BANK OF ENGLAND

The UK/EU approach to bail-in: key design features

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UK Legislative Background

- **Banking Act 2009** did not contain explicit bail-in tool, although economic effect of bail-in could be achieved via partial property transfer powers
- **Independent Commission on Banking** under Sir John Vickers recommended that an explicit bail-in tool be added to UK **Special Resolution Regime**
- **Banking Reform Act 2013** implements Vickers' recommendations, including on bail-in
- **Consultation Document** on statutory instruments to implement bail-in published March 2014
- Subsequent decision to align with implementation of **BRRD's bail-in tool**, scheduled in UK for 1 January 2015

Key aspects of BRRD bail-in tool

- Bail-in is a **resolution tool**, subject to same trigger and (broadly) same safeguards as other resolution tools
- **Mandatory exemptions** from bail-in: covered deposits; fully secured liabilities; client asset holdings; very short-term interbank liabilities; those owed at very short term to payment and settlement systems; certain employee and tax liabilities; and claims of “critical” trade creditors [Article 44(2)].
- **Discretionary exemptions** are possible on an exceptional case-by-case basis if the bail-in of the liabilities would be very difficult on operational grounds; or would undermine continuity of critical economic functions provided by firm; or would cause widespread contagion/adverse effects on financial markets; or would destroy value/increase losses borne by other creditors.
- If discretionary exemptions are made, and losses are not passed on fully to other creditors, resolution funds may contribute once **8% of total liabilities of failed firm have suffered losses**
- This threshold is high and ensures that **discretionary exemptions cannot be used to facilitate widespread bail-out**
- **MREL requirement** is designed to support bail-in (and other resolution) tools
- Note Article 55 requires **debt issued by EU firm subject to non-EU law** to include clauses recognising bail in by home authority

Bail-in and PONV write-down/conversion in the BRRD

- PONV write-down/conversion is a **Basel idea** which pre-dates development of BRRD's bail-in tool
- PONV write-down/conversion much **narrower** than bail-in
- PONV write-down/conversion and bail-in **triggers distinct,** such that PONV write-down/conversion may occur before resolution trigger is met
- But given that resolution trigger is defined in respect of viability of firm, might have been better to **align the triggers**
- But **PONV power is not a resolution tool or power** because (1) its purpose is different (to ensure relevant capital instruments are loss-absorbing on firm's failure rather than to meet broader objectives of resolution) ; (2) it is mandatory not discretionary
- Issue of whether **NCWO safeguard** should apply to PONV power
- Best to view PONV write-down/conversion as **first crisis management action which must be taken in all cases when resolution trigger is met**, either on its own or (almost certainly) in conjunction with a resolution tool

The bail-in power

- **Write-down** of equity or other capital instruments of firm, plus subordinated creditor claims and senior unsecured and uninsured creditor claims against the firm
- **Conversion into equity** or other capital instruments of the firm or its parent (or of a bridge firm to which part or all of the business of the failed firm has been transferred) of all or parts of subordinated and senior unsecured and uninsured creditor claims against the firm
- So power is available on either an **open-bank** or **closed-bank** basis
- Write-down or conversion of any **contingent convertible capital instruments** with pre-resolution triggers or contracts providing for write-down/conversion into equity at the point of non-viability (PONV) whose terms had not been triggered prior to entry into resolution.
- If applied on an open-bank basis, bail-in must be accompanied by a **restructuring** of the firm to address causes of its failure (so cannot be used for “resurrection” of firm) – bail-in restores **solvency** while restructuring restores **viability**

Bail-in: the safeguards

- Mandatory and discretionary **exemptions**
- Bail-in must respect the **hierarchy of creditor claims in insolvency** as *between* creditor classes
- But there is **flexibility to depart from strictly *pari passu* treatment** of creditors *within* a given creditor class on a case-by-case basis, if that is necessary to maintain financial stability or maximise value for creditors as a whole
- Bail-in must be subject to the "**no creditor worse off** (NCWO) than in liquidation" safeguard
- These safeguards are exactly in line with those that already apply to the **other resolution tools in the UK SRR**, eg partial property transfers

Differences between bail-in and other resolution tools/liquidation

- In bail-in, losses are determined **up-front through a valuation**, rather than after the transfer, run-off or liquidation of the firm's assets
- Bail-in may therefore result in **smaller losses for creditors** than other resolution tools and liquidation, because it mitigates the destruction of franchise value that may result from a run-off or liquidation of assets
- Bail-in avoids **break-up** of complex group into good/bad or critical/non-critical components
- Application of open bank bail-in tool results in **going concern with stream of future profits of uncertain value** to be allocated to shareholders and creditors. If any positive value is realised via other resolution tools or liquidation, it is provided to shareholders and creditors via **cash payouts in order of priority in insolvency**
- **EBA** required to draft guidelines on treatment of shareholders and on rates of conversion of debt to equity in bail-in/PONV write-down/conversion

Bail-in and valuation

- **Effect of bail-in** will depend on both going-concern and gone-concern **valuations**
- **Going-concern valuation** of assets should take into account value-preservative effects of application of resolution tools
- **Gone-concern valuation** of assets is based on liquidation counterfactual (eg for NCWO purposes)
- **Case (1)**: firm in resolution has no or negative value on both going-concern and gone-concern basis
- **Case (2)**: firm in resolution has positive value on both going-concern and gone-concern basis
- **Case (3)**: firm has positive value on going-concern basis but no or negative value on gone-concern basis

Case (1)

- Firm enters resolution with **negative or zero net worth** on both going- and gone-concern basis
- Bail-in works via **both write-down and conversion to equity**
- **Write-down** necessary to bring liabilities down into equality with assets
- **Conversion** into equity necessary to recapitalise the firm (ie move liabilities down further below assets by required margin)
- In this case **bail-in exactly replicates creditor hierarchy in insolvency**: it must not write down senior creditors before junior creditors are fully written down first and it must not write down junior creditors before existing shareholders are wiped out
- Main **NCWO risk** arises if some creditors are excluded from bail-in and costs of excluding them are imposed on creditors who are bailed in, although value – preservative effect of bail-in compared with liquidation reduces this risk

Case (2)

- Firm enters resolution with **positive net worth** on both going- and gone-concern basis
- Bail-in works **solely through conversion to equity**: no write-down is necessary (because liabilities are still less than assets)
- In this case, bail-in does not exactly replicate creditor hierarchy in insolvency but **respects it as far as appropriate**
- Bail-in cannot in this case be restricted by **notion that shareholders must be wiped out first before creditors have part of their claims converted to equity**
- Why?
- Because **that would preclude any of residual net equity value of firm from being allocated to shareholders**, providing shareholders with valid NCWO claims and leading to resolution authority facing legal action
- So main **NCWO risk** arises from shareholders, especially if creditors are allocated too much equity via the bail-in

Case (3)

- Firm enters resolution with **positive net worth on going-concern basis** and no or **negative net worth on gone-concern basis**
- Bail-in again works **solely through conversion to equity** not write-down (because it is the going-concern not gone-concern valuation of the balance sheet that matters in application of a resolution tool)
- Again bail-in must **respect creditor hierarchy in insolvency** but cannot replicate it exactly
- Shareholders may be given **residual claim on firm** at same time as creditor claims are converted to equity
- **NCWO risk** is likely to be lower than in cases (1) and (2) because value-preservative effects of resolution are reinforced by negative insolvency counterfactual

Ways of imposing losses on shareholders via bail-in

- (1) existing shares **cancelled** in part or whole and new equity granted in accordance with their claim on residual net worth; or
- (2) part or all of existing shares **transferred** to creditors, with original shareholders' residual holding reflecting their claim on residual net worth of firm; or
- (3) leaving shareholding untouched but heavily **diluting** them through conversion of creditor claims to equity

Shareholder treatment in the three cases

- **Case (1)**: cancellation or transfer to creditors of all shares (“full cancellation or transfer”)
- **Case (2)**: cancellation or transfer to creditors of some shares (“partial cancellation or transfer”) or heavy dilution of shareholders’ existing holdings
- **Case (3)**: either full or partial cancellation or transfer of shares or heavy dilution

Treatment of creditors in bail-in under BRRD: differential conversion rates

- Article 50(1) provides that application of bail-in tool or PONV power may **convert** different classes of capital instruments and liabilities to equity at different rates
- Article 50(2) establishes principle that conversion rate represents "**appropriate compensation**" to creditors for losses sustained through application of bail-in and PONV power
- Article 50(3) requires that, where differential conversion rates are applied, they should be **higher for senior than for junior creditors**
- Differential conversion rates should avoid either senior or junior creditors being made **worse off than in insolvency** and should reflect fundamental property rights
- Much depends on whether the total **estimated value of equity received by creditors** in bail-in (X) is expected to be greater or smaller than the **aggregate amount of debt claims bailed in** (Y)
- If X>Y, differential conversion rates are unnecessary
- If X<Y, differential conversion rates may be necessary

Need for gone-concern loss absorbing capacity (GLAC)

- Bail in (and other resolution tools in BRRD) will only be effective if firms have **adequate GLAC**
- **FSB** tasked to develop proposals on GLAC for G-SIBs by Brisbane summit
- BRRD's **MREL** is a total LAC concept and applies to all EU firms within scope of BRRD
- So GLAC and MREL are distinct and there is **no reason why an FSB GLAC requirement for G-SIBs cannot be designed consistently with the MREL requirement**
- The greater challenge in securing full resolvability of G-SIBs and their global reach justifies a **higher and common GLAC requirement**
- BRRD allows EBA to recommend harmonisation of MREL requirement and EC to make legislative proposal to that effect by end-2016
- GLAC requirement must complement Basel III by ensuring that **gone-concern instruments cannot be eroded before going-concern instruments**