



Legal Problems of Bail-ins

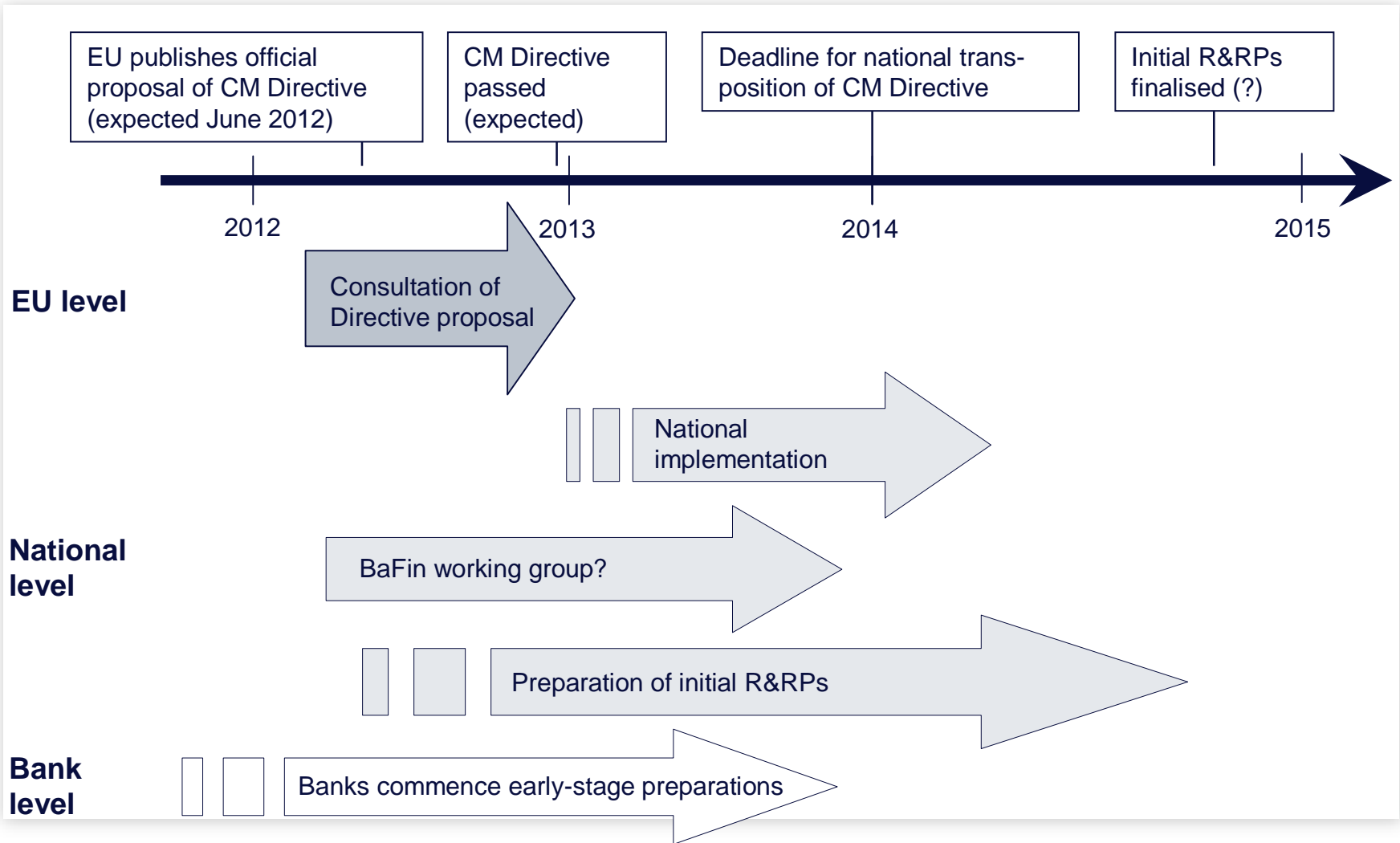
ILF Conference "The Crisis Management Directive:
Europe's Solution for Too Big to Fail?"

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Current Status of Crisis Management Directive



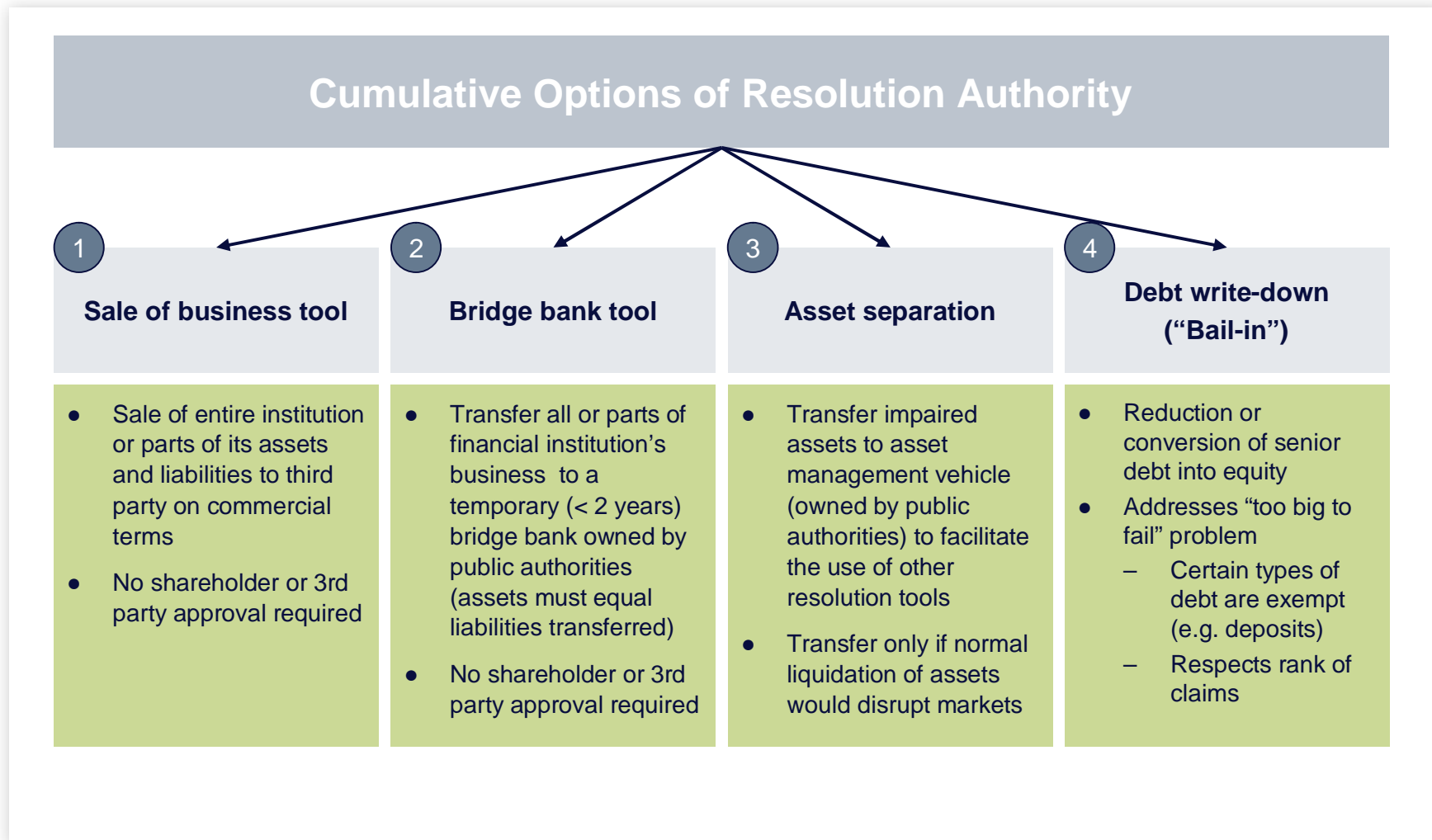
Draft Crisis Management Directive Proposal

Overview of New Tools

Objectives of the Directive	<ul style="list-style-type: none"> • enhance financial stability • reduce moral hazard • protect depositors and critical banking services • save public money • protect the internal market for financial institutions 	
Instruments	Preventative Instruments	<ul style="list-style-type: none"> • recovery planning (Art. 4 et seqq.) • resolution planning (Art. 15 et seqq.) • intra-group financial support (Art. 8 et seqq.) <p>} living wills (R&RPs)</p>
	Early Intervention	<ul style="list-style-type: none"> • require management to take appropriate actions for the recovery or resolution of the credit institution (Art. 23) • special management (Art. 24 et seqq.)
	Resolution Tools and Powers	<ul style="list-style-type: none"> • sale of business tool (Art. 30) • bridge institution tool (Art. 32) • asset separation tool (Art. 34) • debt write-down tool (Art. 35)

Resolution Tools

(Art. 29 et seqq. of draft Directive Proposal)



Debt Write-Down Tool

(Art. 35 et seqq. of draft Directive Proposal)

Overview of Debt write-down (“Bail-in”)

- Objectives include:
 - Recapitalize institution to meet regulatory requirements and reinstate market confidence in institution
 - Convert to equity or reduce principal debt amount transferred to bridge bank in order to provide capital
- May be used both in “open bank” and “closed bank” scenarios
- Applies to all liabilities, except:
 - Deposits, secured liabilities, repos, trust monies
 - Employee claims
 - Tax and social security claims (if preferred in insolvency)
 - Claims by creditors of vital services such as IT services, rental, utilities etc.
 - Further debt classes to be determined
- Resolution authority may exclude short term liabilities

- Bank must maintain liabilities eligible for write-down of at least 10% of total liabilities not constituting own funds
- Resolution authority's powers include:
 - Reduce principal amount of debt (up to zero)
 - Convert liabilities into ordinary shares
 - Cancel debt instruments or shares
 - Require issuance of new shares or capital instruments
 - Amend or alter maturity or interest rate structure
 - Business reorganisation plan (for open bank cases)
 - Replace senior management

Example of Debt Write-Down

Balance Sheet of Example Bank

Assets		Liabilities and shareholder's equity	
Cash	5.000.000.000 EUR	Deposits	30.000.000.000 EUR
Deposits	5.000.000.000 EUR	Repos	10.000.000.000 EUR
Reserve repos	10.000.000.000 EUR	Short term debt	10.000.000.000 EUR
Financial assets	40.000.000.000 EUR 20.000.000.000 EUR	Senior secured debt	20.000.000.000 EUR
Accounts receivable from credit-business	20.000.000.000 EUR	Senior unsecured debt	20.000.000.000 EUR 10.000.000.000 EUR
Other assets	20.000.000.000 EUR	Shareholder's equity	10.000.000.000 EUR 10.000.000.000 EUR
Total assets	100.000.000.000 EUR	Total liabilities and shareholder's equity	100.000.000.000 EUR

1. Reduction of equity to 0 EUR
2. Aggregate amount = 10.000.000.000 EUR
3. Write-down of 10.000.000.000 EUR eligible liabilities
4. Convert 10.000.000.000 EUR into equity

Triggers for Bail-in

1

The competent authority or resolution authority determines that the institution is **failing or likely to fail** (cf. “Bestandsgefährdung” under German Restructuring Act)

- § The institution is in breach or likely to breach the capital requirements for continuing authorization in a way that would justify the withdrawal of the authorization by the regulator
- § the assets of the institution are or are likely to be less than its obligations
- § the institution is or is likely to be unable to pay its obligations as they fall due
- § the institution requires extraordinary financial support

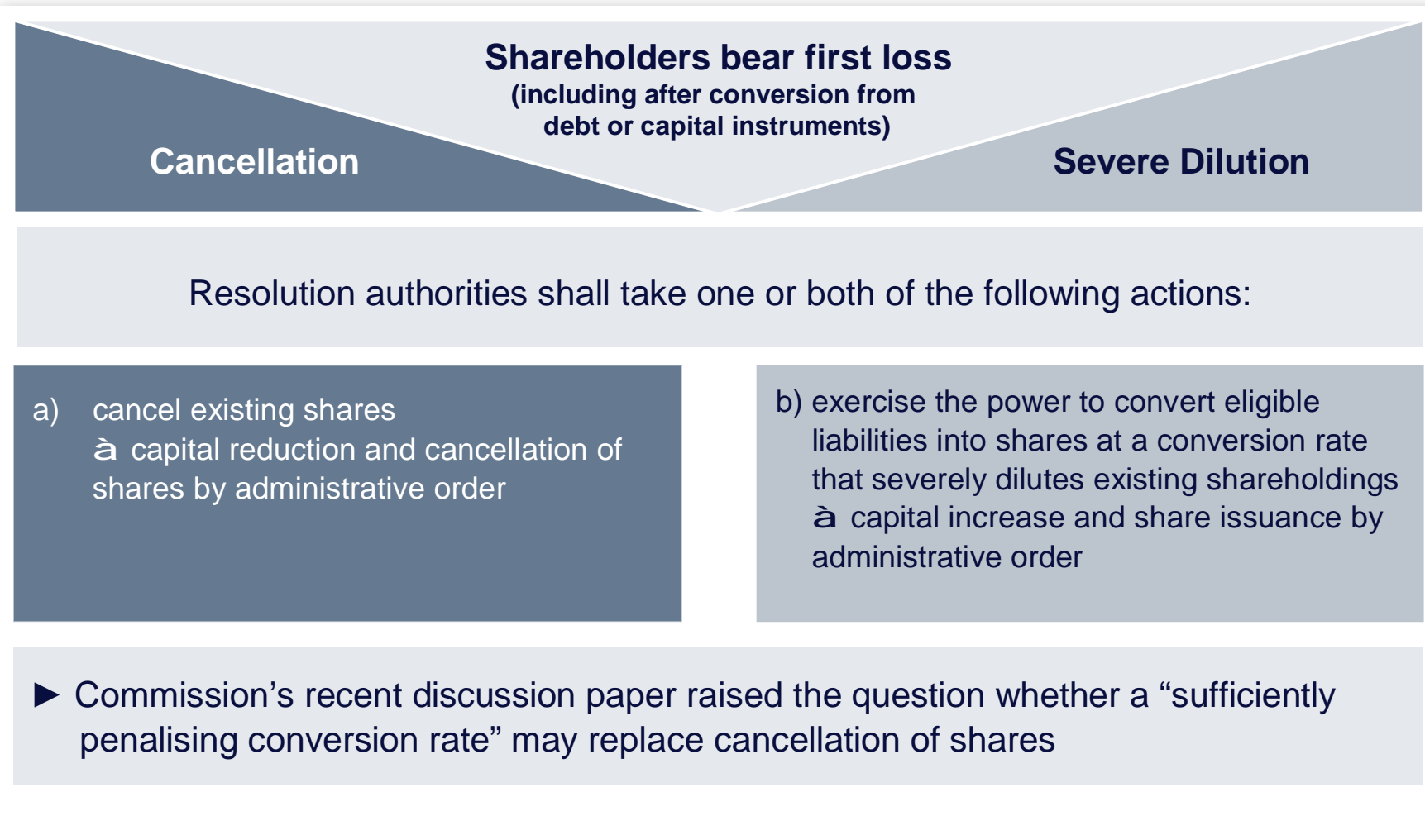
2

No reasonable prospect that any alternative private sector or supervisory action would prevent the failure of the institution within a reasonable timeframe (“ultima ratio”)

3

Bail-in is necessary in the public interest

Supremacy of Creditors over Equity Holders



Inter-Creditor Rules (1/2)

Building and Balancing of Classes

Guiding principles

***Pari passu* treatment of creditors**

Bail-in should be applied in a way that respects the *pari passu* treatment of creditors and the statutory rank of claims under the applicable insolvency law

No worse off than in liquidation

Shareholders and creditors are entitled to compensation equal to which they would be entitled under normal insolvency proceedings (→ valuation dilemma in hypothetical insolvency scenario)

Excluded liabilities: statutory exceptions from bail-in typically reflecting priorities under domestic insolvency regime




- § secured liabilities (to the extent of collateral value?)
- § liabilities secured by title transfer collateral arrangements (including repos)
- § guaranteed deposits (Directive 94/19 – German Einlagensicherungsfonds?)
- § short-term liabilities with an original maturity of less than a month [or three months?]
- § liabilities that arise from a fiduciary relationship
- § other liabilities that are privileged under domestic insolvency rules

Inter-Creditor Rules (2/2)

Building and Balancing of Classes

Write-down Waterfall:

sequential write-down of several classes with pro rata write-down within each class

-  **1** Additional Tier 1 instruments that are liabilities *and* Tier 2 instruments
-  **2** Subordinated debt other than Additional Tier 1 *or* Tier 2 capital
-  **3**
 - a) Senior liabilities
 - **with maturity of more than 1 year? Priority for debt with maturities up to 1 year?**
 - **excluding liabilities arising from derivatives?**
 - b) Recourse claims owed to deposit guarantee schemes after payment?

Sufficient "bail-in-able" liabilities:

Obligation for institutions to hold at all times a certain amount of liabilities eligible for bail-in

- at least 10 % of total liabilities not constituting own funds for regulatory purposes
- or**
- case by case analysis?

Valuation

Quantum of Write-down or Conversion

Assessment of the “aggregate amount” in an open bank scenario

Resolution authority to establish the amount

- § by which eligible liabilities need to be reduced in order to restore the Common Equity Tier 1 capital ratio
and
- § that the resolution authority considers necessary to sustain sufficient market confidence in the institution and to enable it to continue to comply with conditions for authorization and carry on its licensed activities

Valuation of assets and liabilities

- à in compliance with requirements generally established for valuation of an entity that has entered into resolution (gone concern / liquidation values?)
- à based on prudent and realistic assumptions, including as to rates of default and severity of losses
- à the objective should be to assess the market value of the assets and liabilities so that any losses that could be derived are recognized at the moment the bail-in is exercised
- à valuation shall not assume extraordinary public support

Independent valuation

- à independent valuer
- à to be endorsed by resolution authority
- à in urgent situations, valuation by resolution authority

Cross-Border Implementation

Harmonised statutory regimes in all EU jurisdictions

à building in mutual recognition

- ✓ Recognition of reduction or conversion of debt instruments including liabilities governed by local law or owed to creditors located in jurisdiction other than jurisdiction of resolution authority
- ✓ No separate challenge / judicial review in any jurisdiction other than jurisdiction of resolution authority

à joint approach to address cross-border aspects

à harmonization within EU instead of multi-lateral agreements

à contractual recognition of debt write-down in instruments governed by third country laws by domestic law required

But ► no harmonisation beyond EU borders to date

Judicial Review and Remedies

Restriction on normal insolvency proceedings

Challenge only by affected persons

Reasons for challenge

- § legality of resolution order
- § legality of the way in which the order was implemented
- § adequacy of compensation

Legal remedies

- à no veto right of shareholders/creditors
- à no right to rescission, but only individual compensation for net loss suffered as a result of the resolution action (compared to the situation had the resolution action not been taken and had the institution been subject to an insolvency proceeding)

Constitutional Framework (1/2)

Statutory Bail-in and Property Rights

Applicable provisions

“Solange” Rule of German constitutional court
à Art. 17 CFREU and ECHR - Protocol 1
Right to Property as recognized by the ECJ

Scope of Protection

§ All lawfully acquired items
§ Includes rights of shareholders and creditors
§ Problem: are the claims worthless?

Expropriation or Regulation of Property




Expropriation also if the ownership is not technically divested, but the economic value is sufficiently reduced
à in any case, entitlement to compensation

Proportionality

§ Suitable
§ Necessary
§ Proportionate

Constitutional Framework (2/2)

Proportionality of Bail-in

Suitability	§ Bail-in allows to recapitalize and stabilize an institution § Does not rely on public funds § Reduces moral hazard	
Necessity	Alternatives: require banks to hold 10 % Coco Bonds? Private sector solution?	
Proportionality	Fair balance of interests Problem no. 1: severe dilution vs. <u>cancellation of shares</u> Problem no. 2: exceptions from the <i>pari passu</i> treatment of creditors à <u>contagion risk for financial stability</u> Problem no. 3: determination of a <u>conversion rate</u> that reflects a compensation equal to the value of the claim under normal insolvency proceedings (higher conversion rate for senior liabilities than for subordinated debt to the extent appropriate to reflect priority in insolvency proceedings)	

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