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C H A N C E

Legal Aspects of Bank Bail-Ins
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Clifford Chance Contacts



Chris Bates
Partner, London
T: +44 20 7006 1041
E: chris.bates@cliffordchance.com



Simon Gleeson
Partner, London
T: +44 20 7006 4979
E: simon.gleeson@cliffordchance.com

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Abstract

The aim of the bail-in proposal is that governments should have an alternative option to taxpayer-funded rescues of systemic banks. It operates through a mechanism whereby an insufficiently solvent bank can be returned to balance sheet stability by writing down not only the claims of its subordinated creditors but also some of its senior creditors; converting their claims to equity. To be effective, the mechanism should be “hybrid”, in that the terms of the relevant instruments should provide for the bail-in to operate through private contract, but the power to trigger the bail-in and to determine the extent of write-down and the resulting compensation should be vested in the relevant public authority.

The primary objective of bail-in is to enable the relevant institution to avoid a sudden and disorderly liquidation by enabling it to continue in business as a going concern until it can be restructured or run down. This avoids the significant destruction of value which results from a “sudden stop” insolvency, reduces contagion within the financial system and potentially preserves critical functions. It is particularly attractive in respect of institutions or groups whose business are too complex or too international to be capable of being disintegrated into a “good bank”/“bad bank” model in the relatively short space of time required if the good bank is to continue in business without government support.

The application of bail-in techniques within banking groups requires careful thought, and should be addressed by regulators as part of the “living will” analysis. There may be some group structures in which bail-in techniques would be inappropriate or would produce perverse results.

The primary weakness of a bail-in as a bank restructuring tool is that although it

renders the firm creditworthy, it provides no new cash. Thus in order to survive the firm must not only be creditworthy, but credibly creditworthy to at least its central bank, and preferably to the

market as a whole. It is therefore likely that bail-in will require statutory backing in order to convince counterparties to continue dealing with it post-reconstruction.



Why consider bail-in?

The purpose of a bank bail-in regime is to provide a mechanism to return an insufficiently solvent bank to balance sheet stability at the expense of some of its creditors without the necessity for external capital injection – or, more simply, an end to taxpayer-funded bank bailouts. Taxpayers have been forced to bail out banks because there was no other practical option. The aim of the bail-in proposal is to create that option, and to ensure that taxpayers are never again compelled by circumstances to rescue banks or at least, if they are, that subordinated and some senior creditors can be forced to take losses and contribute to the resolution before taxpayers funds are put at risk.

The starting point for the analysis is therefore to understand why it was that taxpayers were in fact compelled to bail out banks. In a modern economy large banks perform services which are valuable to society, and allowing a significant bank to cease to operate would inflict significant damage on the economy and on society. Thus, where a large bank has suffered a loss greater than the amount of its capital, the unappealing choice for government is to recapitalise the bank out of taxpayers' funds, thereby preventing that damage, or to see society suffer a much greater loss as the bank ceases to operate.

It may be asked why it should be so much harder to deal with an insolvent bank than with any other sort of insolvent business, which are dealt with in their thousands every month without causing equivalent societal damage. The general issues which arise in considering a bank failure are not significantly different from those which arise on the failure of any

other socially significant enterprise. In the context of ordinary corporate insolvency it has been agreed for some time that the societal costs of winding up a productive enterprise are significantly greater than those of recapitalising it and allowing it to continue in business, and insolvency law has been developed over many years to minimise this societal damage by creating regimes (the UK administration proceedings, or the US Chapter 11 regime) which permit the insolvent company to continue trading for a period while a buyer can be found for the business as a going concern or while its debts are restructured under the supervision of the court. Put simply, sudden stop liquidation creates massive value destruction – as the Lehman example demonstrated. However, the ordinary Administration/Chapter 11 regimes do not work for banks. A bank is not like an ordinary commercial company, in that although an ordinary commercial company can continue to trade whilst in insolvency, a bank cannot, since no-one would voluntarily deal with an insolvent bank. An insolvent bank cannot trade even for a short period while its debts are restructured. Simply put, the essence of banking is solvency, and an insolvent bank is by definition not a going concern.

The challenge, therefore, in dealing with banks, is to create a mechanism which delivers the same broad outcomes as the insolvency process but which can be executed quickly, outside insolvency legislation and without triggering a formal insolvency process. Bank resolution regimes are in this regard best regarded as specialised insolvency regimes for banks – once a resolution has been commenced, the bank is dead and the issue is how parts of it may be salvaged intact. The success of traditional bank

resolution tools depend on the ease with which the bank can be dismembered and the good parts separated from the bad so that the good parts can continue as a going concern under new ownership. Bail-ins also aim to avoid the need for formal insolvency proceedings, but by restructuring the bank's balance sheet and ensuring the continued survival of the institution without immediate dismemberment. To this extent, bail-ins are another kind of resolution tool which, like temporary public ownership, preserves the institution as a whole as a going concern and imposes losses on shareholders and creditors, but without the explicit or implicit commitment of further public support that public ownership implies.

The idea of bail-in, although initially greeted by regulators and market participants with some scepticism, has recently gained ground. Regulators are familiar with the concept of banks issuing debt which is described as being capable of supporting the bank through its difficulties, and tiers three, two and innovative tier one capital have all been recognised as providing this utility to some extent. It is therefore not too difficult for them to accept the proposition that making some senior debt (and subordinated debt) capable of being written down in some contexts would have a beneficial effect on the stability of banks. The most broad-ranging recent statement in this regard was the European Commission's "Working document on the technical details of a possible EU framework for bank recovery and resolution" published on 6 January 2011¹ which proposes extending national resolution regimes to include a "debt write down tool" capable of being used to write down specified senior and

¹ Available at http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf

subordinated obligations of a bank or bank holding company and mooted two alternative frameworks under which a broader or narrower class of senior debt would be exposed to losses.

As noted below, bail-ins are not a panacea. In particular, the effect of the bail-in mechanism is to allocate some of the losses incurred by a financial institution to its senior creditors. If those senior creditors are themselves financial institutions, then this could achieve little more than the transmission of contagion through the system. A properly designed bail-in regime will minimise this risk by excluding from the scope of bail-in the transaction types which transmit loss directly between system participants (deposits, transaction payments, swaps and others), but since financial institutions may be senior creditors in other financial institutions in a number of ways, it cannot eliminate it.

The optimal environment for a bail-in to work would be in circumstances where a systemically important institution failed for reasons idiosyncratic to itself or its business model, and where the remainder of the financial system remained stable. When dealing with an entire financial system subjected to a substantial exogenous shock affecting many different business models, the likely usefulness of a bail-in approach would be a direct function of the amount of cross-holding of debt within that system – if bail-in debt was substantially owned by other banks, then bail-in could increase systemic risk; whereas if bail-in debt were predominantly held by end investors, then bail-in could substantially reduce systemic risk. The trend amongst regulators (particularly through the Basel III proposals) is to penalise inter-bank

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holdings of debt and, in particular, holdings of other banks' capital instruments, and the market appears to be moving towards an environment where the majority of long-term bank debt is held outside the banking system - this should increase the appeal to regulators of bail-in as a tool for dealing with bank failure.

Bail-in vs subordinated capital vs contingent capital

The idea that banks should be able to subordinate some of their debt in order to enhance their solvency ratios has been around for many decades. These have taken various forms including innovative hybrid subordinated capital (qualifying as tier 1 capital), perpetual subordinated debt (upper tier 2) or term subordinated (lower tier 2). However regulators objected – and events proved – that although this subordination would have had the effect of protecting depositors in an insolvency, it provided no benefit where a bank was in difficulty but liquidation was not a real option. In particular, where taxpayers' funds might be needed to support an entity as a going concern, taxpayers could end up bailing out subordinated debtholders along with senior creditors and subordinated debt might also impede resolution options such as the sale of the whole entity to a purchaser.

Accordingly, just seven days after the issue of the European Commission's consultation on debt write downs, the Basel Committee issued a statement that, under the new Basel III regime, neither subordinated debt instruments nor preference shares would count as capital unless either the terms and conditions of the instruments contain a provision that requires them, at the option of the relevant regulator, to be written off or converted into common equity at the trigger point of non-viability or the bank's home state has laws which require that debt to be written off at that trigger point or otherwise require those instruments to fully absorb loss before taxpayers are exposed to loss. The trigger point is when the regulator determines either that the firm cannot continue in business without an injection of public capital or that the firm will be required to take a write-off which would result in its becoming unviable.² Thus, these proposals, in common with more general bail-in proposals, envisage that subordinated debt at least must be exposed to loss at a “gone concern” (or near “gone concern”) trigger point, in order to facilitate a “going concern” outcome.

The increased focus on the loss-absorbency of banks has also led to the development of new instruments that are capable of absorbing losses on a going concern basis, by being written down or converting into equity at a trigger point

² See the Basel press release of 13 January 2011 at <http://www.bis.org/press/p110113.pdf>. This articulates the policy which was consulted on in its “Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability” – BCBS 174 of August 2010 at <http://www.bis.org/publ/bcbs174.pdf>

which is intended to be long before the point of non-viability. These contingent convertible or contingent capital bonds aim to restore the health of a bank by either converting the debt into equity or writing down the outstanding amount of the debt - thus creating additional core tier 1 capital - at a trigger point generally set by reference to the issuer's capital ratio falling below a level set at a point well above the point at which the bank will be in real crisis.³ The intention is that these instruments should count towards increased regulatory measures of loss-absorbency, such as the new "Swiss finish" requirements which envisage large Swiss banks having levels of loss-absorbing capital well above the Basel III minimum standards, the potential new requirements that may be developed by the Basel Committee or other national regulators for systemically important financial institutions (SIFIs) or the stress tests applied to test the resilience of banks to severe adverse market developments.

It is therefore clear that there is a great deal of similarity between contingent capital and bail-in eligible debt. Both are, in effect, debt instruments that have the capacity to create or restore a bank's core equity capital at a defined trigger point, to secure a going concern outcome for the institution as a whole. Both can take the form of either senior or subordinated debt and both could be required to be converted or written down in whole or in part as needed to achieve their ends.

There are, however, three principal differences between the two. First, contingent capital is based on a "going concern" trigger, in contrast to the "gone concern" (or near "gone concern") trigger

"Existing debt restructuring regimes just don't work for banks."

envisaged by bail-in proposals. Secondly, for that reason, contingent capital can be structured with an objectively defined trigger point and a pre-defined conversion or write-down mechanism, which requires no regulatory intervention to achieve its outcome and no (or minimal) exercise of discretion by the bank's board. In contrast, a bail-in is triggered at a point of non-viability which inevitably requires an exercise of regulatory discretion. At least for bail-ins of senior debt, there will also need to be discretion exercised by regulators as to the quantum of the debt that is subject to conversion or write down and, in the case of conversion, the quantum of shares issued in exchange. Thirdly, as a result of the two previous features, contingent capital can more readily be structured on a wholly contractual basis, where, as discussed below, bail-in proposals (at least for senior debt) are likely to require the backing of a statutory regime empowering regulators to take the necessary actions and to deal with consequential issues, such as the cancellation or dilution of existing equity and the overriding of events of default.

Bail-in vs resolution

Bank rescue – whether by insolvency or through specialised resolution regimes - is harder than it sounds. The essence of a corporate restructuring is that it is essential to keep the business going whilst its finances are restructured, and this in practice means that trade creditors must continue to be paid whilst financial creditors are restructured. A

loss has been incurred, and that loss is too great to be discharged over time out of the ordinary revenues of the business. The question is therefore one of how that loss should be distributed – who should bear it, and in what proportions. Causing trade creditors to bear it will terminate the businesses supplier and customer relationships and cause it to be wound up. Preserving the business, therefore, involves allocating the losses to financial creditors.

The problem that arises in translating this concept into the financial sphere is that for a bank the distinction between trading and financial creditors is more or less meaningless – all creditors of a bank are providers of finance and counterparties to financial transactions. Thus having decided to restructure the bank, the primary problem is to decide which creditors should accept what quantity of loss.

To complicate matters further, banks exist in an industry in which viability is measured minute to minute. In many businesses it is possible for a business to suspend its activities for days or even weeks without doing irreparable damage to its commercial success. However if a bank ceases to function even for a period measured in minutes, its viability as a business is gone. A successful bank rescue is therefore one which can be completely effected in a period in which the bank is closed for business - classically between the close of business in the US on Friday evening and opening of business in Tokyo on Monday morning, or around 50 hours.

The classical bank resolution mechanism involves transferring assets (usually good loans) and liabilities (usually retail and

³ At the time of writing there have only been a small number of such issues, notably by Lloyds in 2009, Rabobank in 2010 and 2011 and Credit Suisse in 2011.

corporate deposits) into a “good bank” (a “bridge bank”) in such a fashion that the bridge bank remains solvent (and can be wound down and sold at a later stage) or to a rival purchaser. The remainder (including ownership of the good bank) will be left in the initial institution - now the “bad bank” - which is likely to be very bad indeed. The residual creditors of the bad bank will generally be entitled to what enterprise value may be secured from the sale of the ownership of the good bank (or the sale to the purchaser) and the realisation proceeds of any (usually illiquid and often toxic) assets left in the bad bank, but are likely to be left short.

This approach has been tried and tested around the world, and in particular is the usual modus operandi of the US Federal Deposit Insurance Corporation, which may have more experience of managing bank failures than any other organisation. However, it is a tried and tested technique in the context of smaller or primarily domestic retail-financed banks, whose structures are generally straightforward and whose funding is non-complex. The difficulty in using this technique in other circumstances is that the more complex the business of the institution the harder it is to perform the division of assets into “good” and “bad”. This difficulty is then magnified many times over if the institution has significant assets or liabilities governed by foreign law or held through foreign branches or subsidiaries, which are subject to their own investor protection or regulatory regime and in the case of overseas subsidiaries with creditors of their own. There is therefore a point at which an institution becomes simply too large or

“Bail-ins aim to avoid the need for formal insolvency proceedings, but to restructure the bank’s balance sheet and to ensure the continued survival of the institution without the need to dismember the bank by the use of conventional resolution tools.”

too complex to divide into a “good” and a “bad” bank in the 50 available hours. This point is well below the size of any institution which could reasonably be considered systemically significant. Resolution planning (“living wills”) can increase the confidence of regulators that these techniques can be used, but the usefulness of the bail-in option is that it can provide a more credible, readily understood alternative.

Alternatively, the simplest way to effect a bank resolution is to arrange for the whole bank to be acquired by a solvent purchaser with sufficient resources to sustain it (although such transactions may be subsequently criticised as leading to over-concentration in the market). However even if potential purchasers exist for the insolvent bank, the problem which may well have to be faced is that there is a tremendous difference between knowing that a bank is in trouble and knowing exactly the extent of the trouble that the bank is in. Rescue purchases may simply have the effect of imperilling the stability of the rescuer, and in such cases the usefulness of the existence of a bail-in option may be considerable.

How does a bail in work?

Bail-in, by definition, is a process which applies to some but not all of the senior creditors of an institution, since some of

these will be the very creditors whom the process is designed to protect. Chief amongst these are depositors, although banks have for some time had depositor protection schemes in place to address such issues.⁴ However, for the reasons given above, if the bank is to be preserved as a going concern its “trade creditors” - payment services customers, short term creditors, securities and trading exposures, etc. - must be preserved intact, and for the purposes of illustration it can be assumed that the bail-in process will be applied to the long-term investment creditors of the bank - loosely, bondholders and holders of subordinated debt.

The essence of “bail-in” is the idea that some senior creditors of a bank should, in certain circumstances, have part of their claim against the bank written down in wholly or in part, after the write down of lower ranking subordinated claims and equity. Such senior creditors may receive new shares in the bank, but subordinated creditors may have their claims simply extinguished.

As shown in the example below, a full spectrum bank might have total assets of €1 trillion financed by (inter alia) €50bn of shareholders equity, €20bn of subordinated debt and €200bn of senior debt securities. Thus applying a haircut of

⁴ However depositor protection is in some respects a misnomer, since what is also sought to be protected is payment accounts and other facilities. Individual depositors did not queue outside branches of Northern Rock only because they believed they were exposed to credit risk (because of the self-insured portion of their claim under the UK’s then deposit-protection scheme), many of them queued because an insured deposit balance which cannot be withdrawn is useless for most of the ordinary purposes for which we keep money in a bank.

40% to the senior debt securities would be more than sufficient to restore the group's equity capital and to replace its subordinated debt with equity, assuming that the group's losses burn through these layers of protection. This is equivalent to having funded the group with €50bn of equity, €20bn of

subordinated debt, €80bn of contingent or other capital securities and €120bn of ordinary senior debt. The advantage of the bail-in structure is that in extremis the whole €200bn would be available for conversion or write down, whereas in the contingent capital structure this amount is limited to €80bn.

It is interesting to compare this outcome to the outcome of a resolution regime involving the creation of a bridge bank to protect retail depositors. In resolution a part of the bank will be "saved" into a good bank, but the remainder will have to be either sold or will disappear as counterparties cease to do business

Example – Bank A (before)

Assets:	€1,000bn
Liabilities:	
Eligible senior debt*	€200bn
Retail deposits	€300bn
Other senior liabilities	€430bn
Subordinated debt	€20bn
Share capital	€50bn
Total	€1,000bn

* Senior debt eligible for bail-in

Assume:

- Unexpected accounting loss of €80bn
- In a liquidation
 - all senior creditors rank pari passu
 - senior creditors would recover 70 cents in the euro
 - i.e. total liquidation losses of €349bn
 - €50bn share capital +
 - €20bn subordinated debt +
 - €930bn senior liabilities x 30% = €279bn
- Therefore, in a liquidation, total recoveries of:
 - Holders of eligible senior debt = €140bn (i.e. 30% loss)
 - Holders of shares and sub debt = €0 (i.e. 100% loss)

Example – Bank A (after bail-in)

Bail-in:

- Eliminate €80bn loss by:
 - Cancelling share capital + subordinated debt (total €70bn)
 - Writing down eligible debt by €10bn
- Recapitalise bank by:
 - Converting €70bn of eligible debt into equity

Assets:

Previous total	€1,000bn
Accounting loss	(€80bn)
Revised total	€920bn

Liabilities:

Residual eligible debt	€120bn
Retail deposits	€300bn
Other senior liabilities	€430bn
Share capital	€70bn
Total	€920bn

Total recoveries:

- Holders of eligible senior debt now hold €70bn (shares) + €120bn (residual debt) = €190bn book value (5% loss)
- Previous holders of shares and subordinated debt = €0 (100% loss)

Note to table:- The imponderable in the above is the increased loss on liquidation – this illustration has been created by assuming that the liquidation loss which occurred in the Lehman case is typical.

with the bank and – if possible – close out against it. Thus we would expect the value destruction in the “bad” bank to be comparable to that which would be realised on an insolvency. In addition, the losses of senior creditors are in principle increased as a result of their effective subordination to otherwise pari passu depositors, unless they are protected by a regime which guarantees that no pre-resolution creditor will be worse off as a result of the resolution than they would have been in a liquidation or other insolvency proceeding of the bank. The results are also illustrated below.

One of the most interesting issues which arises out of this example is the assumption that equity is extinguished in a bail-in. In principle, this is clearly right – a bail-in conducted without a cram-down of existing equity holders would result in those equity holders receiving a windfall

“Although contingent capital and bail-ins aim to secure a going concern outcome for the bank as an institution, contingent capital is based on a “going concern” trigger, in contrast to the “gone concern” (or near “gone concern”) trigger envisaged by the bail-in proposals.”

profit. The conversion of contingent capital, by contrast, involves the creation of new equity which ranks pari passu with the existing equity (although it may heavily dilute it). The implicit sequencing is therefore:

1. subordinated or contingent capital is written off and converted in full to equity;
2. bail-in is triggered, and existing share capital (old and new) is written off; and
3. new equity is issued to the holders of the bailed-in senior bonds.

It probably goes without saying that in order to have any confidence in this

system regulators would need a power to require that a bank maintain at least a specified minimum proportion of its senior financing in the form of either contingent capital or bail-in eligible debt or some combination of the two (although the requirement could also be met by equity or bail-in eligible subordinated debt). An effective bail-in regime depends on the authorities having the “fire power” to deal with extreme levels of unexpected loss. The determination of the level and appropriate combination should be made by regulators as part of the “living will” review process.

Example – Bank A (after resolution)

Resolution method

- Assume resolution by creation of a bridge bank
- Bank A transfers to bridge bank:
 - €300bn of retail deposits
 - €330bn of “good” assets to back deposits and capitalise bridge bank

Bridge bank (after)

Assets:	€330bn
Liabilities:	
Deposits	€300bn
Capital	€30bn
Total	€330bn

Saving for deposit protection fund* = €300bn x 30% = €90bn

Notes:

* Assumes all retail deposits insured and 70% recovery in liquidation

† Assumes that losses in resolution are the same as liquidation losses and that residual Bank A receives benefit of equity in bridge bank

Residual Bank A (after)

Assets: †

Original	1,000bn
Liquidation losses	(€349bn)
Transferred to bridge bank	(€330bn)
Bridge bank equity	€30bn
Total residual assets	€351bn

Residual senior liabilities:

Eligible senior debt	€200bn
Other liabilities	€430bn
Total	€630bn

Total recoveries:

- Senior creditors recover €351bn/€630bn = 56%
- If “no creditor worse off” rule, deposit protection/resolution fund contributes €90bn
- After contribution, senior creditors recover: (€351bn + €90bn)/€680bn = 70%
- Other stakeholders recover €0 (100% loss)



“There is a point at which an institution becomes simply too large or too complex to divide into a “good” and a “bad” bank in the 50 hours typically available.”

Requiring a larger volume of bail-in eligible debt reduces the percentage haircut that will be applied to eligible senior creditors and eliminating the claims of equity holders and issuing new shares to bailed-in bondholders also reduces their overall losses. Those losses are likely to be further reduced, as compared with liquidation or other resolution outcomes, as bail-in preserves the institution as a going concern and avoids at least some of the losses that would otherwise crystallise during an insolvency or resolution process. However, the objective of bail-in is not primarily to reduce the losses of creditors. The primary aim of a bail-in is to recapitalise the relevant institution, and it is argued in some quarters that ensuring that creditors do suffer significant losses is an

appropriate and necessary part of the process, whose development will enhance market discipline.

Impact on pricing of debt

An objection which is sometimes raised to bail-in capital is that because the pulling of the bail-in trigger and the quantum of the resulting write-down or conversion are in the discretion of the regulator, it would not be possible for holders of bail-in eligible debt to make any meaningful pre-estimate of their risk of loss. This, it is argued, would make such debt difficult or impossible to price on the market. Although there is something in this, it is possible by analysing the likely structure of a bail-in

regime to draw some useful conclusions which may assist the pricing process.

Contingent capital instruments generally have defined trigger and conversion/write-down mechanisms specified in the terms of the instrument, whereas the triggering of a bail-in and the resulting conversion/write-down are at the regulator’s discretion. However, holders of senior bonds issued by UK banks subject to resolution under Banking Act 2009 already face a similar risk. The Act allows the authorities to trigger resolution based on subjective determinations of non-viability and to transfer at their discretion a variable quantity of valuable assets out of the failing bank in such a way as to reduce the assets available to meet the claims of residual senior creditors (or to expropriate bond-holders as part of the sale of the bank to a commercial purchaser or temporary public ownership). This has not affected the market’s ability to price these bonds. This may be because dealers and investors have made the simplifying assumptions that the making of a resolution order under the 2009 Act is functionally equivalent to default – that is, that such an order would be made only where the institution would otherwise have defaulted – and that the “no creditor worse off” and compensation safeguards in the Act ensure that their loss in a resolution would be no worse than in a disorderly liquidation. Thus, the existence of the Act may not have affected their fundamental calculation as to the probability of the issuer defaulting or their loss given default.

The same is broadly true for bail-in – the fact of a bond being bail-in eligible should only be material to pricing if the probability of a bail-in is significantly different from the probability of a default absent bail-in or if the creditors’ loss on a

bail-in would exceed their loss given default by other means. If an institution were permitted to operate using only the minimum tier 1 regulatory capital and relied on a bail-in to cover all of its other risks, the chance of bail-in occurring would clearly be significant, and this phenomenon might well be observed. However, any bail-in regime would also need to ensure that institutions maintain sufficient regulatory capital to satisfy regulators, plus a balance of contingent capital sufficient to cover the residual risk of unexpected losses. The risk covered by the bail-in debt would therefore be the risk that the losses suffered by the institution would exceed both expected and unexpected loss. In principle this is a “tail” risk, of a kind which is not generally reflected in pricing.

A bail-in regime does concentrate any loss (not absorbed by equity or subordinated debt) on a sub-set of senior creditors, whereas resolution regimes can spread losses across a wider group, e.g. where only deposit claims are transferred to a bridge bank, leaving all other senior creditors to suffer losses equally. Realistically, however, the increased losses resulting from a liquidation or the dismembering of an institution in a resolution are likely to outweigh these risks – in most cases investors in bail-in eligible debt are likely to be better off than under the alternatives of insolvency or the use of other resolution tools - and investors should in any event analyse their likely loss in resolution on a worst case outcome. In addition, the European Commission proposes that the “no creditor worse off” safeguard should apply equally to the use of the debt write down tool, which should mean that the likely loss given default on bail-in is at least no worse than the loss given default on other resolution outcomes.

“The essence of “bail-in” is the idea that some senior creditors of a bank should, in certain circumstances, have part of their claim against the bank written down in wholly or in part, after the write down of lower ranking, subordinated claims.”

There is a further concern. Since the power to require a bail-in will necessarily involve an element of discretion on the part of the relevant authority, the price of bail-in eligible debt would rise if it were perceived that the regulator were minded to exercise that power in circumstances in which the institution would not have defaulted. This is a behavioural matter, and as such very difficult to model – although the impact could be mitigated if regulators were prepared to give broad guidance as to in what circumstances they would ordinarily expect to use their bail-in power.

However, a more fundamental issue is the possibility that the market has not priced the potential adverse impact of existing resolution regimes into outstanding subordinated or, more importantly, senior bank debt, on the basis that the existing regimes are not perceived to present a credible threat of imposing losses on bondholders, precisely because of the difficulties of using resolution tools that require the dismembering of a large, international systemically important institution. Therefore, it is possible that the introduction of a bail-in regime might be perceived as significantly altering the probability of default, because it would be easier for the authorities to use bail-in powers than their existing resolution powers. In the UK, that might be shortsighted, because the Banking Act provides the authorities with additional resolution tools that can be used to

impose losses on some bondholders without dismembering the institution (by expropriation of securities using the temporary public ownership and sale to a commercial purchaser tools, although the difficulties of imposing losses on holders of non-UK law governed bonds would be a constraint). However, even putting that aside, this argument suggests that any impact on pricing would result from the removal or weakening of the implicit sovereign guarantee for systemically important banks, and the removal of this guarantee (and the subsidy to the cost of bank funding) is the one of the key objectives of the proposals for a bail-in regime.

Finally, there are concerns that a significant number of current investors in bank senior or subordinated debt would be unable to buy bail-in eligible debt because their investment mandates restrict their ability to purchase debt which is convertible into equity and that the resulting restricted market for bail-in eligible debt will drive up funding costs. This could be a particular issue if a bail-in regime is structured based on the use of contractual conversion clauses in debt issues. However, the risk of ultimate conversion into equity is a risk which is taken by every senior creditor of any corporate issuer which can be subjected to a Chapter 11 or similar restructuring regime under which creditors can be required to exchange their claims for equity without their consent. These regimes do not seem to

“It is argued in some quarters that ensuring that creditors do suffer significant losses is an appropriate and necessary part of the process, whose development will enhance market discipline.”

restrict investor appetite for senior debt. This suggests that a statutory bail-in regime which is clearly seen as a form of compulsory debt restructuring would be less likely to restrict investor demand. It may also be possible to reduce the impact of investor mandate concerns by building in a trust or similar mechanism under which debtholders can elect not to receive shares but to have them sold for their benefit. Nevertheless, in one respect, there is likely to be a more restricted investor base in the future for bail-in eligible senior debt than current senior bank debt, as bank regulators are raising the capital charges for exposures to other banks and could decide to treat a bank's holding of bail-in eligible senior debt of another bank as the holding of another bank's capital instruments which may be required to be deducted from core tier 1 capital under the new Basel III regime.

Legal structure – making bail-ins effective

A bail-in regime will be useless unless it is immediately accepted by the bank's customers and counterparties as legally effective. A bail-in, by itself, is purely an accounting adjustment. Its usefulness lies in the fact that by writing off debt it

improves the creditworthiness of the bank concerned to a stage where it can access the money markets and raise liquidity. In order to achieve this objective, providers of liquidity must be left with no grounds to doubt that the write-off is immediately effective and cannot be credibly challenged.

Achieving this level of legal certainty requires a surprisingly large amount of legal analysis. In a situation where the bank and all the relevant creditors were located in a single jurisdiction, simple legislation in that jurisdiction would suffice. However this is not – and will never be – the case for any bank whose failure would give rise to significant systemic concern. The challenge is therefore to construct a legal solution which employs a variety of legal techniques to achieve a robust outcome without falling into impossible demands for global harmonisation of bank resolution legislation.

It might be possible in some jurisdictions – including possibly the UK – to create a bail-in regime entirely by private contract by including the relevant provisions in debt instruments issued by the entity and in the constitution of that entity. However, this would give rise to some interesting legal conundrums, since the issuer would be seeking to create debts on terms allowing the debtor, at its discretion, to eliminate all or part of the debt and to replace that debt with new shares. Even if this were possible, it seems unlikely that it would be acceptable to those creditors or the entity's shareholders that such a regime could be operated by the board of the relevant company entirely in its discretion, and even more unlikely that, in the context of the modern law on

directors liability, any board of directors would in practice be prepared to exercise such a discretion. Thus even if the regime were based entirely on private law, it seems likely that the contractual provisions would need to be structured so that the initiation of the bail-in is triggered by an external act of an appropriate regulator or other public body and to ensure that any discretion about the extent of any necessary write-down or any compensatory issue of equity is also exercised by the authorities rather than the board. This would almost certainly create procedural and technical difficulties for public authorities, who in many cases would perceive unacceptable risks to acting pursuant to private rights rather than public obligations.

An alternative approach would be to provide for bail-in by legislation. Bail-in backed by legislation has a number of appealing aspects – in many jurisdictions legislation will be necessary to deal with company law issues, and legislative backing would clearly underpin market confidence in the robustness of a bail-in. However legislation is an imperfect solution for all but the smallest banks, since for the majority of banks a significant portion of their senior debt is likely to be governed by laws other than that of their place of incorporation – for example most large continental European banks are likely to have bonds governed by English or New York law.

The problem which arises in this case is known to English lawyers as the “Metliss” problem. In *National Bank of Greece v Metliss*⁵, the English courts decided that where a Greek bank owed money under bonds governed by English law, a Greek statute passed for the purpose of varying

⁵ National Bank of Greece and Athens S.A. v Metliss [1958] A.C. 509

“The fact of a bond being bail-in eligible should only be material to pricing if the probability of a bail-in is significantly different from the probability of a default absent bail-in or if the creditors’ loss on a bail-in would exceed their loss given default by other means.”

liability on the bonds would not be recognised by the English courts, since – at its simplest – you cannot vary English legal rights by Greek statute. This principle would almost certainly be applied by the courts of most jurisdictions – thus, if the contractual obligations of a UK bank were varied by UK law, there is a significant risk that the variation would not be effective as against holders of New York law governed bonds. The recent litigation commenced in New York by Fir Tree Capital against Anglo Irish Bank Corporation is an example of a creditor seeking to rely on rights under New York law governed documentation alleged to conflict with the exercise of resolution powers, in this case those conferred on the Irish authorities by the Irish Credit Institutions (Stabilisation) Act 2010.

It is important not to overstate *Metliss*. In particular, the EU proposals would, if enacted, produce a regime in which a bail-in or write-down effected by the law of one member state would be recognised by the laws of other member states. In addition, courts are in some cases prepared to recognise compromises of creditors rights arising under the laws of other jurisdictions. However such recognition in practice tends to be confined to formal insolvency proceedings, and predicated on the assumption that a similar process would be possible under the domestic law of the court concerned. Thus, although a purely statutory regime might be effective in a world where all major financial

jurisdictions had broadly equivalent domestic bail-in regimes, it would not be effective at any time prior to that.

The hybrid approach

The conclusion from this seems to be that the most robust approach would be a hybrid approach. The structure of such an approach would be that the bank should, in its country of incorporation, be subject to a statutory regime whose effect would be to recognise the bail-in in national law. This law should automatically apply the bail-in terms to any bail-in eligible creditor whose claim arose under the law of that jurisdiction. The bank would then be required to ensure that for any bail-in eligible creditor whose claims were governed by any other law, it should be required to include in the agreement with that creditor a term to the effect that the creditor agreed to be bound by any bail-in effected under the law of the place of incorporation as if their rights under the agreement were governed by that law, and to obtain legal opinions that the term would be recognised under the applicable law of the agreement.

This hybrid approach would ensure that the most important part of the bail-in – the reduction of existing creditor claims on the bank concerned – would be legally robust and effective. However, in order to fully accomplish a bail-in you need to do three broad legal jobs. One is to write down the relevant senior debt.

The second is to issue new equity to the written-down debt-holders. The third is to cram down the existing equity. Both the second and the third may also require legislative change in the country of incorporation of the bank.

As regards the creation of new equity, there may well be national company law rules about new equity issuance which require to be observed. In some jurisdictions it may be possible to address these through amendment to the constitution of the company concerned, but in others statutory change may be required.

Cram-down is more problematic. The cancellation of equity may run into issues of protection of property rights in cases where it is not certain that the existing equity is completely valueless – although conventionally a cram-down should be accompanied by the issue of warrants of some description to the former ordinary shareholders such that the holders of these warrants would be entitled to some participation in the recovery of the entity but only after the holders of the bail-in shares had been appropriately compensated. Again, in some jurisdictions this will require legislation in order to amend existing company law concepts.

Scope of bail-in

The question of legal effectiveness is frequently confused with the question of the scope of the bail-in itself. The reason for this is that when considering bail-in regimes, an apposition is sometimes posed between a “targeted” regime, under which the bail-in is only possible for certain pre-designated exposures, and a “comprehensive” regime, in which the bail-in is extended to all senior creditors subject to a closed list of exceptions⁶. It should be clear from the foregoing that a

“comprehensive” regime would be legally ineffective for any institution whose debt was not entirely subject to the laws of the country of its home state regulator. Since it would in practice be impossible to require a global institution to enter into all of its financial contracts under the law of its place of incorporation, the next-best operative solution would be to require the bank as a matter of regulation to include in all of its relevant contracts language which would give effect to the bail-in. At this point the distinction between the “targeted” regime and the “comprehensive” regime disappears - in both cases the mechanism by which the bail-in is effected is the inclusion of language in the documentation creating the relevant exposure, and the principal remaining distinction is the means by which the scope is defined.

Consideration of this exposes another issue regarding a “comprehensive” bail-in regime. It is accepted that not all creditors should be bailed-in - in addition to the “trade” creditors who would have to be preserved, there would clearly be other classes of contracts - purchase of goods, occupation of real estate, unpaid salaries, outsourcing fees and many others - which would also have to be outside the scope of the regime. The legal difficulties which would be caused for banks by the existence of a continuing obligation to consider every contract entered into across the bank against this issue would be considerable, and the legal uncertainties raised by the question of whether the bank had correctly categorised the exposures which it had entered into would result in legal uncertainty affecting the bail-out as a whole - an outcome which would be toxic for the success of the bail-out when required.

Consideration of the “targeted” approach, however, immediately flushes another legal Chimera - the idea that creditors could “contract out of bail-in”. This is clearly true (it is true of all creditors in all possible structures) - the question is whether it is a problem, and the answer to the question of whether it is a problem depends on the way in which bail-in is approached by regulators.

In the context of any bail-in arrangement, it is clear that certain creditors must be capable of being excluded from the possibility of bail-in (secured creditors are an obvious example). It is therefore essential for the institution concerned to be able to say clearly to any creditor whether or not it will be caught by a bail-in possibility. Since the factors which drive that determination must be mechanical and predictable, it will always be possible for any claim to be taken outside the scope of bail-in. The issue is not the fact that this is possible - it is inevitable - but the question of whether the fact of the possibility weakens the reliance which the regulator would seek to place on the bail-in mechanism.

In order to answer this we need to think about the bail-in mechanism from the perspective of the regulator. In general, we expect regulators to determine their approach to bail-in capital levels in the context of a “living will” analysis. Regulators should assess the question of whether:

- (a) there is sufficient existing equity capital to meet anticipated losses
- (b) there is sufficient contingent capital available to meet unanticipated or crisis losses, and
- (c) in the event of a catastrophic unexpected losses, there is sufficient

bail-in eligible debt available to avoid the necessity for a government bail-out.

This process should yield a quantifiable requirement for the institution concerned to maintain a specified amount of bail-in debt - defined as capital containing contractual provisions by which the holder agrees to have his obligation written down or partially converted on the determination of the relevant authority under its legislative powers. If the institution does not maintain sufficient bail-in eligible debt (i.e. permits too many counterparties to contract out of bail-in) the required amount of contingent capital or equity would simply be increased proportionately. However if the institution does have sufficient bail-in eligible debt to satisfy the regulator, there is no reason to assume that the regulator should care whether new creditors fall inside or outside this scope. Since it should be assumed that it will be clear to all creditors how much of the institutions total debt is bail-in eligible and how much is not, an institution which sought to reduce the amount of its debt which was bail-in eligible would be expected to suffer a significant increase in its cost of funding from its remaining bail-in-able debt, and, of course, vice versa. Thus provided that the institution maintained sufficient bail-in debt to satisfy its regulator, there is no reason for concern about “contracting out”. Indeed, the flexibility to issue additional non-bail-in eligible senior debt - which is the remaining distinction between the comprehensive and the targeted approach - may be a source of strength. It allows additional senior funding, presumably at lower cost, in normal times and, in times of stress when it may not be possible to issue further bail-in eligible debt because of the increased risk of

⁶ These are the labels adopted in the European Commission discussion document referenced in note 1 above

loss, would allow the institution to continue to access the capital markets without the need to create a further category of super-senior creditors or debtor in possession financing.

Group issues

Thus far we have considered the bail-in of a bank. However most large banks are members of groups, and it is frequently the case that in a bank group there is an unregulated bank holding company above the bank.

In the case illustrated in fig. 1, if the bail-in were to be conducted at the bank

“Providers of liquidity must be left with no grounds to doubt that the write-off is immediately effective and cannot be credibly challenged.”

level the effect of the bail-in would be to break the group structure (since the bank would cease to be a subsidiary of the holding company) – and would be likely to push the holding company into insolvency (since its shares would become deferred and its dividend flow from the regulated bank would cease). This problem clearly would not arise if the senior borrowing were primarily at the holding company level. However

practices vary amongst banks as to whether funding is (a) raised at the holding company level and downstreamed, (b) raised at the level of the bank itself or (c) raised at both levels. This it is impossible to make any general assumption as to where in the group bail-in eligible debt will be raised.

This means that the structure of any bail-in must be adapted to the specific case of the bank group concerned. This can be most easily understood by considering the case of the slightly more complex bank group illustrated in fig. 2.

In this case, the group has creditors at multiple levels and within multiple legal entities.

The starting point for consideration of this situation should be the fact that it is desirable for both the group and for its regulator that creditors should be clear which parts of the group they are exposed to. Creditors of the holding company will clearly consider themselves exposed to the group as a whole, and creditors of the booking vehicle will consider themselves exposed – in credit terms at least - solely exposed to that booking vehicle. However for the Asian subsidiary bank, for example, the question of whether that bank would, in difficulty, be able to or entitled to call upon the resources of the remainder of the group would have to be determined as part of the living will process. It would clearly be open to the bank group to structure itself on the basis that all of its components were interdependent, and if this were the case then the logical conclusion would be that any bail-in of

Fig. 1

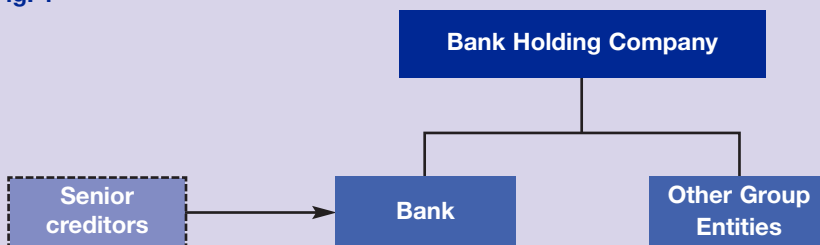
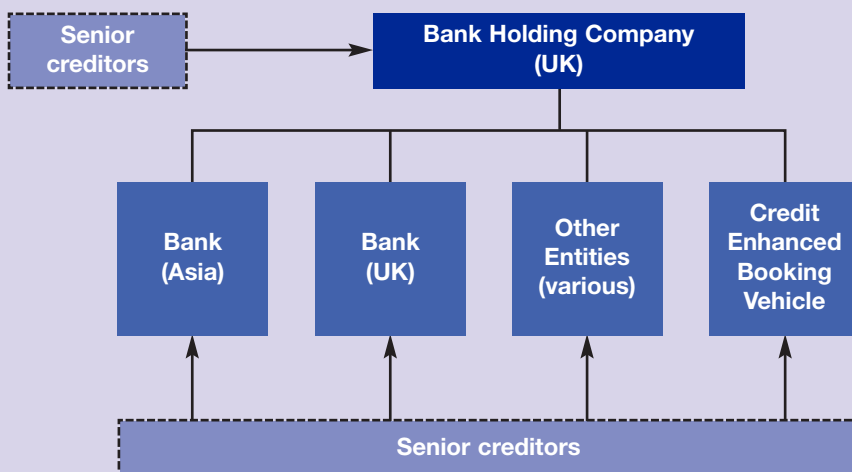


Fig. 2



“An opposition is sometimes posed between a “targeted” regime, under which the bail-in is only possible for certain pre-designated exposures, and a “comprehensive” regime, in which the bail-in is extended to all senior creditors subject to a closed list of exceptions.”

any creditor across the group should provide for the issue of new shares in the holding company. This would result in creditors of a solvent part of the group becoming exposed to the insolvency of other parts of the group, but it is likely that in the absence of formal ring-fencing arrangements (such as are found around credit enhanced vehicles) this would be their ordinary expectation in any event. By contrast, where it is part of the resolution plan that a particular group member be segregated from exposure to the remainder of the group (perhaps so that it could be easily sold off to raise finance), this should also be recognised in the bail-in structure.

What all of this comes down to is nothing more complex than that the bail-in structure should reflect the existing structure of the group and the expectations of creditors as to their counterparty exposures. This is neither unreasonable nor overly challenging, and certainly does not represent an insuperable barrier to the establishment of bail-in regimes, at least where the bank holding company and the entities issuing bail-in eligible debt are incorporated in the same country. The position is more challenging where the group has a more subsidiarised structure containing large entities issuing debt that are not incorporated in the same country as the bank holding company, as the local regulator will not have direct powers over the holding company to implement the bail-in. However, it should also be accepted that there will be some group

structures which render the operation of a comprehensive bail-in regime difficult or effectively impossible. Again, this is not a fundamental objection to the adoption of a bail-in approach by regulators for those groups for whom bail-in is possible and at present most large banking groups with a bank holding company structure have their bank holding company incorporated in the same jurisdiction as their principal banking entities. It also potentially aligns the interests of regulators in effective resolution planning with the interests of banks in operating integrated legal entities operating internationally through branches rather than subsidiaries.

However, cross-border issues should not mean that it is impossible to implement a bail-in in a case where the troubled bank or its bank holding company also has troubled foreign subsidiaries. In many cases, those subsidiaries will have significant intra-group borrowings from their parent bank or bank holding company due to the downstreaming of funding raised at the group level. The bail-in of debt at the level of the bank or bank holding company should create enough capital so that it has capacity to write off or convert those loans to its subsidiaries into equity in those subsidiaries, enabling their recapitalisation as part of the overall process, even if the local regulator does not have an effective resolution regime. This may have the result of bailing out the creditors of those subsidiaries, effectively at the expense of the parent's creditors, but this may be a

better overall outcome than letting those subsidiaries go into liquidation. In addition, if local regulators have a local resolution regime with corresponding powers, there should be ways in which the group's lead regulator and the local regulators can coordinate the exercise of their powers to produce an appropriate result, without the need (outside the EU) for complex international treaties which could take many years to negotiate.

A bail-in of an integrated bank group would therefore require senior creditors of a bank subsidiary to be issued with new shares in the bank holding company rather than the bank itself. The write off of the bail-in eligible debt would create capital reserves in the subsidiary. The issue of the shares in the holding company does not necessarily require any intermediate step of requiring the subsidiary to issue additional shares or debt to its parent company, but the mechanics would depend on local corporate law sensibilities. There is no reason why this should not be done by statute, and if the bank and the holding company are established in the same jurisdiction a legislative solution in that jurisdiction should be capable of being crafted.

In the context of groups, it is also important to note that a consistent policy would be required as regards intra-group debt. The question of whether intra-group debt should be treated differently from any other debt in the context of a bail-in is not straightforward. However it is by no means clear that it is necessary to resolve these on a single global basis as opposed to a case-by-case basis - the optimum solution would seem to be that this issue should be addressed between individual banks and their lead regulators as part of the “living wills” discussion.

Again, this may be easier to accomplish in the “targeted” approach where banks continue to be able to issue senior debt which is not bail-in eligible alongside bail-in eligible debt.

Other issues

Applicability of existing insolvency co-ordination mechanisms

There are a number of international co-ordination measures currently in force which enable corporate restructuring proceedings under the law of one state to be upheld and enforced in the courts of other states. The most important of these are the EU Credit Institutions Winding Up Directive (WUD) and the UNCITRAL model law on cross-border insolvency.⁷

It would be nice to be able to conclude that one or other of these mechanism would enable immediate cross-border recognition of bail-ins in multiple jurisdictions. Sadly nothing is this simple. The UNCITRAL convention generally does not apply to banks (although it would generally apply to reorganisation of bank holding companies), and it is not entirely clear that a partially contractually-based bail-in would fall within the definition of “reorganisation measures” within the meaning of WUD.

The point, however, is that there are existing international measures currently in force which, if slightly varied, would provide exactly the robust platform necessary for cross-border recognition of bail-ins.

“A bail-in of an integrated bank group would therefore require senior creditors of a bank subsidiary to be issued with new shares in the bank holding company rather than the bank itself.”

Creditor safeguards

The laws of most jurisdictions have the effect that people may not be arbitrarily deprived of their property without appropriate safeguards and/or judicial process⁸. For this reason it is important to ensure that the bail-in mechanism adopted contains appropriate provisions to ensure that the rights of creditors are protected.

The contractual element of the proposed hybrid bail-in structure goes a long way towards addressing this issue - if a person contracts in particular terms and the rights arising under that contract are enforced against them, they do not generally have a public law remedy even where the person enforcing the rights is the government. However, there is equally no question that under the hybrid model the person making the determination that the creditor should be bailed-in is the regulator, and the determination of the extent to which those creditor’s claims are reduced is in the regulator’s discretion.

This poses a challenge. The essence of a bail-in is that it should be capable of being completed over a week-end (or appropriately short period of market closure). There is therefore no scope for creditor or shareholder votes, public court

hearings or public consultation, and very little for judicial or political control of the bail-in process.

The approach adopted to this problem in the UK under the Banking Act 2009 was the embedding of the “no creditor worse off” principle” in the legislation. The effect of this is that if the result of government action is that any creditor receives a demonstrably lower return than they would have done had the bank proceeded to disorderly liquidation, they should be compensated by the government.⁹ This approach relieves the necessity for procedural safeguards in the restructuring process by reference to an obligation to compensate in the event of misappropriation.

This is not, however, the only effective approach in this context. It would be quite possible to convene an emergency panel of – say – bankruptcy judges to review the restructuring proposals of the relevant resolution authority¹⁰. Alternative mechanisms could involve the “recruitment” of a representative creditor into the process in order to negotiate on behalf of his fellows, or the establishment of guidelines by public authorities. The key issue is simply that some safeguard mechanism is likely to be required in most jurisdictions in order

⁷ Since WUD applies across the EU and UNCITRAL has been implemented in Australia, Canada, Great Britain, Japan, New Zealand Poland, South Korea, South Africa and the United States of America, these cover a large proportion of the relevant bank groups.

⁸ For example, the 5th Amendment to the US constitution provides that no person should be deprived of property without due process of law. Protocol 1 Art 1 to the European Convention on Human Rights provides that also enshrines the right to “peaceful enjoyment of possessions,” although also recognizes that this right can be constrained. No one should be deprived of property “except in the public interest and subject to the conditions provided for by law.”

⁹ However, in the UK, the government can in effect draw on the deposit protection scheme (to the extent that the resolution actions result in the scheme saving having to pay out to depositors the compensation that would have been payable in a liquidation), which in turn recovers the money from the banking industry in general.

¹⁰ This is broadly the approach adopted in the US, although it should be noted that the relevant judges do not review the substantive fairness of the proposals, but only consider whether they relevant decisions have been arrived at in accordance with the precepts of public law and satisfy a basic standard of reasonableness.

“The triggering of event of default clauses could be heavily value-destroying for the remaining business of the bank.”

to ensure that legal protections of property rights are respected.

However, the operation of bail-in regimes in the context of group structures requires a more careful analysis of the safeguards for other stakeholders. For example, in a case where only one banking subsidiary of the holding company is on the verge of insolvency and the bank holding company has other viable and valuable subsidiaries, it could be perceived as disproportionate to cancel the claims of existing shareholders in the holding company. If the banking subsidiary had gone into liquidation, their shares might still have had significant value because of the value of those other subsidiaries. In those circumstances, the appropriate result may be to compensate the holders of bail-in eligible debt issued by the banking subsidiary with shares representing a part of the enlarged share capital of the holding company but to leave the claims of the existing shareholders intact, albeit diluted by the new equity. What this illustrates is a “no stakeholder worse off” variant of the European Commission’s general safeguard for resolution tools discussed above. It also illustrates that, while the write down of bail-in eligible debt must be immediate to be effective, it may be necessary to delay the issue of new equity and the determination of the rights of shareholders to a later date, when the relative interests can be determined (and in the meantime for trading in the shares to be suspended).

Ownership caps

If a bail-in regime involves the conversion of debt into equity, whether in a bank or its holding company, it is likely to be necessary to include provisions which allow the regulator to cap the amount of an individual shareholding that would be acquired by a single creditor or group of related creditors (and to convert the excess into a claim on the eventual proceeds of disposal of the shares). Large banking groups have regulated subsidiaries around the world and it could undermine the effectiveness of the bail-in if, for example, the bail-in were to result in a single creditor acquiring in excess of a 10% shareholding in the bank holding company if ordinarily that would trigger prior filing or approval requirements in the bank’s home jurisdiction or other jurisdictions where regulated group companies operate (which might also result in possible sanctions against the local regulated entities by local regulators).

Events of default

Philosophically, the function of a bail-in is no different from that of any other corporate restructuring – it is to impose losses upon the financial creditors whilst allowing trading to continue. For a bank, in order for normal business to continue, it is important that counterparties in that business should not be affected. Part of the problem, of course, is that it is considerably harder to draw a bright line between financial creditors and trade creditors for a bank that it is for a trading company. However, another very significant element is that trading creditors generally include “event of

default” language in their agreements with the bank, the effect of which is to give counterparties the right to terminate the agreement, for example if a bank’s regulator institutes proceedings against it seeking relief under “any bankruptcy or insolvency law or other similar law affecting creditors’ rights”. The institution of a statutory or quasi-statutory bail-in is likely to have the effect of triggering these clauses and terminating (or at least providing creditors with an option to terminate) trading agreement.¹¹ The triggering of such clauses could be heavily value-destroying for the remaining business of the bank.

The simplest approach to this issue is that adopted in the US bank conservatorship and bankruptcy provisions, which in broad terms provide that no contractual event of default can be effective if it is triggered as a result of the conservatorship. An alternative (and possibly more nuanced) approach is adopted in sections 22 and 38 of the UK Banking Act 2009, which provide that in the event of a resolution being effected, the authorities can specify that the order effecting the resolution will not trigger a number of broadly defined event of default, termination or other similar provisions in any agreement to which the bank or its subsidiaries are party.

In the context of a bail-in such provisions could be incorporated in the relevant national law of the place of incorporation of the bank. However this would give rise to significant conflict of law issues. Imagine a UK bank which has entered into trading arrangements with derivatives counterparties in Australia governed by New York law. The bank is bailed in. The fact that UK law provides that the event

¹¹ A bail-in operating on a purely contractual basis would probably not trigger such clauses, since the exercise of private contractual rights would almost certainly not constitute a restructuring.

of default provisions of the New York law agreement are not triggered would be of no relevance under New York law and it is hard to see an Australian or New York court being prepared to take cognisance of the UK Act in this respect. However, a counter-argument would be that creditors had entered into their agreements in the knowledge of the existence of the provision and should be treated as having implicitly agreed to it.

The issue could be addressed by requiring the bank to include a specific exclusion of bail-ins in its documentation. However a rule which required the bank to include a particular provision in every agreement into which it entered would be extremely difficult to implement.

In general banks control the events of default which operate against them in their normal business. As a result, the most significant issue in this regard is likely to arise in the context of derivative and other trading documentation, where events of default are likely to be considerably more widely drawn. In the context of the global adoption of a bail-in architecture supported by national legislation in major jurisdictions, it does seem likely that an industry initiative to amend standard terms in these documents would be the most appropriate way to minimise this risk. In addition, resolution planning should identify cases where there are other agreements whose termination may be triggered by a bail-in or other resolution action and where the consequences

“Bail-ins are not a panacea, and will not produce a zero-failure environment for banks.”

could materially adversely affect implementation of the resolution tools so that they can be addressed by individual negotiation or other mitigation action.

Finally, it should be noted that the effect of an event of default is in general to give the non-defaulting counterparty the choice to terminate the relevant contract if he so desires. If the bail-in is effective and the bailed-in form has immediate access to new liquidity as a result of it, the likelihood may well be that counterparties would not choose to terminate profitable business relationships even if they acquired the right to do so. In this regard it may well be that the robustness of the bail-in is itself the answer to the problem.

Transition to a bail-in regime

The European Commission's proposals are that any bail-in regime should only be implemented in a way that applies to future issues of debt, so that existing debt would remain unaffected by the regime. This is in part a pragmatic response. The hybrid approach discussed above can only be implemented with respect to new debt, since it requires the inclusion of contractual provisions in the debt instruments recognising the authorities' powers to bail in the debt. However, it is also a recognition that discussions about extending the regime to existing debt could themselves have a destabilising effect on markets which is likely to be counter-productive, even if existing debt may be exposed to similar risks of loss as a result of the application of other resolution tools.

Even with a significant cushion of equity and contingent capital, it may be difficult for a bank to issue its first tranche of bail-in eligible debt as this tranche will be perceived to be exposed to the full amount of any excess unexpected loss.

There may need to be phase-in arrangements where explicit thresholds are set for each bank, so that the bail-in powers only become exercisable after the bank's total issuance of bail-in eligible debt exceeds those thresholds.

The limits of bail-ins

Bail-ins are not a panacea, and will not produce a zero-failure environment for banks. Recapitalisation only works for good businesses with bad balance sheets - businesses which are fundamentally bad will not be and should not be bailed in, but will be left to a resolution regime in the ordinary way. It is also perfectly possible for a bail-in to fail - if the initial assessment of the extent of the losses of an institution is sufficiently adrift, the amount of new capital created by the bail-in may be insufficient to support the business. Possibly more importantly, a bailed-in bank will only survive if counterparties, creditors and customers believe that the institution is now robust. Leaving aside uncertainties as to the legal robustness of the bail-out (which should be largely eliminated by the use of the hybrid method and appropriate safeguards), it will be important that the market be satisfied that the institution has enough capital for its needs, and in response to the regulators assurance that this is now the case the market might not unreasonably respond “yes, but that is what you said last time”. It has been suggested that this problem could be addressed by creating an equivalent of “debtor-in-possession” financing which could be used in such cases, whereby a bailed-in institution could contract on terms that new creditors were senior to existing creditors. However this proposal is outside the scope of this paper.

The most significant obstacle to the

use of bail-ins, however, is that at the end of the day a bail-in is simply a mechanism for allocating an existing loss. It will only be possible to use it to allocate such losses to the banks creditors if the bank's creditors are sufficiently robust to absorb that loss. In a systemic crisis, where all systemic institutions are simultaneously at risk due to external circumstances, a bail-in could be counter-productive, sending cascades of default across the system. However, even in this case bail-in is preferable to "sudden stop" liquidation, since this would increase the losses realised within the system and therefore increase the damage to the system – thus no matter how bad the overall systemic problem, it will always be the case that a bail-in response will be preferable to a liquidation response. However, if at the end of the day the entire system is unstable then rearranging exposures within the system will not help it.

The road to resolution

The bail-in proposals clearly merit further study. The European Commission's paper

has clearly sparked considerable interest among regulators and banks, not least because it may offer a more complete answer to the existential challenge posed by the "too big (or important) to fail" question for large systemically important banks, without the need for extensive restructuring to separate out economically critical functions into separately resolvable subsidiaries (as is threatened, for example, by some of the proposals under consideration by the UK Independent Banking Commission). Indeed, there are likely to be positive advantages for the effectiveness of bail-ins if the bank conducts most of its operations through a single large banking entity which is the primary (or only) issuer of bail-in eligible debt in the group.

However, there are still many issues that require further work. In particular, there is still uncertainty about the market acceptability of bail-in eligible debt which needs further testing in the context of a more fully developed design framework. There is also further work to be done around the prioritisation of resolution options, in particular whether bail-in should be a first or last resort tool, and

making bail-in options work in a group context. These factors alone mean that it is unlikely that an appropriately market tested package of proposals could be included in the EU legislative proposal on crisis management scheduled for the summer of 2011. Pushing to catch this particular legislative sailing time with an inadequately developed proposal risks sinking the legislative ship. It is particularly important to take care in the process given that the US is unlikely to be able to legislate in a similar way. It is unlikely to be possible to amend the Dodd-Frank Act in any significant way, given the current make-up of Congress following the mid-term elections. Therefore, whatever the EU does it will have to do on its own and argues in favour of taking a measured approach to building the consensus around the proposals.

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