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WORKING PAPER

BAIL IN MECHANISMS IN THE BANK RECOVERY AND RESOLUTION DIRECTIVE

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19 OCTOBER 2014

Abstract:

With the adoption of the Bank Recovery and Resolution Directive, Europe has completed one of the three important pillars of the Banking Union. This directive introduces the resolution tool of 'bail in' that aims at putting the burden of bank rescue operations with the private sector. Bail outs financed with public money must be avoided, as a result of this new mechanism. The original ideas for contingent capital instruments had been developed by the Basel Comité on Banking Supervision in 2010, albeit that the concepts of the Basel Comité aimed at forcing the bank's shareholders and creditors to contribute to loss absorption exclusively in situations where a bank was beyond a point of viability. The manner in which that concept was described at the time of issue of the report in 2010, suggested that the contingent capital mechanism was particularly to be applied in circumstances where a bank's operation were still going concern. The European transposition of the ideas of the Basel Comité has taken place at the level of two different frameworks. On the one hand certain bank regulatory capital providers will be obligated to accept a contingent capital mechanism resulting into write down of debt or conversion of debt to equity if certain regulatory triggers apply. Such regulatory triggers are not necessarily clear evidence that a bank is beyond a point of viability. To the contrary, the trigger as defined in European law suggests that a bank may be financially healthy, albeit that certain constraints in the regulatory capital base became imminent. The other framework where a contingent capital mechanism have been introduced, concerns the bail in mechanism of the BRRD. The distinction between the objectives of the two frameworks is not easy to make. One cannot distinct the contingent capital mechanism in the framework of common regulatory capital rules by stating that it applies only if a bank's operation is going concern, whereas BRRD only applies when the bank's operation is gone concern. Both frameworks aim at safeguarding the continued operations of banks. In this working paper we explore further differences and question whether or not the European lawmakers have sufficiently aligned the applicable rules of both frameworks with each other. In the meantime practice develops where it seems that banks aim at issuing debt capital instruments aligned to avoid the application of the BRRD bail in mechanism, by introducing relative high triggers resulting into recapitalization of the bank at a very early stage and prior to recovery or resolution mechanisms become applicable to the bank.

1. Introduction

Avoidance of the need for bail out operations financed by governments has been one of the most important motives for introduction of the "bail in" mechanisms for banks that are facing difficulties to continue operations (going concern). The concept of this bail in mechanism has been introduced in a time where it became clear that very significant rescue operations for banks were needed in order to avoid further development of turmoil in the financial markets. At the occasion of the rescue operations being put in place, it became evident that bank regulatory capital

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requirements fell short of obligating investors in bank's capital to join in the burden sharing when difficulties with banks arose.

In this working paper² I will briefly comment on the bail in mechanisms set forth in the Bank Recovery and Resolution Directive³, ("**BRRD**"). I am not discussing all the features of the bail in mechanism in the whole context of the BRRD. For instance I will only briefly touch upon the concept of banks being "beyond the point of non-viability" as being an important trigger for the bail in mechanisms to be put in motion. But for a thorough discussion about the instance and circumstances where bank recovery and resolution mechanism come into force, reference is made to specialized literature and other contributions to the Annual Conference of the Netherlands Association for Comparative and International Insolvency Law held on 6 November 2014.

2. Background of bail in mechanism in the international context

The Basel Committee on Banking Supervision ("**BCBS**") published in August 2010 a Consultative Paper⁴ introducing the concept of so-called 'contingent capital instruments' where private investors and creditors of banks are to be required to contribute to the rescue of banks that are facing difficulties. The proposals made by the BCBS introduced the mechanism where providers of regulatory capital should be denied the right to reclaim the principal sums invested in a bank, by means of a conversion of the debt obligations of the bank to equity or write off of such principal. The BCBS motivated this recommended new mechanism in bank regulatory capital regulations as follows:

"During the recent financial crisis a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital. This had the effect of supporting not only depositors but also the investors in regulatory capital instruments. Consequently, Tier 2 capital instruments (mainly subordinated debt), and in some cases non-common Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support."⁵

The BCBS identifies three potential solutions to address this issue: (i) introduce resolution mechanisms that permit the taking of measures against creditors of banks that have contributed to the regulatory capital of banks, (ii) prohibit the use of certain regulatory capital instruments by internationally operating banks (particularly the use of Tier 2 instruments being perceived to provide weak loss absorbing features) and (iii) require that regulatory capital instruments contain a contractual mechanism that ensures loss absorbency at a "point of non-viability" of the bank.

The BCBS consultation paper discusses particularly the latter mechanism, where it concludes that there is a need for alteration of the regulatory framework for regulatory capital instruments. This change should introduce an additional contingent capital mechanism for the so-called 'hybrid capital instruments' (these are usually perpetual subordinated debt obligations containing contractual features that make these instruments to provide the holder of the debt instrument rights and obligations as if he participates in the equity capital of the bank) and the so-called "Tier 2" capital instruments. Tier 2 capital instruments are the lowest quality regulatory capital that banks may use, subject to certain limitations, to established the entire regulatory capital of the bank. Tier 2 capital instruments are often shaped as subordinated medium term bonds that contain mechanisms to be repaid to the creditors within a time horizon of 5 to 7 years.

The BCBS concludes that there is a need for a fundamental change in dealing with the loss absorbing ability of regulatory capital instruments. These instruments are absorbing losses in any event, once a bank enters into

² Most of the text of this working paper is taken from a contribution that I wrote for a comprehensive book on "Bank Crisis Management" to be published shortly.

³ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJEU L. 173 of 12 June 2014, pages 190-348.

⁴ BCBS, 'Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability', August 2010, to be consulted at www.bis.org.

⁵ BCBS, op cit, p. 1.

liquidation or insolvency. Under the applicable frameworks for bank regulatory capital as they had been introduced decades ago, it is beyond doubt that once a bank is being liquidated or is being declared insolvent, the investors and creditors holding bank regulatory capital instruments (whether they participate in the core equity instruments (so called core Tier 1 instruments, usually the share capital of the bank (“**CET1**”), or in hybrid instruments or in Tier 2 instruments) lose their claim to be repaid principal, dividend and interest coupon. This is related to the fact that bank regulatory capital instruments are subordinated in the event a bank is being liquidated or being declared insolvent.

The financial crisis learned, however, that governments and regulatory authorities attempted to rescue banks in circumstances where liquidation or insolvency of the bank was to be avoided. If such liquidation or insolvency would be enacted, certain unwanted effects would arise in the financial markets, disrupting also the continuation of operation of other banks that did not face financial difficulties or the operation of financial markets. A problem with one bank, would result into undesirable cascade effects with other banks or in the financial markets as a whole. Rescue operations were often directed at avoiding such ‘systemic risks’ occurring.

Particularly in circumstances where the bank concerned was not yet in a state that liquidation or insolvency could not be avoided, but where the financial difficulties or other problems were too serious to continue operating the bank without measures, intervention of governments by bailing out the bank with capital injections or other financing operations could not be avoided. In these circumstances, creditors providing ordinary bank regulatory capital escaped the scrutiny of the market, as the customary trigger events contained in the contractual terms and conditions of the bank regulatory capital instruments did not include loss absorbing mechanisms in such circumstances. The BCBS notes in this respect:

“The Basel Committee is of the view that all regulatory capital instruments must be capable of absorbing a loss at least in gone-concern situations. Furthermore, it believes that a public sector injection of capital needed to avoid the failure of a bank should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred had the public sector not chosen to rescue the bank.

To achieve this objective the Basel Committee has developed a proposal that would ensure all regulatory capital instruments are able to absorb losses in the event that a bank is unable to support itself in the private market including situations when the public sector steps in to recapitalise a bank that would otherwise have failed. Under this proposal gone-concern loss absorbency would continue to work through subordination in liquidation for failed banks when the authorities allow them to enter liquidation. However, if the authorities choose to rescue a bank, then the proposal would give the regulatory authorities the option to require regulatory capital instruments (other than common shares) to be written-off or converted into common shares.”⁶

The BCBS recommendations have been followed up, by introducing in the Basel III qualitative requirements for bank regulatory capital criteria that require banks to include in the terms and conditions of the capital instruments to be issued on the markets, so called “contingent capital mechanisms” that require creditors to accept once the ‘point of non-viability’ of the bank is reached, that debt obligations of the bank are either converted in equity capital or that the debt instruments are wholly or partly written off.⁷ The point of non-viability, however, has been defined as a measure where reference is made to the decrease of the bank’s regulatory capital levels at a certain percentage interest. In this respect the European Capital Requirements Regulation (“**CRR**”) of 2013⁸ determines that the

⁶ BCBS, op cit., pages 3 and 4.

⁷ See for these criteria developed by the BCBS: ‘Basel III: A global regulatory framework for more resilient banks and banking systems’, December 2010, revised version of June 2011, reflecting the changes to the section on Credit Valuation Adjustment, document to be consulted on www.bis.org and BCBS, ‘Minimum requirements to ensure loss absorbency at the point of non-viability’, Press Release 11 January 2011, Ref no: 03/2011, www.bis.org.

⁸ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJEU L 176 of 27 June 2013, p. 1-348 as this text has been subject to a complete corrigendum published in OJEU L 321 of 30 November 2013.

contingent capital mechanism should be incorporated in the terms and conditions of so-called Additional Tier 1 capital instruments (“**AT1**”) only.⁹

The provisions of the CRR for AT1 capital instruments require a bank to invoke the contingent capital mechanism at least if a so-called ‘trigger event’ occurs when the CET1 capital ratio of the bank falls below 5.125%. Banks, however, may include in the terms and conditions of the AT1 capital instruments higher triggers related to a higher percentage of the CET1 capital or other triggers.¹⁰ The specification of the triggers in the CRR and the mechanisms of contingent capital instruments are based on the generic qualitative requirement of the CRR, which determines:

“the provisions governing the instruments require that, upon the occurrence of a trigger event, the principal amount of the instruments be written down on a permanent or temporary basis or the instruments be converted to Common Tier 1 instruments;”¹¹

The write down mechanism or the conversion to CET1 instruments (or share capital) are also the two methods to effectuate the bail in mechanism of the BRRD. As I will discuss in the further paragraphs although there is similarity of the chosen methods for effectuating the bail in mechanism, there are principally differences with respect to the triggers causing the bail in mechanism to be effectuated.

3. Bail in pursuant to the BRRD as burden sharing instrument or as penalization of creditors?

The motives set out in many studies and reports on the subject matter of bail in are reiterated to a great extent in the background recitals of the BRRD. In recital (67):

“An effective resolution regime should minimise the costs of the resolution of a failing institution borne by the taxpayers. It should ensure that systemic institutions can be resolved without jeopardising financial stability. The bail-in tool achieves that objective by ensuring that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution. The bail-in tool will therefore give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances and meets the Financial Stability Board recommendation that statutory debt-write down and conversion powers be included in a framework for resolution, as an additional option in conjunction with other resolution tools.”

The language used in the BRRD is sharper in its nature, where it is suggested that shareholders and creditors should “suffer appropriate losses”. This deviates from the background motives as set out in the BCBS documents from which we cited here above and it also deviates from the CRR language used to address this subject matter. In the BRRD the bail in mechanism is placed in the context of penalization of creditors and shareholders, rather than a burden sharing mechanism that was the original concept of the international authorities advocating the contingent capital mechanism. The BRRD language also overestimates the influence that shareholders and creditors may have in monitoring the financial health of European banks in going concern situations. Investors in regulatory capital have little influence on the course of affairs of banks and must accept rather strict reduction of rights exercisable towards the bank when purchasing regulatory capital instruments.

Coffee, however, notes the following:

“This potential wealth transfer [after conversion holders of debt take a significant position as holder of equity capital and dilute existing (common) shareholders, add. author], is intended to deter the equity from approaching the trigger points at which conversion would occur — and thus disincentivize them from increasing risk and leverage”.¹²

⁹ See for a further and elaborate discussion of this topic my contribution ‘Regulatory capital requirements and bail in mechanisms’, in ‘Bank Crisis Management’, a publication to be published shortly.

¹⁰ See: article 54, paragraph 1 (a) and (b) CRR.

¹¹ See: article 52, paragraph 1 (n) CRR.

¹² John C. Coffee, Jr., ‘Bail-ins versus Bail-outs: Using Contingent Capital To Mitigate Systemic Risk’, The Centre for Law and Economic Studies, Columbia University School of Law, Working Paper No. 380, 22 October 2010, p. 35.

These remarks must be placed, in my view, in the context of the corporate governance environment of banks regulated and active in the United States of America. As is often the case with certain concepts developed in view of the specific requirements and issues relevant for the US-markets, the rationale to introduce certain principles for these markets is not always applicable or justified for markets in other jurisdictions where other mechanisms and other legal principles apply.

Without debating this topic in too much detail, my view is that the consequences of shareholders' activism and the influence of shareholders on the management of banks must be seen in another perspective if it concerns banks subject to the corporate laws adopted in Europe. The European Commission however, has projected the discussions held to address constraints occurring in the US-markets, to the European situation as well. It is with this in mind, that the above cited consideration of the Commission must be read.

4. *Bail in going concern and gone concern*

The BRRD provides for numerous scenarios that may apply to a bank that is facing difficulties to continue its operations. The bail in mechanism requiring shareholders and creditors to cooperate with a reduction of their rights may also be applied in numerous circumstances. Where the original concepts of the contingent capital mechanism had been, that such mechanisms should in principle be applied when the "point of non-viability" of a bank was reached and the bank's business must be considered gone concern, numerous references in the BRRD for application of the bail in mechanisms in a partial or whole 'going concern' situation can be found too. The BRRD bail in mechanism can therefore play a role in going concern as well as in gone concern situations. In recital (68) of the BRRD this is expressed as follows:

"In order to ensure that resolution authorities have the necessary flexibility to allocate losses to creditors in a range of circumstances, it is appropriate that those authorities be able to apply the bail-in tool both where the objective is to resolve the failing institution as a going concern if there is a realistic prospect that the institution's viability may be restored, and where systemically important services are transferred to a bridge institution and the residual part of the institution ceases to operate and is wound up."

From this recital it clearly appears that the BRRD bail in mechanisms may be applied in a wider range of circumstances than the original concepts as developed by the BCBS intended to achieve. The principal mechanism as laid out by the BCBS is to force shareholders and creditors of a bank that is made subject to a rescue operation requiring tax payer monies to be made available for the capitalization of the bank, to participate in the loss absorption to the fullest extent with this one attempts to avoid that shareholders or creditors of a rescued bank would be in the position that their claims on the bank would revive after the rescue operation would be performed and the bank would successfully return to become a viable business.

The BRRD has made the circumstance where the bail in mechanism may be applied much broader and, therefore, deviates from the internationally agreed upon background and motives for contingent capital mechanism applicable to banks. The purposes of the bail in tool are set forth in article 43, paragraph 2 of the BRRD as follows:

"Member States shall ensure that resolution authorities may apply the bail-in tool to meet the resolution objectives specified in Article 31, in accordance with the resolution principles specified in Article 34 for any of the following purposes:

- (a) to recapitalise an institution or an entity referred to in point (b), (c) or (d) of Article 1(1) of this Directive that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation (to the extent that those conditions apply to the entity) and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU, where the entity is authorised under those Directives, and to sustain sufficient market confidence in the institution or entity;
- (b) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred:
 - (i) to a bridge institution with a view to providing capital for that bridge institution; or
 - (ii) under the sale of business tool or the asset separation tool."

The resolution objectives of article 31 BRRD are not necessarily restricted to the avoidance of development of systemic risk in the financial markets, but may also relate to other objectives. The avoidance of system risk is, as noted here above, one of the main (if not the exclusive) driver for the introduction of the bail in mechanisms as suggested by the BCBS in August 2010. However, the resolution objectives under the BRRD may also relate to the protection of rights of depositors having claims on the bank, with the exception of depositors not protected by the deposit guarantee scheme of Directive 2014/49/EU¹³ or investors protected by the investor compensation scheme of Directive 97/9/EC¹⁴. Another resolution objective is to ‘ensure the continuity of critical functions’. This may be relevant for banks that are not systemically important, but whose insolvency may nevertheless cause significant issues in the markets or in the provision of services to customers. One could for instance think of a bank that plays an important role in the payments system in a certain member state of the EU.¹⁵

5. Bail in principles of article 34 BRRD

The application of the bail in principles set out in article 34 BRRD are important for the mechanisms to be applied in the bail in operation. Five of the principles concerned are relevant in this respect. These are listed below by citing the provision of article 34, paragraph 1 BRRD in an abbreviated way:

“Member States shall ensure that, when applying the resolution tools and exercising the resolution powers, resolution authorities take all appropriate measures to ensure that the resolution action is taken in accordance with the following principles:

- (a) the shareholders of the institution under resolution bear first losses;
- (b) creditors of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings, save as expressly provided otherwise in this Directive;
- (f) except where otherwise provided in this Directive, creditors of the same class are treated in an equitable manner;
- (g) no creditor shall incur greater losses than would have been incurred if the institution or entity referred to in point (b), (c) or (d) of Article 1(1) had been wound up under normal insolvency proceedings in accordance with the safeguards in Articles 73 to 75;
- (h) covered deposits are fully protected”

There is a close connection, as far as the position of providers of regulatory capital is concerned, with the provisions of the CRR as regards the subordinated treatment of claims held by investors in CET1, AT1 and Tier 2 capital instruments. The subordination mechanism of those regulatory capital instruments all require that the terms and conditions provide for a full cancellation of claims of the holders of capital instruments, both as relates principal and dividend, interest or comparable claims, in case of an insolvency or liquidation procedure. There is no doubt, that in this respect the resolution principles of the BRRD as set out in article 34, paragraph 1 will be met in those cases where a bank issued CET1, AT1 or Tier 2 capital instruments. For the fulfilment of the principles of the BRRD it is also unlikely that the national laws of the member states of the EU must be revised or supplemented with language to implement the provision of article 34, paragraph 1 BRRD, as the CRR provisions already are directly applicable and have binding vertical and horizontal effect.¹⁶

¹³ Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, Pb.EU L. 173 of 12 June 2014, p. 149-178.

¹⁴ Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes, OJEC L. 84 of 26 March 1997, p. 22-31.

¹⁵ See: the definition of ‘critical functions’ in article 2(35) of the BRRD: “means activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations”.

¹⁶ See amongst many other contributions: J.A. Winter, ‘Direct Applicability and Direct Effect; Two Distinct and Different Concepts in Community Law’ (1972) 9, Common Market Law Review, pp. 425-438 and Arthur Hartkamp, ‘The Effect of the EC Treaty in Private Law: On Direct and Indirect Horizontal Effects of Primary Community Law’, European Review of Private Law 3-2010, p. 530.

However, the position of other creditors than the regulatory capital financiers must be addressed separately in the national laws of the EU member states. For subordinated creditors holding claims pursuant to capital instruments or loans not meeting the CRR requirements for AT1 or Tier 2 capital instruments and for other ordinary creditors, the principles of article 34, paragraph 1 BRRD are not likely to form already part of the national laws of the member states and therefore specific provisions of national law must be introduced.

6. What is the scope of the bail in mechanism under the BRRD?

The bail in mechanism of the BRRD follows a specific approach with respect to the selection of debt that may be subject to bail in mechanisms. With the approach followed certain liabilities of banks are identified that may be subject to the bail in mechanism, whereas other liabilities are excluded from such mechanism. The BRRD obviously applies the bail in mechanisms to shareholders and regulatory capital instrument holders of the bank. This means that all contributors to the CET1, AT1 and Tier 2 capital may be subject to the bail in mechanism. Furthermore, other subordinated creditors are likely to be subject to the bail in mechanism as well. Finally, certain parts of the senior medium term or long term unsecured debt must be 'bail-in able', meaning that the bank concerned should have sufficient senior debt instruments or loans outstanding, enabling the resolution authority to allocate senior debt, together with the other debt instruments and share capital to be subject to a bail in proceeding once the resolution authority has decided to apply this resolution tool.

The provisions of the BRRD contain a complex system of determining the minimum requirement for own funds and eligible liabilities ("MREL") that takes into account the levels of own funds established by banks pursuant to the generic regulatory requirements, with a further correcting factor to ensure that sufficient 'senior liabilities' may be subject to the bail in mechanism. By ensuring the MREL is at sufficient levels, the resolution authorities will have possibilities to enforce with individual institutions the appropriate composition of the bank's liabilities-structure and to avoid in this way that banks structure their liabilities in such a way that effective bail in is impeded.¹⁷

Certain debt obligations of the bank are excluded from the bail in mechanism. Article 44, paragraph 2 BRRD exclude from the scope of the bail in the following (summarizing the complex legal language of the BRRD):

- Savings deposits, subject to the protection of deposit guarantee schemes, up to, in principle, an amount of EUR 100,000¹⁸;
- Liabilities benefiting from security interests (secured liabilities), including so-called 'covered bonds' issued by banks where certain parts of the assets of the bank serve as collateral for the benefit of the holders of the covered bonds. Together with the liabilities stemming from the covered bonds issued, also certain liabilities of the bank pursuant to derivatives entered into to hedge certain risks in connection with the covered bond transaction are excluded from¹⁹;
- Liabilities towards clients regarding the custody of assets held by the bank for the clients in respect of investments in collective investment schemes regulated under European laws;
- Liabilities towards clients of the bank for monies held under fiduciary relationship between the bank and the client where the fiduciary relationship gives specific protection under applicable insolvency laws;
- Liabilities towards other banks or investment firms with an original maturity of less than seven days;
- Liabilities towards clearing and settlement systems for the securities or payments markets with a remaining maturity of less than seven days;
- Liabilities towards employees for wages and comparable employee's claims;
- Liabilities towards trade creditors that supply goods or services critical to the functioning of the bank's operations;

¹⁷ See for an elaborate discussion of this issue: Simon Gleeson, 'Legal Aspects of Bank Bail-Ins', LSE Financial Markets Group Paper Series, 205, January 2012, p. 18 and further. See also recital 79 and 80 of the BRRD Directive.

¹⁸ Any sums due above the guaranteed amount of EUR 100,000 may be subject to bail in, see the third section of article 44, paragraph 2 BRRD.

¹⁹ The claims exceeding the value of assets required to settle the obligations of the covered bonds (the overcollateralised part) may be subject to bail in, see the second section of article 44, paragraph 2 BRRD.

- Liabilities towards tax and social security authorities, provided these claims are preferred under the applicable law;
- Liabilities towards deposit guarantee schemes set up in accordance with the DGS-Directive²⁰.

Furthermore, resolution authorities may exclude further liabilities from the scope of the bail in proceedings, subject to certain strict conditions being met. With the exclusion of certain liabilities, the burden of creditors non-excluded liabilities to accept a greater proportion of their debt being bailed in increases, in principle.²¹

7. *Contractual triggers versus statutory triggers*

Perhaps one of the most complex issues concerning contingent capital concerns the question whether or not conversion or write off mechanisms are enforced by contractual or by statutory obligations. In other words, what is the basis for the fact that creditors must accept at a certain point of time that their claim vis-à-vis the bank is reduced, cancelled or extinguished entirely once the contingent capital mechanisms are put in motion? One could take the view that there is a double basis for such mechanisms, it is both a contractual mechanism and a statutory mechanism.

The clearest analysis of this issue has been delivered by Bates and Gleeson in 2011 where they define this issue in the context of bail-in instruments as follows:

“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 writedown 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.”²²

It is based on these thoughts that I reiterate in this working paper that both for contingent capital instruments under the ordinary regime for regulatory capital — particularly the provisions applicable to AT1 capital instruments — as well as for bail in instruments applied to creditors (no matter which status these creditors have, whether they are contributors to the regulatory capital or if they are common creditors), for the contingent capital or bail in mechanisms to be legally enforceable and effective, an ‘hybrid’ application of both contractual provisions and statutory provisions is necessary.²³

²⁰ Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, Pb.EU L. 173 of 12 June 2014, p. 149-178.

²¹ See: article 44, paragraph 3 BRRD.

²² Chris Bates and Simon Gleeson, ‘Legal aspects of bank bail-ins’, Law and Financial Markets Review, July 2011, p. 269-270.

²³ See also: Bates and Gleeson, op cit, p. 270 where they have based their reasoning also on the complexity of the laws governing the relevant contractual relationship between the banks and investors in the (capital) instruments or the lenders of (subordinated) debt borrowed by banks. For internationally operating banks it shall be necessary that any contractual obligation of a creditor to accept

As for bail in mechanisms applicable once a resolution process is being initiated, one could not refer to the application and effectiveness of statutory provisions only for the determination in which way the rights of bank's creditors are reduced, cancelled or extinguished entirely. In my view there must be a basis in the relevant contractual terms and conditions too. This particular 'hybrid' construction of contractual and statutory law has been acknowledged by the European legislator as well, but only for certain cases.

In article 55 (Contractual recognition of bail-in), paragraph 1 BRRD, the following provision is given:

"Member States shall require institutions [...] to include a contractual term by which the creditor or party to the agreement creating the liability recognizes that liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or amount outstanding due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority [...]."

The relevant requirement is particularly relevant for all those instances that banks enter into contracts with external financiers of "eligible liabilities" where the contractual terms and conditions are governed by the "law of a third country". For instance a German bank issues debt instruments in the US capital markets (e.g. a US Dollar denominated medium term bond) where the terms and conditions are (as is customary) governed by the laws of New York. For such a debt instrument, the German bank shall be required to include in the contractual terms and conditions provisions to support the potential application of bail in mechanisms effected by the resolution authority responsible and authorized for the resolution of the German bank. The European legislator has recognized that in such cases, one cannot rely (only) on the binding effect of the laws in the European Union for investors in other jurisdictions. The obligations of investors must be enforced by imposing specific contractual provisions in such instance.

At least for this example of an international financing arrangement involving an European bank seeking financing in the international capital markets, the European legislator is not confident that the mere application of statutory provisions applicable pursuant to the transposition of the BRRD in the laws of the Member State where the bank is established, suffices to enforce the bail in mechanism towards the external creditors. In my view this issue is also relevant for other situations where there is no connection to a jurisdiction outside the European Union. This is particularly caused by the fact that the European legislator has (unfortunately) chosen to use the instrument of a European directive for the implementation of the recovery and resolution schemes in the Members States of the European Union. Directives do not have direct horizontal effect and it will therefore be dependent as to how national laws of the Member States may contain sufficiently 'mandatory effect' to set aside contractual terms and conditions once a bail in mechanism would apply to the creditors concerned having lent monies to the bank.

In line with this reasoning, it is my view that for regulatory capital instruments structured and issued in conformity with the CRR provisions for CET1, AT1 and Tier 2 capital instruments and (subordinated) loans, less doubt will exist as to the effectiveness of the bail in mechanism. This is caused by the fact that contractual obligations governing the relationship between shareholders and creditors on the one hand and the bank on the other hand, are backed up by the direct horizontal effect of the statutory CRR provisions. Even if the contractual terms and conditions would be ambiguous or multi-interpretable, the CRR provisions will ultimately determine the consequences of the bail in mechanism applied to the bank. In my view, there is also to a certain extent redundancy in the BRRD provisions that attempt to reconfirm the principles of contingent capital as set out in the CRR, certainly if it concerns AT1 instruments.

However, none of the CRR-requirements for Tier 2 instruments impose to include in the terms and conditions a contingent capital mechanism, requiring the holders of Tier 2 debt to accept either conversion of the debt into equity or to accept write down of the principal and coupon. Recent activity in the capital markets has demonstrated that a large number of European institutions commenced to introduce Tier 2 capital instruments containing contingent

bail in or contingent capital mechanisms must be backed up by statutory law provisions in the jurisdiction where the relevant bank is established.

capital features. Some of those Tier 2 instruments convert to equity at the reaching of low triggers, others even convert when relatively high triggers are reached (the dropping of the Tier 1 ratio below 7%).²⁴

Interestingly, institutions opting for such contractual enforcement of contingent capital features are not basing their funding policies on mandatory requirements following from the CRR. Rather, the introduction of the contingent capital contractual mechanism is based on voluntary choices. Institutions that introduce these contractual mechanisms with “high triggers” even take a more aggressive stance as regards the revision of the common principles of ranking of obligations of the bank towards its shareholders and creditors. Rights and obligations of holders of CET1 and AT1 capital instruments of these institutions are determined by the CRR provisions and contractual back up of these mandatory rules. Holders of Tier 2 capital instruments with high trigger contingent capital features even effect a greater dilution of the rights of holders of the CET1 and AT1 capital instruments beyond the mandatory qualitative capital requirements.

In my view, institutions following these strategies wish to anticipate on the introduction of the bail in regime of BRRD. By taking the lead in reshaping the regulatory capital base of the institution voluntarily introducing regulatory capital instruments beyond mandatory qualitative capital requirements, they attempt to avoid the detrimental effects of application of the resolution tool of bail in. These strategies may well be a response of the market to the perceived undesirable effect of introducing uncertainties for the common creditors of the bank as a result of their potential participation in bail in as imposed by the authorities once the BRRD provisions come into effect. The uncertainty is about the lack of a mandatory rule (at least as far as the provisions of the BRRD is concerned) to revise or amend the contractual terms and conditions of financing instruments qualifying as ordinary debt issued by banks to address the potential impact of bail in as imposed by the resolution authorities for those creditors.

In such circumstances it is easier for a bank to place new Tier 2 instruments in the markets containing clear contractually enforceable provisions as regards the contingent capital mechanism, than to repaper existing contractual relations with ordinary creditors. Such repapering exercise would not be backed by mandatory law provisions. Such repapering would, therefore, need the consent of the creditors concerned. Absent a mandatory law provision enforcing such consent to be provided (or replacing it), banks would be either too dependent on the cooperation of the creditors. Banks could also take the risk of relying on interpretations as regards the effectiveness of the provisions of the national laws implementing BRRD giving the resolution authorities the (superior to contractual rights) authority to extinguish the rights of common creditors once the bail in comes into force. Such reliance on the effectiveness of statutory law will be, at least, qualified to the extent complexities arise in international transactions involving multiple jurisdictions and international private law complexities not covered by article 55 BRRD.²⁵ In other words, article 55 BRRD is flawed to the extent that it only imposes obligations on banks to consider implementing contractual bail in mechanisms for debt obligations where there is a relation with a third country creditor.

8. Bail in mechanisms for regulatory capital providers under the BRRD

When referring in the previous paragraph to the fact that for the application of the principles of article 34(1) BRRD as regards the bail in mechanism, there is no need to introduce provisions in the national laws of the EU member states, this does not mean that the application of the bail in mechanisms of the BRRD as regards regulatory capital instruments will follow automatically from the CRR provisions. This is, obviously, not the case. Rather, the various

²⁴ Credit Suisse Tier 2 Buffer Capital Notes, www.credit-suisse.com/investors. See for another issue of these notes: RPT-Fitch Rates Credit Suisse AG's Tier 2 Low-trigger Contingent Capital Instruments 'BBB+(EXP)', Reuters 29 July 2013, www.reuters.com/assets. See for a “low trigger issue” of AT1 instruments (still being the most common form of contingent capital instruments for European continental banks): the 1.75 billion euro and 1,25 billion US Dollar issue made by Deutsche Bank AG in May 2014 (€1,750,000,000 Undated Non-cumulative Fixed to Reset Rate Additional Tier 1 Notes of 2014 and U.S.\$1,250,000,000 Undated Non-cumulative Fixed to Reset Rate Additional Tier 1 Notes of 2014), prospectus dated 26 May 2014, www.db.com/ir/en and for a “high trigger issue” the Barclays issue of €1,076,730,000 6.50% Fixed Rate Resetting Perpetual Subordinated Contingent Convertible Securities (Callable 2019 and Every Five Years Thereafter), prospectus dated 17 June 2014, www.barclays.com/content/dam/barclayspublic/InvestorRelations.

²⁵ See Bates and Gleeson that seem to support this conclusion, *op cit*, p. 270.

rights and obligations attached to regulatory capital instruments as provided for in the CRR are likely to form the foundation of bail in mechanisms carried out under the BRRD, but CRR rules concerning the reduction or limitation of claims of holders of CET1, AT1 or Tier 2 instruments are complimentary to the BRRD regime and does not substitute the BRRD regime.

The concurrent principles of CRR and BRRD makes it also very complex to analyze what the exact consequences are for holders of the CET1, AT1 and Tier 2 capital instruments in a situation where a resolution mechanism is applied towards a bank and where the resolution authority decides to apply the bail in tool as set forth in article 37, paragraph 3 (d) BRRD. This is certainly the case if the bail in mechanism is applied after some of the 'bail in features' of the ordinary CRR provisions already have been put in motion in the past. For instance, a situation may occur where a bank has notified the holders of the AT1 or Tier 2 capital instrument holders, that a trigger event has occurred and that the principal sum of the capital instruments needs to be converted into CET1 capital. Such trigger mechanism may be applied, in circumstances where a bank is still properly capitalized and meets all the requirements to maintain sufficient levels of own funds under the provisions of the CRR. A subsequent application of the BRRD bail in mechanism may effectively result in a subsequent and additional reduction of claims of the holders of the CET1 capital instruments they obtained after the contingent capital mechanism has been applied pursuant to the CRR rules when a bank was still way before the 'point of non-viability'. Such subsequent application of bail in mechanisms, effectively results into a 'double dip' situation for bank regulatory capital providers. The BRRD bail in rules do not provide for protection of the position of the holders of CET1 instruments that they obtained after the application of the contingent capital mechanism prior to the application of the bank resolution regime under the BRRD.

It is noteworthy that in practice, some of the issuers of contingent debt capital instruments have introduced 'dual triggers', where the bank debt converts to equity based on either the (i) passing of the regulatory threshold for minimum capital or (ii) a decision of the relevant resolution authorities. With such a contractually agreed upon 'dual trigger', the investors in such contingent capital instruments are clearly agreeing on the possibility that a double dip mechanism may be applied. Either their claims convert to capital in a going concern situation with the bank in case certain capital ratio's are no longer met. Or the conversion takes place gone concern, when the resolution authorities have taken over the management of the bank²⁶ or where such resolution authorities wish to avoid the reaching of the 'point of non-viability'.

In article 45 BRRD (Application of the minimum requirement) it is determined that the member states of the EU must provide the resolution authorities the power to determine the "minimum requirement for own funds and eligible liabilities" that should be met by banks. This minimum requirement shall be "calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution (this means, amongst others a bank, *add. author.*)" With "own funds" reference is made to the Tier 1 and Tier 2 capital of the bank.²⁷ With "eligible liabilities" reference is made to the liabilities that may be in scope of the bail in mechanism (other than the "own funds" that are automatically in scope) pursuant to article 44, paragraph 1 BRRD. Eligible liabilities are, in brief, unsecured, non-preferred medium-term liabilities²⁸ of banks, always with the exception of the part of the deposits covered by the deposit guarantee schemes applicable to the bank concerned.

²⁶ Such dual triggers in issued contingent capital particularly (and as far as I could investigate exclusively) are agreed upon in terms and conditions of Swiss Banks issuing contingent capital instruments. See for a further background of this: Deutsche Bank Research, 'Contingent Convertibles', 23 May 2011 in which it is stated: "Under the new Swiss capital regulations [...] CoCos were placed in the market in a comparable way for the first time, as opposed to previous issues of bonds similar in nature to CoCos. The CoCos featured a 30-year maturity, a coupon of 7.875% and a trigger deemed to have been met if the core capital ratio drops below 7%. Conversion may also be made if the national supervisory authority is of the opinion that the bank would reach the point of non-viability without such a swap."

²⁷ The definition of "own funds" in article 2, paragraph 1 (38) BRRD refers to the definition of "own funds" within the meaning of article 4(1)(118) of the CRR.

²⁸ The liabilities should have a maturity of no less than 12 months, see article 45, paragraph 2 BRRD.

The “resolution authorities” may determine the minimum requirement of own funds and eligible liabilities in order to make potentially applied bail in mechanisms upon a resolution proceeding being applied in the future effective. The reasoning is that once a bail in mechanism is applied, there should be sufficient room for conversion or write down of liabilities that either (i) a bank may be reinstated to act in compliance with the requirements for authorization or (ii) sufficient capitalization is available for a bridge institution or an acquiring bank pursuant to the application of the sale of business tool or asset separation tool. See the provision of article 43, paragraph 2 (a) and (b) BRRD for a description of this objective.

From the perspective of own funds requirements, this provision of the BRRD is a potential source of conflicts between views of the resolution authorities and the ordinary competent authorities that supervise banks for a number of reasons. Quantitative levels of regulatory capital are determined by the provisions of the CRR for ordinary risk exposures and in respect of the additional capital buffers (that is the capital conservation buffer, countercyclical buffer and systemic risk and systemically important institution buffers) by means of the national law provisions implementing the CRD IV Directive²⁹. The regulations of the BRRD determining the powers of the resolution authorities in the member states provided for a separation of functions, in principle, of the resolution authorities on the one hand and the ordinary competent authorities on the other hand. See the provisions of article 3 BRRD for further detail in this respect.

It is not clear whether the resolution authorities, applying the provision of article 45 BRRD as regards the minimum level of “own funds” may take different views about the levels than the national competent authorities on the basis of the CRR and CRD IV Directive provisions. In other words, how must banks deal with potentially conflicting views by the two different competent authorities if the views on the levels of own funds are conflicting? And furthermore, where the CRR and CRD IV Directive provisions on capital adequacy for banks are already a significant driver to force banks to increase levels of own funds, is the BRRD regime interfering with this process of recapitalization of banks that is the effective result of the Basel III standards? For instance, if a resolution authority determines that a bank must maintain the liabilities that may be subject to bail in mechanisms pursuant to the BRRD in the form of a certain percentage of “own funds” pursuant to the application of article 45, paragraph 6 BRRD that deviates from the ordinary CRR and CRD IV Directive levels, how will this conflict be resolved?

This is one of the examples where the introduction of the BRRD raises concerns as to whether or not the European lawmakers have sufficiently thought of the combined application of CRR and BRRD, certainly if one looks at the original motives of the new capital requirements for banks upon adoption of the Basel III standards.

9. Bail in mechanisms for ordinary creditors under the BRRD

European politicians were keen to adopt a regime where the bail in mechanisms applicable in the case a bank is failing extends to ordinary creditors as well. With “ordinary creditors” is meant, all creditors that are not subject to the qualitative capital requirements provisions of the CRR. This means that this may concern creditors with an ordinary claim on the bank that would rank *pari passu* with all other ordinary creditors, but it may also comprise subordinated creditors that exercise claims under a subordinated loan provided to the bank that is not eligible to be comprised in the Tier 1 or Tier 2 compartments of the regulatory capital of the bank.

For the definition of liabilities that may be within scope of the bail in mechanism, the BRRD provisions provide for a list of eligible liabilities in article 44 paragraph 2 BRRD. The list is drawn up as a negative list of excluded liabilities that are outside the scope of applicability of the bail in mechanism applied if a resolution proceeding becomes applicable and the resolution authorities have decided to apply the bail in tool. In drawing up the list of liabilities excluded from the bail in mechanism, a number of choices have been made by the European law makers. The obvious exclusion concerns all depositors with a coverage under the deposit guarantee schemes applicable to banks in the

²⁹ Directive 2013/36/EU of the European Parliament and the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, Pb.EU L. 176 of 27 June 2013, p. 338-436.

European Union. Effectively this means that depositors will be protected against the bail in mechanism up to EUR 100,000 of the deposit made with the bank. Other obvious exclusions concern certain wage liabilities of banks towards employees of the bank and other comparable preferred claims that are customarily excluded in insolvency proceedings from the application of the principles of *concursum creditorum*.

The BRRD introduces a number of new principles applicable to bank's financing to regulate the subject matter of effective bail in mechanism. In this working paper, two of these innovative elements are discussed. Firstly it concerns the subject matter of quantitative requirements imposed on banks in respect of maintaining sufficient eligible liabilities that may be subject to bail in mechanisms. Secondly it concerns the qualitative requirements to be imposed on creditors that have an ordinary claim on a bank and that must be eligible for application of the bail in mechanism.

The quantitative requirements follow from the application of article 45, paragraph 1 BRRD that has been highlighted before when discussing the subject matter of effects of the bail in mechanism for the providers of Tier 1 and Tier 2 bank regulatory capital. The provision concerned determines the following:

"Member States shall ensure that institutions meet, at all times, a minimum requirement for own funds and eligible liabilities. The minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution."

With "eligible liabilities" reference is made to the provision of article 44 paragraph 2 BRRD. These are the ordinary claims and subordinated claims of creditors that do not participate in the regulatory capital of the bank and that are not otherwise excluded from the bail in mechanism. Typically, this provision of the BRRD will have a significant influence on the manner in which banks will be capitalized in the future, as it will to a great extent determine, in my view, the costs of funds that banks may raise by means of savings from depositors not being protected by deposit guarantee schemes as well as by means of the issue of regulatory capital instruments and other debt instruments not qualifying as regulatory capital. Whilst depositors being covered by deposit guarantee schemes are protected against potential bail in mechanism to the extent of coverage (being EUR 100,000), any other depositors may face a threat that its claim may be comprised in the bail in mechanisms upon resolution of the bank. The pressures on the funding schemes by banks come from two sides. On the one hand, banks would like to encourage creditors to finance the bank with loans and deposits that may be excluded from potential bail in mechanisms in order to avoid the costs of funding to increase. On the other hand resolution authorities may impose on banks to have a significant tranche of eligible liabilities written in the books in order to make the bail in mechanism effective.

This detrimental effect of the BRRD is amplified by the second innovative element that I wish to highlight in this working paper. This concerns the qualitative requirements for "eligible liabilities" as set forth in article 45, paragraph 4 BRRD. In this provision the following list of requirements is set forth in order for liabilities to be eligible for bail in mechanisms:

"4. Eligible liabilities shall be included in the amount of own funds and eligible liabilities referred to in paragraph 1 only if they satisfy the following conditions:

- (a) the instrument is issued and fully paid up;
- (b) the liability is not owed to, secured by or guaranteed by the institution itself;
- (c) the purchase of the instrument was not funded directly or indirectly by the institution;
- (d) the liability has a remaining maturity of at least one year;
- (e) the liability does not arise from a derivative;
- (f) the liability does not arise from a deposit which benefits from preference in the national insolvency hierarchy in accordance with Article 108."

The reference in this clause to "own funds" is a complete redundant and confusing one. All of the requirements listed in this provision are already regulated in the provisions of the CRR. In this respect I take the view that for regulatory capital instruments, in so far as they have not already been subject to the contingent capital mechanisms

prior to the entry into force of the resolution proceedings, the contractual and statutory backing of the obligations of the creditors holding such instruments rather follows from the original contract and the CRR provisions and not necessarily from the Member State law provisions implementing the BRRD. For other “eligible liabilities” this provision introduces a new concept of law that fundamentally deviates from the ordinary provisions of company law and contract law that usually govern the relationship between a bank and its (ordinary) creditors. These requirements effectively reduce the quality of the claim of the creditor on the bank and results into a shift of these claims to the compartment of high risk investments. Such loans or investments made by external financiers, will, consequently, be priced in accordance with this high risk profile and will be resulting into high yielding debt obligations for the bank.

10. Closing remarks

In the political discussions that have been held in connection with the adoption of the BRRD, one could note observations that the bail in mechanism introduced intends to ensure that public (tax payer) monies would no longer be needed to rescue failing banks. Rather the ‘private sector’ should be fully absorbing the losses with such banks through the application of the bail in mechanisms. Bail outs of banks should be replaced with bail in processes.

As noted here above, many politicians took the view that failures with banks should result in penalization of the private sector by imposing drastic measures. In these discussions it is often forgotten (or deliberately ignored) that Basel III and the implementation of these standards in the CRR already introduced far reaching limitations of the rights of the providers of regulatory capital financing to banks. In other words, the achievements of the BRRD introducing a bail in mechanism for these types of creditors are, in my view, rather concurrent with the already existing rules in the CRR for the qualitative requirements for CET1, AT1 and Tier 2 capital instruments and loans.

In my view the lawmakers in Europe have insufficiently addressed the potential competing and conflicting principles of CRR and BRRD with respect to capital requirements for banks. The provisions of the CRR and BRRD again result in a patchwork of provisions in Europe as regards capital requirements for banks, where it has been the objective of the CRR to reduce the differences in the member states in the EU as much as possible. There are many examples in the provisions of the BRRD where these conflicts of laws and potential overlapping provisions can be observed. It would take too much space to address all of these BRRD provisions to the fullest extent. The example given here above (and my views are not limited to this example), demonstrates this issue in a clear way.

BRRD is also flawed as regards the subject matter of the effectiveness of the bail in mechanism that is not otherwise supported by clear contractual obligations of the common creditors concerned. As noted in this working paper, a hybrid application of both contractual rights and obligations and mandatory law provisions would be the most effective way in introducing enforceable bail in mechanisms that also encompass the position of common creditors that are to be selected as being part of the sum of eligible liabilities that may be subject to bail in.

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