Seminar on bail in – Panel II

AEDBF/ILF

House of Finance 18 September 2014

Overview and Introduction to Panel II

Moderator: **Dr. Sven Schelo**, Linklaters LLP

Overview over bail in tool

- bail in is one of four resolution tools (bridge bank, sale of business and asset separation tool being the others)
- bail in can be triggered if the bank is failing or likely to fail
- bail in gives the resolution authority the power to write down equity, own funds and liabilities and to convert into equity
- generally liabilities are subject to potential bail in except:
  - inter alia secured liabilities, covered deposits, short term liabilities with a maturity of less than 7 days (excluding intercompany liabilities)

Overview over bail in tool

- derivatives can only subject to bail in if they have been terminated beforehand
- authorities can carve out liabilities from bail for certain reasons, however only if an amount of not less than 8 percent the total liabilities including own funds have participated and contributed to the loss sharing
- no creditor worse off than in an hypothetical insolvency
- each bank has to have a minimum requirement of eligible liabilities (MREL) for bail in

Overview

Prof Tobias Tröger:

- bail-in objectives and implementation issues

Holger Hartenfels:

- derivatives and bail-in

Dr Tim Schabert:

- valuation and bail-in

Karl-Heinz Raschtuttis:

- future capital structures in the light of MREL/GLAC

Objectives and Implementation Issues of the Bail-in Tool

Tobias H. Tröger

ILF-AEDBF Conference on Bail-in

September 18, 2014

House of Finance

SAFE
Sustainable Architecture for Finance in Europe

A Cooperation of
the Center for Financial Studies
and Goethe University Frankfurt

Center for Financial Studies

Goethe Universität Frankfurt am Main

Implicit government guarantees for bank capital (bail-out)

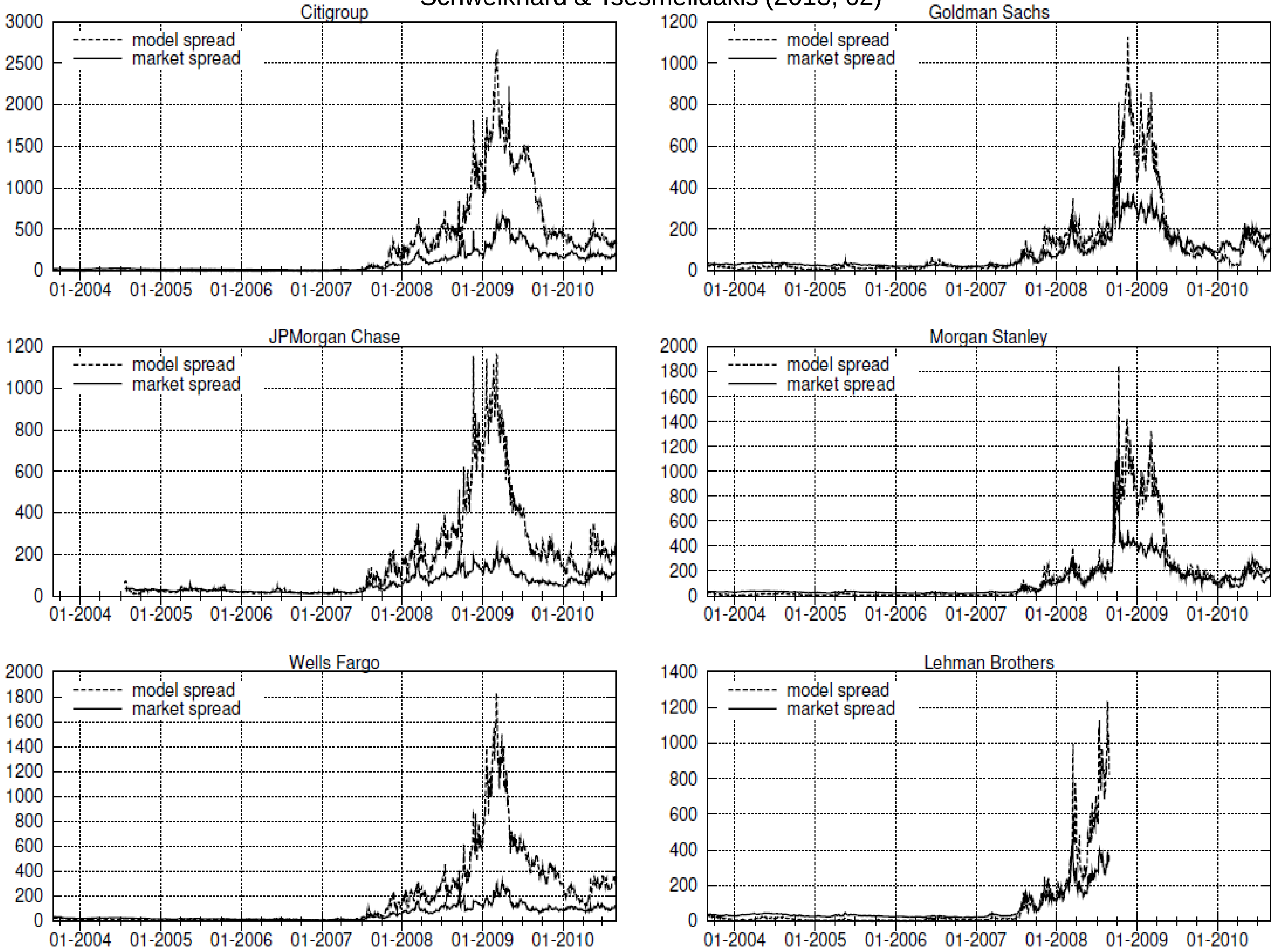
Government guarantee provides lower bound to value of assets and shifts default probability downward compared to model with endogenously determined (asset valuation process) default

Banks benefiting from implicit guarantees (TBTF etc.) enjoy lower risk premiums and can thus raise capital from rational investors at lower prices, i.e. inefficient market pricing on liability side of balance sheet

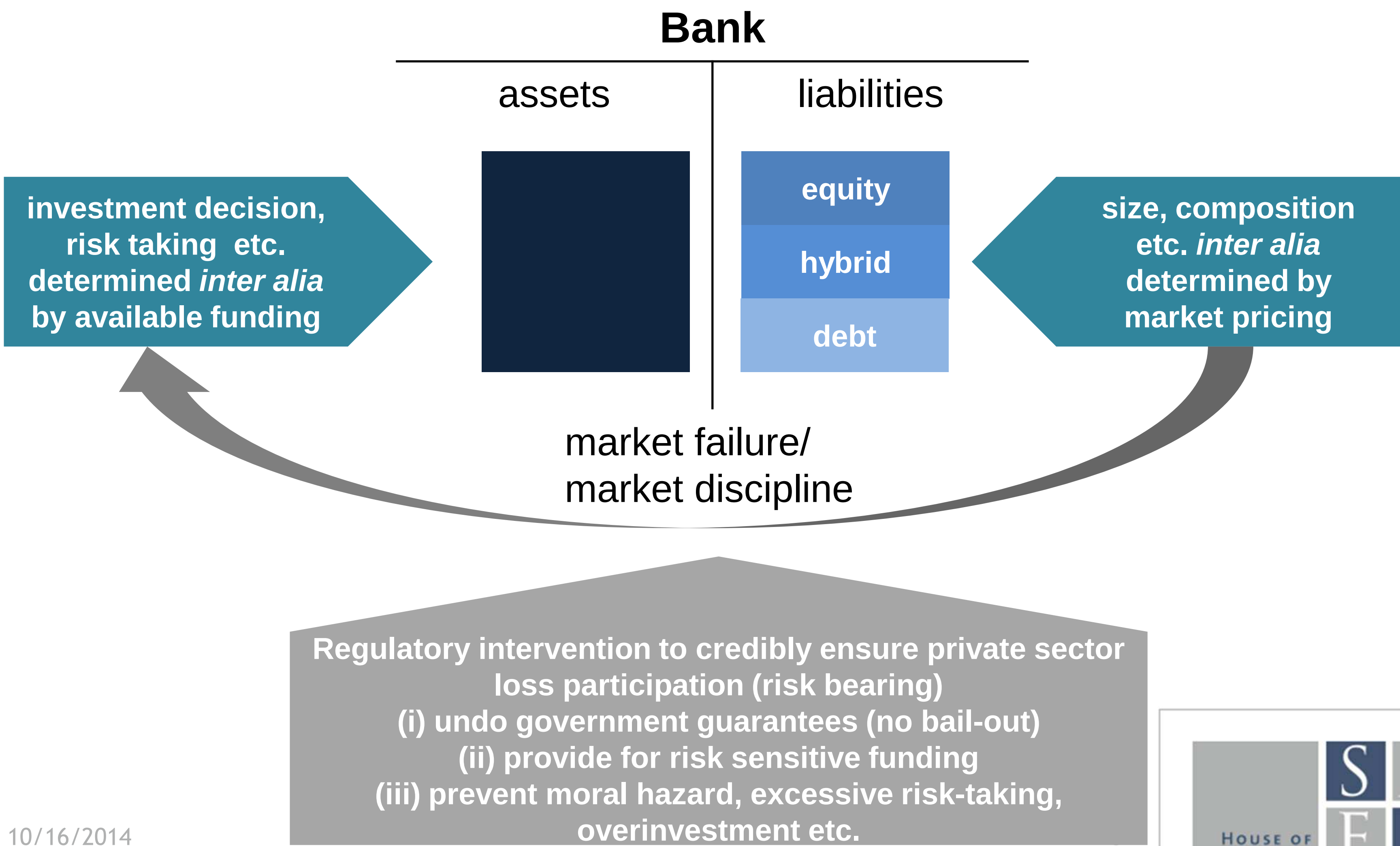
Government subsidy allows to fund excessive risk-taking (moral hazard), i.e. inefficient investment decisions on asset side of balance sheet

Debt-governance doesn’t work, because risk bearing capacity does not drive pricing of capital (no market discipline)

Schweikhard & Tsesmelidakis (2013, 62)



Regulatory intervention to instill market discipline (bail-in)



Preconditions for effective bail-in tool

Desiderata (e.g. Liikanen)	BRRD/SRMR
Sophisticated investors must be	Sophisticated investors will find it

Article 44

Scope of bail-in tool

…

(3) In exceptional circumstances, where the bail-in tool is applied, the resolution authority may exclude or partially exclude certain liabilities from the application of the write-down or conversion powers where:

….

(c) the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union…

is akin to chapter 11 airline

Key problems of BRRD bail-in tool

- Exemption of certain liability classes may lead to regulatory arbitrage (ultra-short-term inter-bank borrowing)
- Political element in private sector loss participation persists
  - forecasting nature of trigger event allows forbearing CAs to delay reorganization/resolution (e.g. Spain)
  - discretion for RAs to grant exemptions *ad hoc* opens door to conventional bail-out rationality even within BRRD-framework
- Existence of resolution tools does not guarantee their time-consistent application by political agents
  - resolution financing arrangement (BRRD, arts. 99 et seq.) may take losses only if ≥8% liabilities were bailed-in, BRRD, art. 44(5)(a)
  - does not necessarily preclude bail-out outside BRRD/SRM-framework (no DFA § 214) → E.U. COM's stance on state aid will be key (Banking Communication, 2013)

LEGAL / COMPLIANCE / GOVERNMENT & REGULATORY AFFAIRS

Bail-in Tool & Derivatives

AEDBF/ILF Seminar, 18 September 2014

Holger Hartenfels

The views expressed in this presentation are solely those of the presenter and do not necessarily represent the views of Deutsche Bank AG

Passion to Perform

Agenda

Introduction

Key Attributes & BRRD

- In October 2011, the Financial Stability Board (FSB) published its "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes).
- The Key Attributes have been transformed into European Law by the Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (the Bank Recovery and Resolution Directive, BRRD).
- European Member States must implement the BRRD by 31 December 2014.
- On 9 July 2014, the German Government issued the draft Recovery and Resolution Act (*Sanierungs- und Abwicklungsgesetz* – SAG).

Introduction

Resolution

- "Resolution" means the restructuring of an institution through the use of resolution measures (e.g., transfer tool, bail-in tool, stays).
- The purpose of the resolution is to ensure the continuity of the institution's critical functions, the preservation of its financial stability and the restoration of the viability of all or parts of the institution.
- Depending on
  - the strategy when trading or entering into derivatives (e.g., hedging of the institution's loan book, market making), or
  - the market share of the institution and its function as liquidity provider

  resolution authorities may view the derivatives trading activity of an institution as "critical".

Introduction

Bail-in tool

- “Bail-in tool” means the write-down or the conversion into equity of the liabilities of an institution (Article 2 (1) point (57) BRRD).
- The bail-in tool must be applicable to all liabilities of an institution, except those “exempted liabilities” specified in Article 44(2) BRRD.
- The BRRD provides for additional powers that support the application of the bail-in tool, e.g., the right to suspend contractual termination rights (Article 71(1) BRRD).
- The bail-in tool is subject to certain safeguards (Articles 73 et seq. BRRD) that protect creditors rights, e.g., the no creditor worth off (NCWO) principle.
- This presentation deals with the application of the bail-in tool to derivatives.

Exemptions

Mandatory Exemptions

- The bail-in tool does not apply to the liabilities specified in Article 44 (2) BRRD:
  - Secured liabilities [1]: exempted are derivatives that are subject to margin requirements under a credit support annex (CSA) or under the rules of a central counterparty (CCP); see Article 11 (3) of Regulation(EU) No. 648/2012 (EMIR);
  - Covered bonds: exempted are derivatives with the cover pool of a mortgage bank which benefit from the privilege of § 29 PfandBG;
  - Short-term liabilities to institutions: exempted are derivatives with an original maturity of less than seven days; definition of “maturity” in Article 162 of Regulation (EU) No 575/2013 (CRR)?

(1) the term ‘secured liability’ is defined in Article 2 (1) point (67) BRRD and means a liability where the right of the creditor to payment or performance is secured by a charge, pledge or title transfer collateral arrangements.

Exemptions

Discretionary Exemption

- In exceptional circumstances the resolution authority may exclude or partially exclude certain liabilities from the application of the bail-in tool (Article 44 (3) BRRD) where:
  - Bail-in within reasonable time is impossible;
  - <u>Exemption is necessary to achieve continuity of critical functions</u>; e.g., credit derivatives transactions that are used for hedging the institution's loan book;
  - Exemption is necessary to avoid widespread contagion, which would severely disrupt the functioning of the financial markets and its infrastructure;
  - Bail-in would <u>cause a destruction in value</u> such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in; this potential justification is also relevant for the bail-in of derivatives (see Article 49(4)(c) BRRD).

Term “Derivative”

The MiFID Definition

- The term “derivative” is defined in Article 2 (1) point (65) BRRD by reference to Article 2 point (5) of Regulation(EU) No. 648/2012 (EMIR).
- The EMIR definition refers to the financial instruments set out in points (4) to (10) of Section C of Annex 1 to Directive 2004/39/EC (MiFID) and Articles 38 and 39 of Regulation (EC) No. 1287/2006.
- The MiFID definition does not cover:
  - Spot transactions; e.g., foreign exchange spots
  - Physically settled commodity derivatives; e.g., OTC forward on natural gas
  - Commercial foreign exchange forwards?

Term “Derivative”

The Scope of Master Agreements

- The scope of master agreements is considerably broader. They usually cover more transactions than just “derivatives” in the meaning of the MiFID.
- They may include spot transactions as well as security financing transactions (SFT) like repos and securities loans.
- The broader coverage requires the resolution authority to calculate a separate netting set for purposes on bail-in and in order to determine whether the NCWO principle is complied with.

How to Bail-in?

Principles

- The application of the bail-in tool to derivatives is governed by Article 49 BRRD.
- The principles are as follows:
  - The bail-in power may be exercised only upon or after closing-out the derivatives;
  - The resolution authority shall determine the value of the derivatives in accordance with appropriate methodologies and principles for (i) valuation of derivatives by asset classes, (ii) establishing the relevant valuation date and (iii) determining the destruction in value that would arise from the close-out of derivatives.
  - Where derivatives are subject to a netting agreement, the value that is subject to bail-in is to be determined on a net basis in accordance with the netting agreement.
- The requirement to close-out in accordance with the parties' netting agreement constitutes an important safeguard for counterparties.
- EBA to draft regulatory technical standards for the appropriate methodologies and principles by 3 January 2016 (Article 49(5) BRRD).

How to Bail-in?

Supporting Resolution Powers

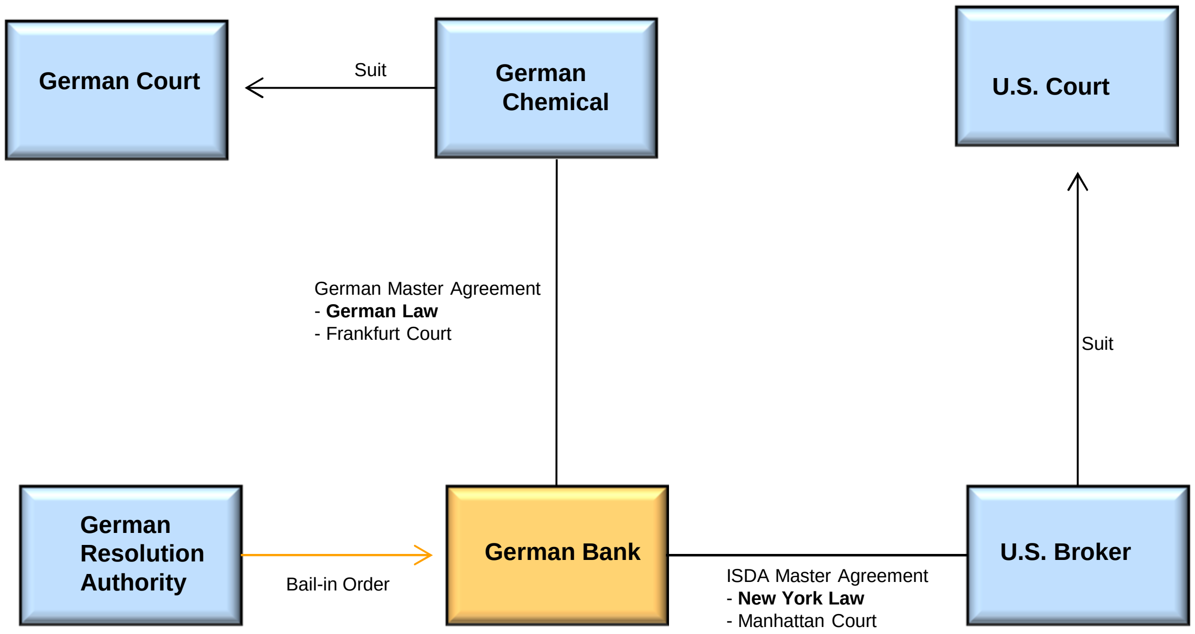
- Article 63(1)(k) BRRD requires Member States to ensure that resolution authorities have the power to terminate and close-out of derivatives for purposes of Article 49 BRRD.
- Article 68(3) BRRD provides that resolution measures taken in relation to an entity, including the occurrence of any event directly linked to such measures, shall not make it possible to exercise termination, suspension, netting or set-off rights.
- In order to avoid a termination and close-out by the counterparty for other reasons, resolution authorities must have the right to suspend termination rights (Article 71(1) BRRD); such stay should not take longer than midnight of the business day following the publication of the stay (48 hours).

Governing Law

Recognition of Bail-in by Third Countries?

- Resolution measures are taken prior to the institution of a bankruptcy proceeding.
- Any dispute with respect to derivatives subject to bail-in are settled in the courts agreed between the parties in the master agreement.
- These are usually the courts of the country the jurisdiction of which is governing the derivatives (i.e., the courts of the State of New York if the ISDA Master Agreement is governed by New York law).
- The question is whether a third country court would recognize resolution measures taken by a German resolution authority.
- Article 55(1) BRRD recognizes the issue and requires institutions to include contractual terms by which the counterparty to the agreement recognizes that its liabilities may be subject to bail-in.

Governing Law



Governing Law

ISDA Resolution Default Protocol

- In 2013, the home regulators of the 18 largest swap dealers (Major Dealer Group) approached the International Swaps and Derivatives Association (ISDA) to discuss a contractual approach that would overcome the governing law issue.
- They asked ISDA to develop clauses through which the non-defaulting counterparty of an institution would recognize resolution measures taken with respect to such institution, including a temporarily imposed suspension of termination rights.
- ISDA developed a draft resolution default protocol, which is still subject to discussion.
- The home regulators require the Major Dealer Group to bilaterally amend their existing netting agreements through such protocol by not later than October 2014.
- It is also expected that other users of derivatives adhere to the protocol in the course of 2015.

Governing Law

ISDA Resolution Default Protocol

- Key issues are:
  - How to define resolution regimes that the non-defaulting party should submit itself to? Specify them individually or cover them by a “catch-all” definition?
  - How to ensure that selected resolution regimes continue to be eligible, i.e., provide the necessary safeguards?
  - How to ensure that all relevant market participants adhere to the protocol?
  - How do we cover derivatives documentation not sponsored by ISDA?
- The better solution would be an international treaty on mutual recognition of resolution regimes that covers at least the G20 States.
- The Brisbain summit in November 2014 would be perfect for endorsing the G20 States’ intention to initiate negotiations.

KPMG

cutting through complexity

Valuation in the context of bank resolution

AEDBF/ILF Seminar

Frankfurt, 18. September 2014

Dr. Tim Schabert

Art. 36 – “Valuation for the purposes of resolution“ (1/2)

Valuation as an integral part of the decision regarding the application of resolution tools

Purpose of the valuation

Pre-requisites

- Determination, of whether the **conditions for resolution** or the conditions for the write down or conversion of capital instruments **are met**

Decision

- Inform the decision on the **appropriate resolution action** to be taken

Scope

- Determination of the **extent of resolution instruments** that are to be applied
  - extent of the write-down and / or dilution of capital instruments
  - extent of the write down or conversion of eligible liabilities
  - scoping of bridge institution tool (incl. value of any consideration to be paid as compensation)
  - scoping of sale of business (incl. definition of “transfer at commercial terms”)
- Ensure **full recognition of any losses** at the moment the resolution tools are applied

Requirements

- **Fair, realistic and prudent** valuation of assets and liabilities (incl. prudence as to **rates of default** and **severity of losses**)
- **No assumption of** any future **extraordinary public financial support** or central bank emergency liquidity assistance
- **Consideration of all costs** of the resolution incurred **by the resolution authority**
- Valuation to be supplemented by an updated **balance sheet,** a **report of the financial position** of the institution, analysis and an estimate of the **accounting value of assets** and a list of the outstanding balance sheet and off balance sheet **liabilities with an indication of the respective credits and priority levels under the applicable insolvency law**
- Indication of the subdivision of **creditors in classes i**n accordance with their **priority level under the applicable insolvency law**
- Estimate of the treatment that each class of shareholders and creditors would have been expected to receive in a **liquidation under normal insolvency proceedings**

Art. 36 – “Valuation for the purposes of resolution“ (2/2)

Basic requirements for the valuation

- The valuation is to be carried out by **a person independent** from any public authority and the institution
- Where due to the **urgency** in the circumstances of the case this is not possible, a **provisional valuation** shall be carried out
- A valuation that does not comply with all requirements shall be considered as **provisional valuation**
- Any provisional valuation is to be replaced by a **ex-post definitive valuation** as soon as practicable

Provisional valuation

- Does **not necessarily need to be carried out by an independent person** (e.g. can be provided by resolution authority)
- Allows **simplifications** for the valuation of assets and liabilities with respect to:
  – **Standards** of the valuation (fair, prudent, realistic)
  – Detail of required **supplementing information** (e.g. updated balance sheet)
  – Subdivision of creditors in classes
  – Indication of treatment of creditors and shareholders in regular insolvency regime
- Contains a **buffer for additional losses** (to be justified)
- Is a **valid basis** for resolution authorities in order to take resolution actions

Ex-post definitive valuation

- Is to be carried out by an **independent person**
- Has to ensure that **any losses** on the assets of the institution are **fully recognized**
- **Fully complies with all requirements** for a valuation for the purposes of resolution as specified in article 36
- Uncovers **potential differences** to the provisional valuation
- Provides base for **a decision to write back creditors’ claims** or to increase the value of the consideration paid

Art. 74 – “Valuation of difference in treatment “

Objective	Ensure necessity and proportionality of a state intervention in private property rights (Basic principle: **“No creditor worse off“**)

Subject of valuation

a) Valuation of potential losses shareholders and creditors would have incurred under the assumption that the institution had been wound up under normal insolvency proceedings instead of a resolution (“**deemed liquidation**”)

b) Determination of the **actual treatment** that shareholders and creditors have been afforded in the resolution

c) Comparison between actual treatment of shareholders and creditors and their expected treatment in a deemed liquidation

Approach

- To be carried out “as soon as possible” **after the resolution actions** have been effected
- To be conducted **distinct from the valuations for purposes of resolution** pursuant to Article 36
- Detection of a positive difference entitles to a **compensatory claim** that is to be paid from the resolution financing arrangements
- **No suspensory effect for resolution actions**

Basic Assumption

- **Entering of normal insolvency proceedings instead of resolution actions** at the time when the resolution decision was taken
- **Without consideration** of any **resolution action** actually taken
- **Disregard** of any provision of **extraordinary public financial support**
- Valuation exclusively based on **information available at the time** when the resolution decision was taken

Bail-in Tool & Derivatives

AEDBF/ILF Seminar, 18. September 2014
Frankfurt am Main

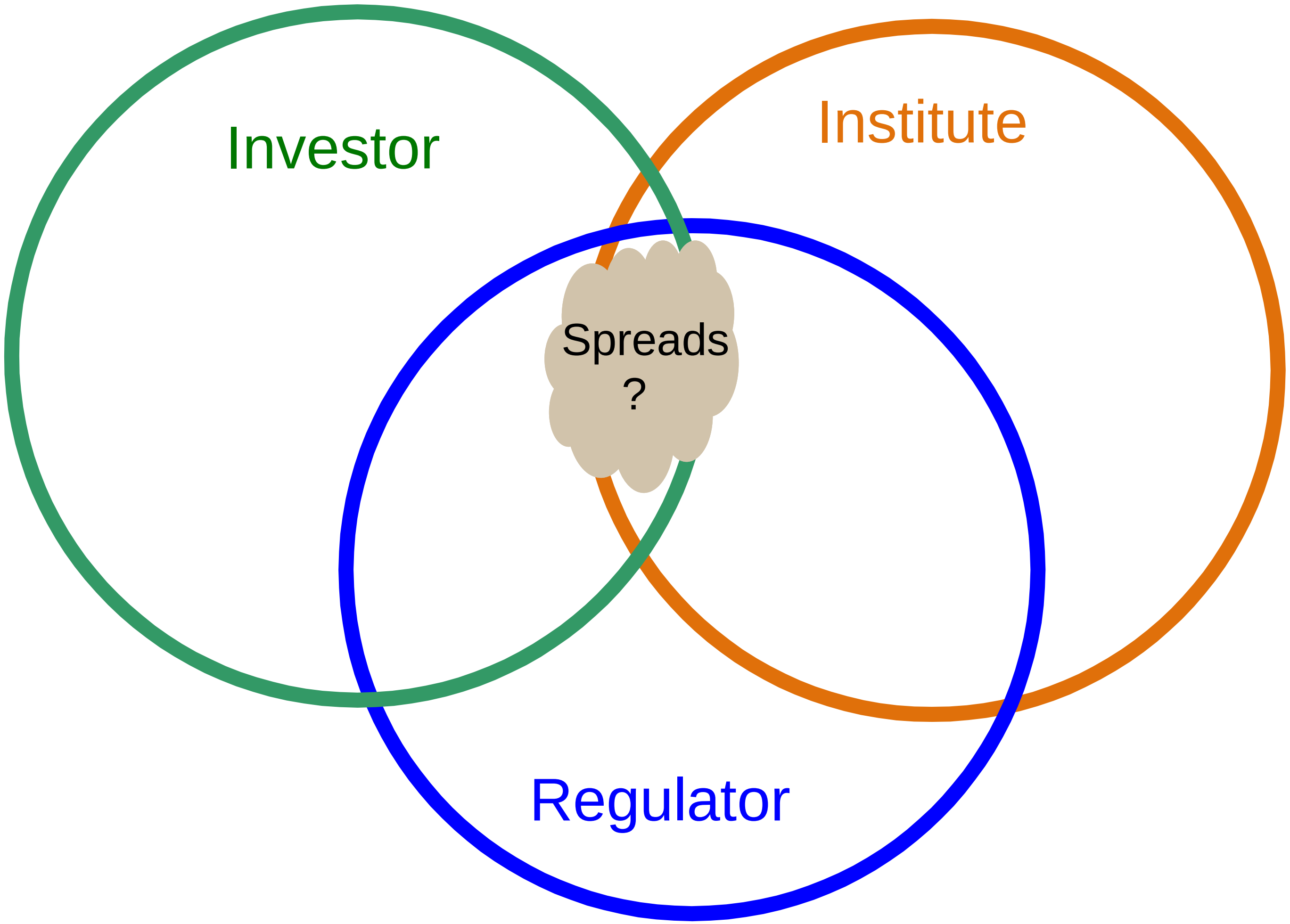
Karl-Heinz Raschtuttis

The regulator‘s perspective: defining the playground

1. **Bail-in**
   - Restructuring of an institution through the use of a bail-in tool
   - Write down or conversion of liabilities into equity
   - Applicable to all liabilities, except those defined in Article 44 (2) BRRD
   - But: no creditor worse off principle may trigger compensation by Resolution Funds
   - Defines Loss Given Default in case of resolution
2. **MREL: Minimum requirements for loss absorbing own funds and liabilities**
   - Going Concern requirement, calibrated by Resolution Authority
   - Volume defined as a percentage of total liabilities
   - Remaining maturity: more than 1 year
3. **GLAC: Gone concern loss absorbing capital / TLAC: Total loss absorbing capacity *)**
   - Applicable to G-SIBs only
   - Going concern requirement, calibrated by Resolution Authority
   - Legally, contractually or structurally subordinated
   - Volume defined as percentage of RWA and the level of leverage ratio

*) at least according to REUTERS

In search for a new equilibrium …



COMMERZBANK

The issuer‘s perspective

1. **What is the appropriate capital structure?**
   - Pillar 1: Minimum and buffer requirements as defined by regulators
   - Pillar 2: Additional requirements possible
   - Demands of other market participants and rating agencies
   - Are additional management buffers necessary?
2. **What is the appropriate debt and funding structure?**
   - MREL (and GLAC/ TLAC) requirements defined by regulators/ resolution authorities
   - Market guidance on funding strategy, esp. intended thickness of different layers
3. **What prices will institutions have to pay?**
   - Will the cost of capital of a resolvable institution be lower or higher than today?
   - What are the expected spread levels of Tier 2 and senior unsecured debt?
   - Will investors differentiate between legal, contractual or structural subordination?
   - Inverstors universe: who will be allowed to invest?

The investor‘s perspective

1. **What is the exact position in the hierarchy of loss absorption?**
   - To determine the exact position in the hierarchy, transparency is crucial
   - Transparency is best achieved by a single, reliable and public resolution strategy
   - Resolution strategies with too many options (e.g. use of different resolution tools, unexpected exemptions to bail-in etc.) will create additional investment risk
2. **What is the institution‘s *probabilty of resolution* (PR, formerly known as *probabilty of default - PD*)?**
   - PR (instead of PD) depends on volume of capital
   - It also depends on the knowlegde of the applicable resolution strategies
3. **What *loss given resolution* (formerly known as *loss given default*) is to be expected?**
   - PR (instead of PD) depends on volume of capital and MREL/ GLAC/ TLAC
4. **What are the appropriate spread levels for each instrument?**
   - Will the cost of capital of a resolvable institution be lower or higher?
   - How will the necessary, risk-adjusted spread levels of Tier 2 and senior unsecured debt evolve?