  - no creditor shall incur greater losses than they would have incurred under normal insolvency proceedings
  - covered deposits are fully protected
Before any resolution action (or writing down/converting capital instruments) can be taken, assets and liabilities of the institution must be valued by a valuer independent from the institution, as well as from the resolution authority and any other public authority. Among other things, this valuation is used to determine the extent to which capital instruments need to be written down/converted and the extent of any write-down or conversion where liabilities are bailed in, using the bail-in tool. Valuation based on prudent assumptions, including as to rates of default and severity of losses, but must assume no future provision of extraordinary public support or central bank assistance on emergency/non-standard terms.
BRRD – Valuation (cont.)

- Must indicate sub-division of different creditors, based on priority levels under applicable insolvency law, and an estimate of recovery for each class under a standard winding-up action

- EBA may draft regulatory technical standards to specify methodology for assessing value of assets and liabilities – draft RTS published in July 2014
BRRD – Resolution tools

• Sale of business tool – power to transfer to a purchaser (on commercial terms) shares, or all or any assets, rights or liabilities of institution, without consent of shareholders or third parties and without complying with any procedural requirements under company or securities law

• Bridge institution tool – similar power to transfer to a bridge institution shares, or all or any assets, rights or liabilities of institution. Bridge institution is a publicly-owned entity, created for purpose of receiving shares/assets/liabilities in a resolution with a view to maintaining access to critical functions and selling the institution
BRRD – Resolution tools (cont.)

- Asset separation tool – power to transfer assets, rights or liabilities of an institution under resolution or of a bridge institution to one or more publicly-owned asset management vehicles, who will manage the transferred assets with a view to maximising their value by sale or eventual write-down
- Bail-in tool
- Tools can be applied individually or in combination
• What is bail-in?
• The imposition of losses on liabilities owed by a financial institution where such liabilities would not, by their terms, be required to absorb such losses

• Loss absorption by:
  ➢ conversion of the liability into a common equity instrument – the most loss-absorbent instrument
  ➢ writing down/off the principal amount of the liability

• Bail-in tool can be used either to:
  ➢ recapitalise the institution under resolution to the extent necessary to restore its ability to comply with the conditions for its authorisation and so continue performing its authorised activities, and to sustain market confidence in the institution; or
  ➢ convert to equity, or reduce the principal amount of, claims or debt instruments that are transferred to a bridge institution (in order to provide capital for that bridge institution) or under the sale of business tool or asset separation tool
• What is bail-inable?
• All liabilities that are not expressly excluded from the scope of bail-in

Express Exclusions

- covered deposits – deposits up to the amount covered by a deposit guarantee scheme
- liabilities in respect of holding client assets or client money, where the client is protected under applicable insolvency law
- liabilities resulting from a fiduciary relationship, where the beneficiary is protected under applicable law
- liabilities to other financial institutions (outside its group) with an original maturity of less than seven days
- liabilities with a remaining maturity of less than seven days, owed to payment or securities settlement systems or their participants
- employee remuneration or benefits (other than variable remuneration)
- liabilities to commercial/trade creditors relating to provision of critical goods/services
BRRD – Scope of Bail-In Tool (cont.)

- liabilities to tax and social security authorities that are preferred by law
- liabilities for contributions owed to deposit guarantee schemes
- secured liabilities – expressly including covered bonds and hedging instrument liabilities of the covered bond issuer

Additional exclusions

- Resolution authority can wholly or partially exclude liabilities from the scope of bail-in in the following circumstances:
  - where it is not possible to bail-in the liability in a reasonable timeframe
  - where the exclusion is necessary and proportionate to achieve continuity of critical functions/core business lines
  - where the exclusion is necessary and proportionate to avoid widespread contagion that would disrupt functioning of financial markets – particularly as regards deposits of individuals and SMEs
  - where bailing-in the liability would cause higher losses to other creditors than not bailing it in
BRRD – Scope of Bail-In Tool (cont.)

• European Commission to adopt delegated acts as to when such an exclusion is necessary

• Where such an exclusion is made by a resolution authority, it may proportionately increase the level of write down or conversion to be imposed on other eligible liabilities

• European Commission can block a proposed exclusion where this would result in a contribution from the resolution financing arrangement

• Where an eligible liability is excluded and the losses that would have been absorbed by that liability is not passed on fully to other creditors, contribution can be made by the resolution financing arrangement to:
  - cover any unabsorbed losses and restore net asset value of institution to zero; or
  - purchase shares or capital instruments in the institution to recapitalise the institution so as to restore its Common Equity Tier 1 capital ratio
BRRD – Scope of Bail-In Tool (cont.)

- Resolution financing arrangement to be established by each Member State, to be funded by:
  - ex ante contributions from institutions authorised in that Member State, including EU branches of non-EU banks (to reach at least 1% of the amount of covered deposits of all institutions authorised in that Member State, by 31 December 2024)
  - ex post extraordinary contributions (where ex ante contributions insufficient) limited to 300% of the annual ex ante contributions
  - contract borrowings and other forms of financial support where the ex ante and ex post contributions are insufficient

- Resolution financing arrangement may only contribute to loss absorption for an institution under resolution where:
  - own funds, capital instruments and eligible liabilities have already absorbed losses of at least 8% of institution’s total liabilities (including own funds) measured pursuant to the resolution valuation; and
  - the contribution from the resolution financing arrangement does not exceed 5% of total liabilities (including own funds) measured pursuant to the resolution valuation
BRRD – Scope of Bail-In Tool (cont.)

• Such contribution can be funded from ex ante contributions, amounts that can be raised from ex post contributions within 3 years, and from alternative financing arrangements.

• In extraordinary circumstances, resolution authority can seek additional funding from alternative sources where 5% contribution has been used up and all unsecured non-preferred liabilities (other than eligible deposits) have been fully bailed-in.

• The resolution financing arrangement can contribute even where the 8% loss absorption has not been effected if the institution has consolidated assets below EUR 900bn and:
  - loss absorption equal to at least 20% on institution’s risk weighted assets has been effected; and
  - resolution financing arrangement has at its disposal ex ante contributions (excluding deposit guarantee scheme contributions) of at least 3% of covered deposits of institutions authorised in that Member State.
Bail-in sequence under BRRD

- **Regulatory Capital**
  - Common Equity Tier 1
    - Fully loss absorbent
  - Additional Tier 1
    - Going concern loss absorbent and gone concern loss absorbent
  - Tier 2
    - Gone concern loss absorbent (possibly also going concern loss absorbent)
  - Other Subordinated Debt Instruments
    - Gone concern loss absorbent
- **Non-regulatory capital**
  - Senior Unsecured Liabilities (incl. non-privileged deposits)
    - Gone concern loss absorbent
  - Privileged/Secured/Insured Liabilities
    - Excluded/non-loss absorbent
BRRD – Minimum Bail-inable Liabilities

• Each Member State must set a minimum required level of loss-absorbing liabilities (consisting of own funds (regulatory capital) and bail-inable liabilities) expressed as percentage of the aggregate of an institution’s own funds and total liabilities – N.B. not risk-weighted assets

• Minimum own funds are already established by Capital Requirements Regulation by reference to risk-weighted assets

• Where liability governed by law of a non-EU country, it will only count towards minimum bail-inable liabilities where resolution authority is satisfied that the non-EU country would give effect to a decision to bail-in that liability, whether by virtue of the terms of the contract creating the liability, or by international agreements on the recognition of resolution actions/proceedings
In context of financial groups, group level resolution authorities and institution-level resolution authorities must reach joint decision on the levels to be applied, and can require that all or part of the minimum eligible liabilities be in the form of contractual bail-in instruments.

Contractual bail-in instruments are those which:

- contain a contractual term providing that where a resolution authority decides to apply the bail-in tool the instrument shall be written down/converted before other eligible liabilities are written down or converted; and
- are subject to a binding subordination agreement, undertaking or other provision under which, in the event of normal insolvency proceedings, it ranks below other eligible liabilities and cannot be repaid until other outstanding eligible liabilities have been settled.
BRRD – Bail-in treatment of shareholders

• Existing shares to be cancelled or transferred to bailed in creditors
• Where, under the resolution valuation, the institution has a positive net asset value, existing shareholders to be diluted by conversion of existing capital instruments or conversion of eligible liabilities
• In such a case, conversions must “severely dilute” the existing shareholdings
• Above applies also to shareholders who had already been converted pursuant to going concern conversion of capital instruments (e.g. Additional Tier One capital) or of other debt instruments
BRRD – Bail-in of Derivatives

- A derivative liability can only be bailed-in once the derivative contract has been terminated and closed out.
- Where subject to a netting agreement (e.g. ISDA Master), the liability should be valued (for the purpose of the resolution valuation) on a net basis.
- EBA to develop (in consultation with ESMA) draft regulatory technical standards by 3 January 2016 on the methodologies and principles for valuing derivatives liabilities.
- Where subject to a netting agreement, EBA “shall take into account the methodology for close-out set out in the netting agreement”
BRRD – Bail-in of Derivatives (cont.)

- In relation to derivatives contracts, Article 71 BRRD gives resolution authority power to suspend termination rights of parties to contracts with institution under resolution, until midnight on the business day following official notice of the resolution action, so long as obligations regarding payments/deliveries/collateral exchange are kept current.

- FSB and other regulators concerned that powers such as these might not be enforceable against third country counterparties, where contract governed by the domestic law of the relevant court.

- Strongly encouraged derivatives industry to take steps to insert termination suspension provisions into the contracts governing derivatives and ISDA has been preparing a draft protocol for parties to be able to modify terms of their ISDA Master Agreement – 18 major global banks have indicated their willingness to accede.

- Also intended to be in sufficiently generic language that it would be used for other arrangements such as securities repo contracts.

- FSB will recommend that national regulators require regulated entities to adopt similar contractual language.
BRRD – Effects of Bail-In

- Different equity conversion ratios may be applied to different classes of capital instruments and liabilities, to reflect:
  - appropriate levels of compensation for loss incurred due to exercise of write down and conversion powers
  - the seniority of the liability that was bailed-in – higher conversion rates for more senior liabilities
- EBA to develop guidelines by 3 January 2016
- Exercise of bail-in tool to recapitalise an institution must be followed by preparation of a business reorganisation plan
- Where principal amounts are written down, they cannot be subsequently written up – compare position on a going concern write-down under CRR
Effect of BRRD on Deposits

- Covered deposits (i.e. the amount of a deposit that is covered by a deposit guarantee scheme) is excluded from bail-in.
- BRRD also requires that national insolvency regimes give deposits priority status.
- Therefore, in a winding-up proceeding (i.e. not a resolution) the amount of an eligible deposit that is not covered by a deposit guarantee scheme ranks senior to other unsecured liabilities, as do deposits that would have been eligible deposits if they had not been made with a non-EU branch of an EU bank.
- In turn, covered deposits and claims for covered deposits subrogated to a deposit guarantee scheme will rank senior to the deposits in the previous bullet point.
BRRD – Bail-In Ancillary Provisions

• Resolution authority given powers to complete (or require completion of) all administrative procedures needed to give effect to exercise of bail-in tool, including amending registers, delisting securities, admitting new securities to trading, relisting any debt securities that have been written down (without the need for a PD-compliant prospectus)

• Institutions must maintain sufficient authorised, unissued share capital/common equity tier 1 instruments to ensure any bail-in conversion can be carried out effectively and Member States must ensure no procedural impediments to conversion (e.g. overriding shareholder pre-emption rights or shareholder consents)
BRRD – Bail-In Ancillary Provisions (cont.)

• Where a liability of an institution is:
  ➢ not expressly excluded from bail-in under BRRD
  ➢ not a preferential deposit
  ➢ issued after the date on which the institution’s Member State implements the BRRD nationally
  ➢ governed by the law of a non-Member State

the contractual terms of that liability must provide that the creditor recognises that the principal of the liability may be written down or converted and agrees to be bound by any bail-in action by a resolution authority
BRRD – Cross-border Recognition of Bail-in

- FSB Consultation of 29 September, 2014 proposed statutory changes to be adopted by countries and also contractual approaches that G-SIBs should implement, in each case to enhance effectiveness of cross-border resolution actions

- Statutory provisions as to recognition of foreign resolution actions are preferable in the long term, but will take time to implement

- In the meantime, FSB recommends mandating contractual clauses providing for recognition of resolution bail-in actions, based on five key principles:
  
  - there should be a clear agreement by the creditor to be bound by the terms of the bail-in, and that the terms of the bail-in will be given effect
  
  - the consequences of a bail-in should be prominently disclosed to investors in the instrument, in accordance with applicable disclosure requirements
  
  - the recognition provisions should be drafted in general terms, in order to ensure no conflict with how the statutory bail-in regime may be applied in practice
institutions should seek independent legal advice in the jurisdiction of the instrument’s governing law, to ensure that the contractual provisions take into account relevant legal issues and

institutions should be required to demonstrate the enforceability of any statutory bail-in of instruments governed by foreign law, including through the provision of an independent legal opinion.

• The FSB further recommends that if the laws of the jurisdiction governing the instrument do not provide a bail-in mechanism, the inclusion of the proposed contractual recognition language could be a condition to eligibility of the instrument to count towards loss-absorbing capacity

• Similar provisions are contained in the Basel Committee/CRR requirements for gone concern loss absorption of regulatory capital instruments
UK Implementation of BRRD

- Recent consultations by HM Treasury, PRA and FCA all closed in September/October 2014
- Bail-in tool will be implemented by 1 January 2015, and the remainder of BRRD by 1 January 2016
- According to PRA consultation, requirement for foreign law – governed liabilities to contain contractual bail-in recognition clauses may be phased in – 1 January 2015 for regulatory capital, bonds and other debt market instruments, and 2016 for other liabilities
- In the UK, bail-in powers are already provided for in Financial Services (Banking Reform) Act 2013, which amends Special Resolution Regime in Banking Act 2009. This part of the 2013 Act yet to be commenced, and HMT decided that it will not now commence before implementation of BRRD. It will be amended to comply with BRRD and take effect on 1 January 2015, with the exception of Article 45 concerning the Minimum Requirement for Eligible Liabilities (“MREL”)
- These provisions being delayed until FSB’s proposals on Gone-Concern Loss Absorbing Capital for Global SIFI’s are outlined and adopted by G20 summit in Brisbane in November 2014, as well as regulatory technical standards from EBA on the assessment criteria for MREL
The Market for Bailable – In Instruments

• Who will buy unsecured debt instruments issued by banks post – 2015 (or post - 2014, in respect of UK institutions)?

• Traditional fixed income investors may not have an investment mandate allowing the holding of equity or contingent convertible instruments – if not, mandates will need to be adjusted either to allow holding of post- conversion equity instruments long term, or at least until they can be disposed of – which may take time in an environment of law liquidity after a major bank failure

• Bail-in consequences will have to be clearly disclosed to ensure investor understanding. Will regulators continue to allow retail investors to invest in unsecured bank debt? Are retail investors capable of understanding bail-in mechanics? How much do they need to understand?

• Regulators have concerns about selling contingent convertible bonds to ordinary retail investors due to concerns about ability to comprehend the loss absorption mechanics and trigger points, and to compare them with other products. FCA has imposed a 12 month ban on sales of CoCos to ordinary retail investors until 30 September 2015. Will they have similar concerns about instruments subject to resolution bail-in?
The Market for Bailable – In Instruments – (cont.)

• Will banks and investment firms still be able to invest in unsecured debt and contingent convertible instruments issued by other banks and investment firms?

• Regulators concerned about possibility of financial contagion in event of bank’s failure

• Article 44(2) BRRD states that, in addition to any large exposure rules that apply to banks and investment firms, resolution authorities must limit the extent to which other institutions hold liabilities eligible for bail-in

• Limits can be imposed as part of resolution authority's powers to remove impediments to resolvability
How will senior unsecured bank debt be priced?

- Unsecured debt – bail-inable in a resolution, and so provides gone-concern loss absorption. How will this be priced in comparison with other funding instruments issued by an institution, such as:
  - additional tier 1 capital (which will always have going-concern and gone concern loss absorption)
  - tier 2 capital (which will always have gone concern loss absorption) with going concern loss absorption
  - tier 2 capital without going concern loss absorption
  - other subordinated instruments
  - contingent convertible instruments with a “high trigger point”
  - contingent convertible instruments with a “low trigger point”
What Structures May Become Attractive to Debt Investors?

- Covered bonds
  - expressly excluded from bail-in powers, as are financial instruments used for hedging and forming part of the cover pool
- Other secured liabilities, such as secured bank bonds
  - also expressly excluded from bail-in provisions
- BUT for both covered bonds and other secured liabilities, they are only excluded from the bail-in powers to the extent of the value of the assets securing those liabilities. Any amount of liability in excess of the value of the secured assets will be treated as unsecured and subject to bail-in powers
- For covered bonds with high levels of over-collateralisation, unlikely to be caught by bail-in, but not impossible
- Volumes of secured liabilities that could be issued by an institution will be limited by, inter alia:
  - existing asset encumbrance limits imposed by bank supervisors
  - new national requirements, pursuant to Article 45 BRRD, to maintain minimum levels of regulatory capital and bail-inable liabilities, as a percentage of their total liabilities plus own funds
What Structures May be Attractive to Debt Investors? (cont.)

- Secured bank bonds
  - full recourse secured bonds issued directly to investors, secured by mortgage loans or other financial assets
  - perhaps structured as a continual issuance programme
  - structures may (or may not) allow replenishment of cover pool for flexibility
  - therefore could be similar to covered bonds, but not subject to same collateral tests and other requirements of a statutory covered bond
What Structures May be Attractive to Debt Investors? (cont.)

- Put option
  - for liabilities that cannot be made exempt from bail-in, may be possible to structure in investor put option
  - would need to trigger well in advance of any resolution decision and would need to be drafted very carefully
  - Article 68 BRRD will prevent any resolution measure, early intervention measure, or exercise of powers to remove impediments to recoverability or resolvability, being used to affect the contractual rights of the institution
  - A put option would affect pricing significantly and difficult to design with any degree of certainty, due to possibility of an institution's financial health deteriorating rapidly
Defeasance Structure

• In cases where it is not possible to structure a bond so as to fall within any exemptions to the bail-in requirements, a defeasance structure could be considered

• 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 is by the issuer transferring low risk assets 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
Defeasance Structure (cont.)

• The bonds will provide for the issuer to be released from its payment obligations provided certain criteria are satisfied.

• 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 would 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.
Defeasance Structure Diagram

- **Issuer**
  - Transfer of risk-free assets to **Defeasance Entity**
  - Release of Issuer from liability under bonds

- **Defeasance Entity**
  - Security over assets

- **Bondholders**
  - Undertaking to assume all bond obligations
Bail-in Case Study: Cyprus

- Cyprus financial system under significant strain in aftermath of financial crisis
  - January 2012 - emergency €2.5bn loan from Russia
  - March 2012 – Cyprus banks downgraded to sub-investment grade by Moody’s
  - June 2012 - Cyprus banks downgraded to BB+ by Fitch
  - Cyprus requested bail-out from European Stability Mechanism (ESM)
  - ECB proposed bail-out terms in November 2012 subject to strict austerity measures being put in place – no agreement reached
  - Continued financial pressures meant Cyprus Popular Bank (Laiki) was insolvent
Bail-in Case Study: Cyprus (cont.)

- Initial agreement for €10bn financing for Cyprus agreed on 16/17 March 2013 with European Commission, Eurogroup, ECB and IMF:
  - one off “bank deposit levy” (write-down) of 6.7% for insured deposits on all domestic bank accounts (up to €100,000) and 9.9% for higher deposits
  - depositors to be compensated with bank shares
  - introduction of capital controls
  - no write-down for other senior creditors/bondholders
  - deal widely criticised
  - rejected by Cyprus Parliament on 19 March 2013
Bail-in Case Study: Cyprus (cont.)

• Subsequent arrangement agreed on 25 March 2013:
  - Laiki to be resolved with full contribution of equity shareholders, subordinated and senior bondholders and uninsured depositors
  - Laiki to be split into good and bank banks
  - Good bank (including insured deposits and various assets including € 9bn of Emergency Liquidity Assistance from Eurozone central banks) transferred to Bank of Cyprus
  - Writedown of uninsured deposits of Bank of Cyprus so it met capital ratio of 9%
  - ECB to provide liquidity support to Laiki
  - Capital controls imposed
Bail-in Case Study: Cyprus (cont.)

- Original Cyprus agreement contrary to fundamental principles in BRRD including principle that creditors should bear losses in accordance with normal priority of their claims, that no creditor should incur greater losses than they would under normal insolvency proceedings and that covered deposits should be fully protected.
- Final agreement more in line with these principles.
- How will BRRD/bail-in impact similar future crises?
- Not clear whether Cyprus deposit guarantee fund was adequately funded and interaction between DGSD and BRRD likely to be complex in future crises.
- BRRD is likely to provide much clearer framework and mechanisms for future use of ESM funds.
- Cyprus crisis was highly politicised which affected terms of both initial and final agreements. BRRD framework and mechanisms may help in setting fairer parameters for future restructurings but considerable scope for political involvement remains.
• BRRD likely to add complexity to future restructurings which may make obtaining agreement more difficult. At the same time it will provide a clearer framework of principles and rules that may assist in establishing more consistent templates.
Final Thoughts

- The full effect of BRRD will not be known until we have the detailed standards still being prepared by EBA.
- Of crucial importance to bank sector is the minimum required level of MREL, to be submitted to European Commission by July 2015 – FSB work on levels of GLAC for G-SIBs will be keenly anticipated and expected by November 2014 G-20 summit in Brisbane.
- Unsecured debt may become more expensive for banks to raise – how much will depend on many factors, including the extent to which national regulators are perceived to be prepared to tackle too-big-to-fail, and to bail in senior debt.
- Will certainly become more challenging for banks to price different elements of their funding due to complex matrix of instruments that can absorb losses.
Final Thoughts (cont.)

• Some traditional senior unsecured debt investors will in future be minded to focus on secured debt. Some may be tempted by better pricing of subordinated instruments, if they believe that senior unsecured debt could actually be bailed in. Others will keep on investing in senior unsecured, if the price is right. Some will stop investing in financial institutions altogether.

• In cross-border cases, co-operation between different countries and recognition of foreign resolution actions will be crucial to the success of resolution regimes. Within the EU, the combination of the Credit Institutions Winding Up Directive and BRRD address many relevant issues. However, successful resolution of the biggest, global banks will hinge upon the ability to reach international agreements between supervisors and resolution authorities. This has to be addressed at G-20 level.