Information on Bank Resolutions and Bail-ins

Responding to experience gained during the financial crisis of 2008, numerous countries have adopted rules which allow for the orderly resolution of banks in the future that are failing or likely to fail, without the involvement of taxpayers. As a result, shareholders and creditors may be drawn upon to share in the losses of a bank being resolved – with the objective of making the resolution of a bank without the use of public funds.

The European Union has adopted the following legal acts for this purpose:

– the Bank Recovery and Resolution Directive (**"BRRD"**); and

– the Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (the **"SRM Regulation"**).

Amongst other things, the BRRD provides for a national resolution authority – having certain rights for the recovery and resolution of credit institutions – to be established by each EU member state. To the extent that such measures are taken, they may have a detrimental effect upon banks' shareholders and creditors.

The specific details of such measures on a national level which resolution authorities may take may differ in detail. In this document, we outline potential resolution actions, taking Germany as an example. Resolution procedures of other countries (especially those outside Europe) may be different, and may have even more far-reaching consequences.

At what point in time might I be affected?

You may be affected as a bank's shareholder or creditor – that is, if you are holding financial instruments issued by the bank (such as shares, bonds, or structured products), or if you have claims against the bank as a contractual counterparty (e.g. from transactions entered into under a Master Agreement for Financial Derivatives Transactions).

Securities which you hold in a custody account maintained by your bank, and which were not issued by the custodian bank, are outside the scope of any resolution action taken against that bank. In the event of a custodian bank being resolved, your rights of title to the securities held in the custody account – which were not issued by the custodian bank – will not be affected by a resolution.

Who is the resolution authority?

Resolution authorities were established in order to ascertain orderly resolution in the event of a crisis. Once certain conditions for resolution have been fulfilled, the competent resolution authority is authorised to impose resolution actions upon the bank in question.

In Germany, the competent resolution authorities are the Single Resolution Board (**"SRB"**) and since 1 January 2018 the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – **"BaFin"**). For reasons of simplicity, we will jointly refer to both authorities as "resolution authority" below.

When will a bank resolution and/or bail-in occur?

The resolution authority may impose certain resolution actions, provided that the following conditions for resolution have been met:

– the affected bank is failing, or likely to fail. This assessment is made in line with legal rules – for example, where the bank no longer meets the legal requirements for authorisation as a credit institution, due to losses incurred;
– there is no reasonable prospect that any alternative private sector measures (or other measures taken by regulatory authorities) would prevent the failure of the institution;
– the resolution action is necessary in the public interest – i.e. it is required and proportionate – and a liquidation under regular insolvency proceedings does not provide an equivalent alternative.

What measures can the resolution authority take?

Provided that all conditions for resolution have been met, the resolution authority may take extensive resolution actions, even prior to insolvency proceedings, which may have a detrimental effect upon bank's shareholders and creditors:

– the so-called **bail-in tool**, where the resolution authority may impose a partial or full write-down of financial instruments issued by the bank or claims against the bank, or require such instruments or claims to be converted into equity (shares or other forms of equity instruments), in order to stabilise the bank in this manner;
– the **sale of business tool**, whereby shareholdings, assets, rights or liabilities of the bank to be resolved are transferred, in whole or in part, to a certain buyer. To the extent that shareholders and creditors are affected by the sale, they will be facing another existing institution;
– the **bridge institution tool**, whereby the resolution authority has the option of transferring a shareholding in the bank, or all of its assets and liabilities, to a so-called bridge institution – which may impair the bank's ability to meet payment or delivery obligations to creditors, and may impair the value of the bank's shares;
– the **asset separation tool**, whereby assets, rights or liabilities are transferred to an asset management company for the purpose of assets being managed, with the objective of maximising their value until subsequent sale or liquidation. Similar to the sale of business tool, creditors will be dealing with a new borrower following transfer.

The resolution authority has the power to adjust the terms of financial instruments issued by the bank and of claims against the bank by official order; for example, it may amend the maturity or interest rate to the creditor's disadvantage. Furthermore, payments or delivery obligations might be temporarily suspended, or otherwise modified. Likewise, creditors' rights to terminate or otherwise modify the financial instruments or claims might be suspended on a temporary basis.

As a creditor, in what cases will I be affected by a bail-in?

Whether or not your position as a creditor will be affected by the 'bail-in' resolution tool depends upon the scope of the measure prescribed, and on the classification of your financial instrument or claim. Within the framework of a bail-in, financial instruments and claims are assigned to different classes: the sequence in which they are held liable (the so-called 'liability cascade') is defined by law.

The following principles apply to whether shareholders or creditors are held liable: only if a class of liabilities has been drawn upon in full – and provided that this is insufficient to fully offset losses to an extent that is sufficient to stabilise the bank – then the next class of liabilities in the liability cascade may be written down or converted.

Certain types of financial instruments and claims are excluded from the bail-in tool by law: this includes, for example, deposits of up to EUR 100,000 covered by the statutory deposit guarantee scheme, as well as asset-backed liabilities (such as Pfandbriefe).

Liabilities which are subject to a bail-in are also referred to as **"eligible liabilities"**.

From 1 January 2017 onwards, the following classes are distinguished for the liability cascade of a bank domiciled in Germany:

(1) Firstly, resolution actions affect **common equity tier 1 capital**, and hence, the bank's shareholders (i.e. holders of shares or other equity units).

(2) In a next step, creditors **of additional tier 1 capital** (holders of unsecured, perpetual subordinated debt, and of silent partnership contributions subject to conversion or write-down provisions, which are subordinated to tier 2 instruments) will be drawn upon,

(3) followed by **tier 2 capital**; this affects creditors of subordinated liabilities (such as subordinated loans).

(4) The next level within the liability cascade involves **unsecured subordinated financial instruments/ claims**, which are not eligible as additional tier 1 capital or tier 2 capital.

(5) This is followed in the liability cascade by unsecured non-subordinated financial instruments and claims (**"other unsecured financial instruments/claims"**).

    (a) This comprises **non-structured financial instruments/claims** such as

    – non-structured bearer bonds, negotiable registered bonds ("Orderschuldverschreibungen"), or similar rights which, by their nature, can be traded on the capital markets; and

    – registered bonds, promissory loans (Schuldscheindarlehen), unless they are assigned to class (6) as deposits, or exempt from bail-in.

    This also includes financial instruments or claims where the amount of interest payments depends exclusively on a fixed or variable reference rate.

    (b) This group also comprises liabilities in the form of structured, unsecured, non-subordinated financial instruments and claims (**"structured financial instruments/claims"**). Within this liability level, structured financial instruments/claims are only drawn upon after non-structured financial instruments/claims. In the case of structured financial instruments/claims (such as structured products on equity indices or claims under derivatives), the amount of interest or redemption payments depends upon an uncertain future event, or fulfilment is made in a form other than cash. This group also includes deposits by companies of more than EUR 100,000 which are not assigned to class (6).

(6) Ultimately, deposits by private individuals, small businesses, small and medium-sized enterprises (SMEs) may be drawn upon to the extent that they exceed the level of the statutory deposit guarantee scheme, which is generally EUR100,000 ("other deposits").

Effective 1 January 2017, the following liability ranking (shown in a simplified manner, and indicated by the arrow) applies, whereby a lower class will only be drawn upon if the drawdown on the higher-ranking classes (starting with common equity tier 1 capital) has been insufficient:

Liability cascade

(simplified display)

(1) Common equity tier 1 capital

(e.g. shares in a public limited or private limited company, or in a limited partnership)

(2) Additional tier 1 (AT1) capital

(e.g. unsecured, perpetual subordinated debt or silent partnership contributions subject to conversion or write-down provisions)

(3) Tier 2 capital (T2)

(e.g. subordinated loans or subordinated bearer bonds)

(4) Unsecured subordinated financial instruments/claims

(e.g. subordinated loans or subordinated bearer bonds which are not eligible as additional tier 1 capital or tier 2 capital)

(5) Other unsecured financial instruments/claims

Note: within this liability level, structured financial instruments/claims are only drawn upon after non-structured financial instruments/claims.

(a) Non-structured financial instruments/claims

(e.g. non-structured bonds, negotiable registered bonds, promissory note loans or registered bonds, unless they are subject to preferential treatment as deposits (see below))

(b) Structured financial instruments/claims

(e.g. certificates on equity indices, claims from derivatives, or deposits by companies of more than EUR 100,000 which are not assigned to class (6))

(6) Other deposits

(generally deposits by private individuals, small businesses, small and medium-sized enterprises (SMEs) in excess of EUR 100,000)

Exempt from bail-in

(no conclusive presentation)

Deposit covered by the statutory deposit guarantee scheme (generally up to EUR 100,000)

Asset-backed liabilities

(e.g. Pfandbriefe)

In particular cases the resolution authority can deviate from this principle.

What are the potential consequences of resolution actions for me as creditor?

If the resolution authority orders or resorts to an action under these rules, creditors are not permitted to terminate a financial instrument and claim or enforce other contractual rights simply on the grounds of this measure. This applies for as long as the bank honours its principal obligations under the terms of the financial instrument and claim, including payment and performance obligations.

In the event of the resolution authority taking such measures, shareholders and creditors may lose all of their invested capital. This means that shareholders and creditors of financial instruments and claims may lose the entire amount paid for the purchase of such financial instrument and claim (for example, the purchase price paid plus any costs associated with the purchase).

The mere possibility of resolution actions being invoked may complicate the sale of a financial instrument or claim on the secondary market. This may mean that shareholders or creditors will only be able to sell the financial instrument or claims at a substantial discount – even if the issuing bank has an obligation to repurchase.

Shareholders and creditors should not be worse off in the event of bank resolution, compared to insolvency proceedings.

However, should a resolution action lead to a shareholder or creditor being disadvantaged, compared to ordinary insolvency proceedings against the bank, this will give rise to a compensation claim of the shareholder or creditor against the fund established for resolution purposes (the Single Resolution Fund – **"SRF"**). Any such compensation claim is exposed to the risk that any resulting payments might occur substantially later than would have been the case, had the bank properly fulfilled its contractual obligations.

Where else can I find information?

The German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – **"BaFin"**), and Deutsche Bundesbank have provided information concerning resolution and recovery rules applicable in Germany. Details are available here:

https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2016/fa_haftungskaskade_bankenabwicklung.html.

BaFin and Deutsche Bundesbank have published a joint interpretation guidance, which provides further notes on how to classify money-market instruments, or which debt instruments are to be classified under (5)(a) (non-structured financial instruments/claims) or (5)(b) (structured financial instruments/claims).

https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Auslegungsentscheidung/A/ae_180102_Auslegungshilfe_Insolvenzrecht.html

Modification to the liability cascade, effective 21 July 2018

An amendment to the BRRD, designed to harmonise the ranking of senior unsecured bank debt at a European level, was published on 27 December 2017; its implementation into German law takes effect as from 21 July 2018. Accordingly, from this date onwards, senior debt securities issued by category 5 credit institutions or investment firms only have to be assigned to the lower (5)(a) ranking if, at the time of issuance, they have a minimum contractual term of one year – and provided that the terms of issue and the prospectus (if available) contain an express notice indicating the lower ranking of such issues, relative to other senior financial instruments or receivables. From 21 July 2018 onwards, any non-structured debt securities without such notice will be issued in the higher class (5)(b).

This amendment has no impact upon financial instruments or receivables issued prior to the date of its coming into effect, nor does it require issuers to amend the terms of outstanding financial instruments or receivables. Any non-structured financial instruments or receivables already issued in class (5)(a) will retain their ranking, even without an express notice regarding the lower ranking.