

## **Legal Aspects of Bank Bail-Ins**

**By**

**Simon Gleeson**

**SPECIAL PAPER 205**

**LSE FINANCIAL MARKETS GROUP PAPER SERIES**

**January 2012**

**Simon Gleeson specialises in financial markets law and regulation, clearing, settlement, derivatives and sovereign debt. He was seconded to the UK Financial Services Authority to assist with the development of the market abuse regime, and advised the World Economic Forum on its 2009 Report on The New Global Financial Architecture. His experience includes advising governments, regulators and public bodies as well as banks, investment firms, fund managers and other financial institutions on a wide range of regulatory issues. He is a member of the Financial Markets Law Committee, the Institute for International Finance's Special Committee on Effective Regulation and the FSB Legal Technical Advisory Committee. Any opinions expressed here are those of the author and not necessarily those of the FMG. The research findings reported in this paper are the result of the independent research of the author and do not necessarily reflect the views of the LSE.**

## Legal Aspects of Bank Bail-Ins

### 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 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.

Much of the discussion about bank resolution is predicated on the basis of the simplifying assumption that a bank is a single entity. In economic terms this is broadly correct, but in legal terms it is clearly not. Most banks, and all systemically important banks, are groups of legal entities. In legal terms groups do not exist – it is only the companies which comprise the group which can enter into contracts, incur liabilities or fail. This is not, however the way that economists (or people generally) see the world. Businesses are generally thought of as single undertakings – "Ford" or "BP" are unitary concepts. Thus for a lawyer it makes perfect sense to talk of a group being partially insolvent, in that some of its components are insolvent whilst others are not. For non-lawyers, however, the concept is almost meaningless – it is like speaking of a human being as being partly dead.

However, in the same way that it is possible in emergencies to preserve the life of a living organism by removing dead parts, it is possible in emergencies to save parts of bank groups by allowing other parts to become insolvent. To press the analogy slightly further, the question of whether this is possible or not rather depends on the functions of the parts being amputated. There are some parts of a group whose removal can be accomplished without damaging the business of the group as a whole; but there are others whose removal entails the immediate and automatic extinction of the entire organism. It is by no means always crystal clear which is which.

There is therefore no automatic answer to the question "what are we trying to resolve – the group or the bank?" - the only meaningful answer is "it depends". Consequently it is necessary to think about bank resolution tools not only in the context of individual

undertakings, but also in the context of how those tools could be applied to bank subsidiaries within a group, to parent companies of banks, and potentially to non-bank subsidiaries of banks. This is a difficult piece of analysis. To complicate matters further, bank groups are by no means uniform, and different bank managements have different strategies as to how the economic activity of the bank should be reflected in the legal structure of the group. We conclude by suggesting a basic taxonomy of bank groups which may permit these issues to be addressed.

## **1. 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 2011<sup>1</sup> which proposes extending national resolution regimes to include a "debt write down tool" capable of being used to write down specified senior and subordinated obligations of a bank or bank holding company and moots 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 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.

---

<sup>1</sup> Available at

[http://ec.europa.eu/internal\\_market/consultations/docs/2011/crisis\\_management/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf)

## 2. 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 – not all, since the object of the process is to protect some of these creditors. Chief amongst those to be protected are depositors, although banks have for some time had depositor protection schemes in place to address such issues.<sup>2</sup> 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 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.

---

<sup>2</sup> 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.

## Example – Bank A (before)

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

\* 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

<b>Assets:</b>	
Previous total	€1,000bn
Accounting loss	(€80bn)
Revised total	€920bn
<b>Liabilities after bail-in:</b>	
Residual eligible debt	€120bn
Retail deposits	€300bn
Other senior liabilities	€430bn
Share capital	€70bn
<b>Total</b>	<b>€920bn</b>

### 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.

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 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.

## Example – Bank A (after resolution)

<b>Resolution method</b> <ul style="list-style-type: none"> <li>■ Assume resolution by creation of a bridge bank</li> <li>■ Bank A transfers to bridge bank: <ul style="list-style-type: none"> <li>● €300bn of retail deposits</li> <li>● €330bn of "good" assets to back deposits and capitalise bridge bank</li> </ul> </li> </ul>																					
<b>Bridge bank (after)</b> <table> <tr> <td><b>Assets:</b></td><td>€330bn</td></tr> <tr> <td><b>Liabilities:</b></td><td></td></tr> <tr> <td>Deposits</td><td>€300bn</td></tr> <tr> <td>Capital</td><td>€30bn</td></tr> <tr> <td><b>Total</b></td><td>€330bn</td></tr> </table>		<b>Assets:</b>	€330bn	<b>Liabilities:</b>		Deposits	€300bn	Capital	€30bn	<b>Total</b>	€330bn										
<b>Assets:</b>	€330bn																				
<b>Liabilities:</b>																					
Deposits	€300bn																				
Capital	€30bn																				
<b>Total</b>	€330bn																				
Saving for deposit protection fund* = $€300bn \times 30\% = €90bn$																					
<small>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</small>																					
<b>Residual Bank A (after)</b> <table> <tr> <td><b>Assets: †</b></td><td></td></tr> <tr> <td>Original</td><td>€1,000bn</td></tr> <tr> <td>Liquidation losses</td><td>(€349bn)</td></tr> <tr> <td>Transferred to bridge bank</td><td>(€330bn)</td></tr> <tr> <td>Bridge bank equity</td><td>€30bn</td></tr> <tr> <td><b>Total residual assets</b></td><td>€351bn</td></tr> <tr> <td><b>Residual senior liabilities:</b></td><td></td></tr> <tr> <td>Eligible senior debt</td><td>€200bn</td></tr> <tr> <td>Other liabilities</td><td>€430bn</td></tr> <tr> <td><b>Total</b></td><td>€630bn</td></tr> </table>		<b>Assets: †</b>		Original	€1,000bn	Liquidation losses	(€349bn)	Transferred to bridge bank	(€330bn)	Bridge bank equity	€30bn	<b>Total residual assets</b>	€351bn	<b>Residual senior liabilities:</b>		Eligible senior debt	€200bn	Other liabilities	€430bn	<b>Total</b>	€630bn
<b>Assets: †</b>																					
Original	€1,000bn																				
Liquidation losses	(€349bn)																				
Transferred to bridge bank	(€330bn)																				
Bridge bank equity	€30bn																				
<b>Total residual assets</b>	€351bn																				
<b>Residual senior liabilities:</b>																					
Eligible senior debt	€200bn																				
Other liabilities	€430bn																				
<b>Total</b>	€630bn																				
<b>Total recoveries for senior creditors</b> <ul style="list-style-type: none"> <li>■ Senior creditors recover <math>€351bn / €630bn = 56\%</math></li> <li>■ If "no creditor worse off" rule, deposit protection/resolution fund contributes €90bn</li> <li>■ After contribution, senior creditors recover:  <math>(€351bn + €90bn) / €680bn = 70\%</math></li> </ul>																					
<b>Other stakeholders recover €0 (100% loss)</b>																					
CLIFFORD CHANCE	August 2011 4																				

One of the most interesting of the issues which arise 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 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.

Requiring a larger volume of bail-in eligible debt reduces the percentage hair-cut 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.

## **2.1 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.

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

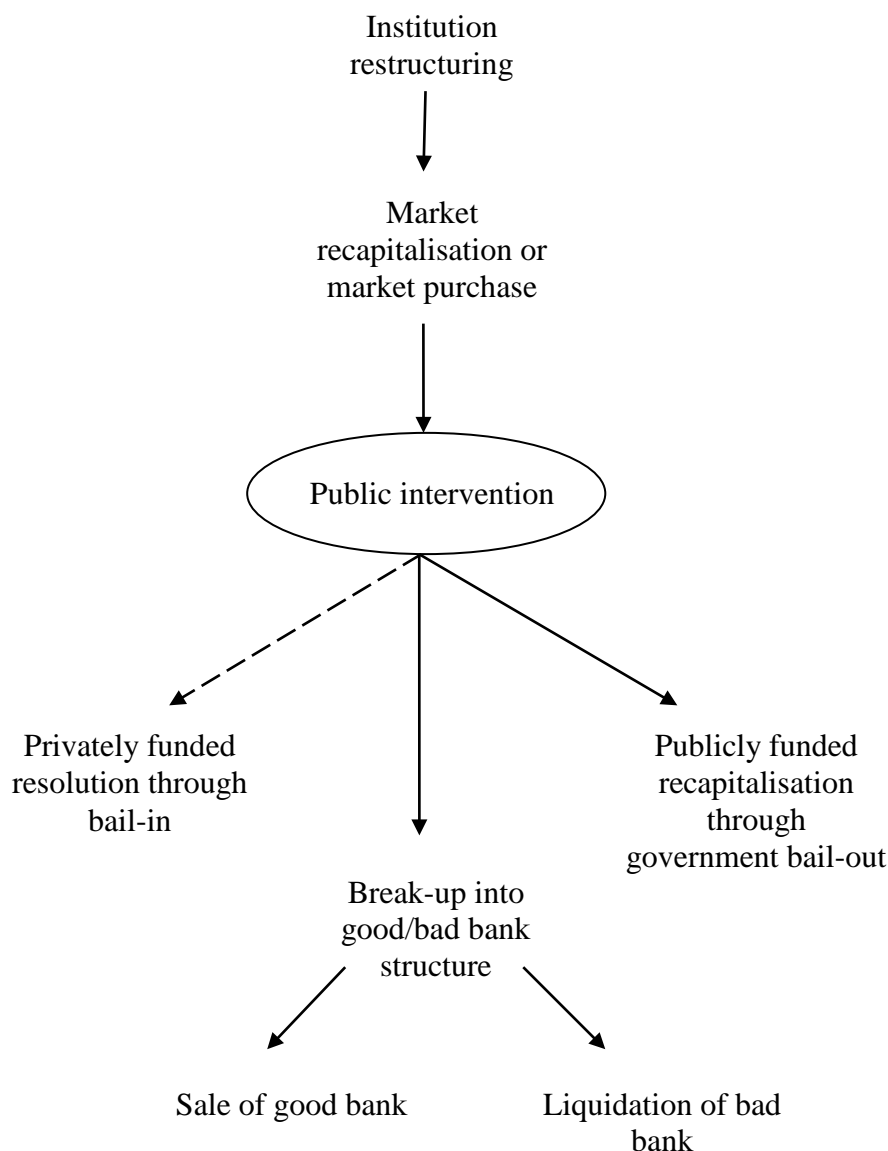
resulting restricted market for bail-in eligible debt will drive up funding costs. This could be a particular issue if a bail-in regime is structured based on the use of contractual conversion clauses in debt issues. However, the risk of ultimate conversion into equity is a risk which is taken by every 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 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.

### **3. Bail in compared with other resolution tools**

#### **3.1 Bail-in vs the private sector "lifeboat"**

Resolution through disposal of the entire undertaking of the failed institution is always the preferred resolution option - private sale and transfer to public ownership both have the immense advantage of not requiring a detailed analysis of which liabilities and assets are in which subsidiary in which jurisdiction. It is therefore worth considering how bail-in fits in to this strong policy preference.

There is a reasonably clear decision path which faces a supervisor confronting a troubled bank. The steps are set out schematically below, but the logic is perhaps easier to follow than the schema. In a perfect world an institution can be resolved by internal restructuring – liquidating some assets, withdrawing from certain lines of business, raising cash and paying down debts. However the practicability of this course of action is largely determined by the state of the rest of the financial system – for an institution which has suffered an idiosyncratic shock in an otherwise buoyant market this may be a practical proposition, but in a depressed or non-existent market this is unlikely to be an option.



The first recourse for an institution which cannot resolve itself is to go to the market to raise more capital – this can be achieved either by placing new equity with market investors, or by engineering a purchase by a solvent purchaser. Again, this will be possible for some institutions in some contexts, but not for all in all.

At this point public intervention will be required. This intervention can take a number of forms. At its simplest, this intervention is a reorganization process. This will involve the exercise of statutory powers to divide up the institution concerned, generally into a "good" bank, which can be sold, floated or otherwise restored to health, and a "bad" bank. The proceeds of sale of the "good" bank will be used to reduce the losses of those creditors left in the "bad" bank. In extreme cases the institution as a whole may be past saving and may have to be closed in its entirety. However in any sufficiently large bank there should be sufficient assets to enable the construction of a "good" bank of some size. Those creditors whose claims

are transferred to the "good" bank are effectively preferred to other creditors of the institution – in general, retail deposits are protected in this way. Once this has been done, the "bad" bank is run off.

This is the architecture which has been used successfully in a number of jurisdictions, and has been applied to institutions as large as Indymac and Bradford & Bingley. It is robust, and (in the US at least) has a long track record of successful use with smaller institutions. The problem is that it is not a technique which has yet been used for the largest globally systemically important financial institutions (SIFIs). Opinions vary between those who believe that this technique could be applied to the largest banks easily, and those who fear that those banks are too complex to be resolvable in this way within the time available. The basis of the latter view is that global SIFIs are, by definition, massively multinational. Their activities, and their obligations, will be governed by a number of different laws, and no one resolution authority can be given control of the entire group. Since global SIFIs generally take the form of complex groups, it is also doubtful that resolution techniques which are effective when applied to a single national entity would be equally effective when applied to a complex global group. In order to make such resolution techniques fully effective on a cross-border basis, it will be necessary for jurisdictions to make progress towards international agreement – and quite possible an international convention – co-ordinating the jurisdiction of relevant resolution authorities. The IMF, the FSB and many commentators have spoken in favour of this approach, but progress towards it is slow. In the absence of such an agreement, these conflicts of law problems provide another strong incentive for resolution to be addressed at the group level.

It is clear from the schematic diagram above that the problem which is faced by public authorities is that once a bank is in need of resolution, if conventional resolution is not an effective solution, the only remaining alternative is publicly funded recapitalization – taxpayer-funded bail-out. It is clearly true that this is by no means a bad thing. As Lord Turner said in his Clare College speech in February 2011<sup>3</sup>:

"..., the International Monetary Fund's (IMF) estimates of the total direct cost of public support during the crisis, published in June last year<sup>4</sup>, suggest that on average it might amount to less than 3% of GDP. And latest estimates for the US suggest that it could still be less, indeed it could be negative, with the public authorities making a profit, certainly in relation to the commercial banks, if not in relation to Fannie Mae, Freddie Mac and AIG."

This prediction seems even more accurate now than when it was delivered.

However, no matter how well the taxpayer may end up doing out of bank bail-outs, it is important to understand that the taxpayer at the moment has no appetite for them. At least some politicians are determined to ensure that they can never again be placed in the position where they are obliged to do politically toxic bank bail-outs in order to avoid significant economic damage. If this means breaking up the global banks into national ring-fenced local

---

<sup>3</sup> [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0218\\_at.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0218_at.shtml)

<sup>4</sup> <http://www.imf.org/external/np/g20/pdf/062710b.pdf>

entities, that will be regarded by them as a price well worth paying – not least because the political costs of foregoing future economic growth may be minimal – lost potential growth is, after all, invisible. Consequently, the challenge which the industry faces is to create a third policy option which is credible and practicable in a public intervention context, alongside efforts to demonstrate that conventional resolution is possible through living wills.

Privately funded recapitalization is a technique which has a surprisingly long history. Central banks have had considerable experience over the years with a technique which involves identifying the largest creditors of the troubled institution concerned, locking them in a room together, and explaining that their mutual self-interest clearly indicates their assembling a resolution fund out of their own resources. For example, in the 1970s the bank of England dealt with the secondary banking crisis by organizing a "lifeboat" amongst the major clearing banks which at its peak amounted to 40% of their capital, and in 1998 the Federal reserve facilitated the rescue of LTCM by a group of the largest US commercial and investment banks.

The primary problem with this model of privately funded recapitalization is that it is more or less impossible to identify every significant creditor of a SIFI in any reasonable timescale, and even harder to persuade them to agree amongst themselves in the short period available to those charged with resolving a bank. These issues are more acute where a bank is significantly dependent on capital markets funding with a dispersed bondholder group. Even within a small "lifeboat" group under great time pressure the prisoners dilemma will arise, and, as the Lehman experience shows, orchestrating all the parties towards a consensual solution in a weekend timetable may just prove too challenging.

The obvious solution to this problem is to require at least some creditors of an institution to commit to contribute to privately funded recapitalisation. This could be accomplished by providing in the terms of the agreement by which the creditor becomes a creditor that, in the event of a recapitalization being required, the amount due to him will be reduced by the amount of his contribution to the recapitalization in exchange for shares in the bank or by giving the authorities statutory powers to achieve this result (or a "hybrid" combination of the two methods). This is the basis of the technique known as "bail-in". It is by no means the only method of approaching this problem, and it is entirely possible that other mechanisms may prove to be equally or even more effective. However, for the reasons set out in our previous paper <sup>5</sup>, we believe that the bail-in technique represents the most legally efficacious mechanism for ensuring private sector participation in the refinancing of a troubled institution currently available to a multi-jurisdictional entity operating within multiple legal regimes.

There is, however, one final point which should be made as regards the use of this technique. For any firm in any business, a financial crisis can be defined as the moment when it runs out of cash. Extinguishing liabilities, whilst restoring balance sheet solvency, does not produce a penny of new cash. A balance-sheet restructuring, therefore, is only useful if it is sufficient to restore credibility – and therefore access to liquidity - to the institution concerned. A private recapitalization done using bail-in techniques will therefore involve a significantly greater write-down of creditor assets than the amount which would be required if those creditors

---

<sup>5</sup> *Legal Aspects of Bank Bail-ins* Clifford Chance 2011 ,at [http://www.cliffordchance.com/publicationviews/publications/2011/05/legal\\_aspects\\_ofbankbail-ins.html](http://www.cliffordchance.com/publicationviews/publications/2011/05/legal_aspects_ofbankbail-ins.html)

were to agree to advance new money to the troubled institution. It may, therefore, be the case that the principal effect of the possibility of a bail-in might be to resolve the prisoner's dilemma<sup>6</sup> and make it easier for central banks to create lifeboats. This would not be a bad or an undesirable outcome.

### **3.2 Bail-in v subordinated capital v 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.<sup>7</sup> 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 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.<sup>8</sup> The intention is that these instruments should count towards increased regulatory measures of loss-absorbency, such as the new "Swiss

---

<sup>6</sup> Or, in technical terms, to restore Pareto optimality to the class of outcomes of individual choices

<sup>7</sup> 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>

<sup>8</sup> At the time of writing there have only been a small number of such issues, notably by Lloyds in 2009, Rabobank and Credit Suisse in 2011.

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 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.

### **3.3 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 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 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.

#### **4. 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*<sup>9</sup>, 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 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.

---

<sup>9</sup> *National Bank of Greece and Athens S.A. v Metliss* [1958] A.C. 509

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.

#### **4.1 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.

#### **4.2 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 exceptions<sup>10</sup>. 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

---

<sup>10</sup> These are the labels adopted in the European Commission discussion document referenced in note 1 above

(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 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.

## **5. Other issues**

### *5.1 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.<sup>11</sup>

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.

---

<sup>11</sup> 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.

## 5.2 *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 process<sup>12</sup>. 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.<sup>13</sup> 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 authority<sup>14</sup>. 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 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

---

<sup>12</sup> 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."

<sup>13</sup> 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.

<sup>14</sup> 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.

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).

### 5.3 *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).

### 5.4 *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 than 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.<sup>15</sup> 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

---

<sup>15</sup> 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.

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 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 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 firm 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.

### *5.5 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.

## **6. 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.

## **7. Bank Resolution and Bail-ins in the context of Bank Groups**

### **7.1 Bank Group Structures**

Slightly paradoxically, in order for a lawyer to understand the practicalities of bank structure, the easiest mental model is the Marxist model. Marx regarded society as composed of the "base" – the forces and relations of production which constitute economic reality – and the "superstructure" - culture, institutions and social norms. Base determines superstructure, and a failure to perceive the realities of the base constitutes false consciousness. Banks can usefully be considered using this paradigm. The "base" is the systems and processes which

conduct the banks day to day business, whereas the "superstructure" is the legal construct which sits on top of the base. In analysing the bank itself, a focus on legal structures is a form of false consciousness. In determining whether an entity can continue to function, what matters is not whether the legal entities are solvent on an accounting basis, but whether the underlying systems are continuing to operate. The failure of Lehman Brothers International Europe provides a dramatic demonstration of this proposition – when the systems stop working, the institution is finished, and the notional solvency or otherwise of the legal entities is a detail for historians rather than a material fact.

The reason that this is important in the international context is that in most situations where banks operate through different national subsidiaries, it is highly likely that their operational, payment and functional activities will be conducted through a single bank-wide system. Even in contexts where bank regulators have required national subsidiarisation they have generally not gone so far as to require the maintenance of separate free-standing national operational systems – generally because such a requirement would add substantially to the service costs incurred by national customers. However, in the absence of such a requirement, the question of the possible survivability of the national subsidiary is a function of the continuing existence of the underlying systems. This has a number of consequences. One is that if the architecture of the bank is such that the system concerned is effectively operated by the troubled institution, then the failure of that institution will necessarily cause cessation of operations throughout the group. In order to address this issue without fragmenting operational systems in a way which would create massively increased costs, it is clearly necessary to create some degree of independence for the function concerned. However, any significant reconstruction of bank systems would impose costs which are very significant on banks, and such costs (payable as they are out of profits) would directly impact capital levels and further inhibit bank's ability to create credit. In short, it is by no means clear that any SIFI break-up would be feasible without requiring in effect a complete reconstruction of the bank itself.

Lawyers (perhaps justifiably) tend to perceive corporate groups on a legal entity by legal entity basis. However, this is not in general how groups are either managed or resourced. A simplified model of a conventional bank group might be as follows

		Management & Business Structure		
		IT Infrastructure		
		Legal structure		

The key point here is that each of these layers will be subdivided. Legal structure will be subdivided into individual legal entities. IT Infrastructure will be subdivided into different systems. Management structure will be subdivided into business areas. These subdivisions are not necessarily congruent with the subdivisions at other layers.

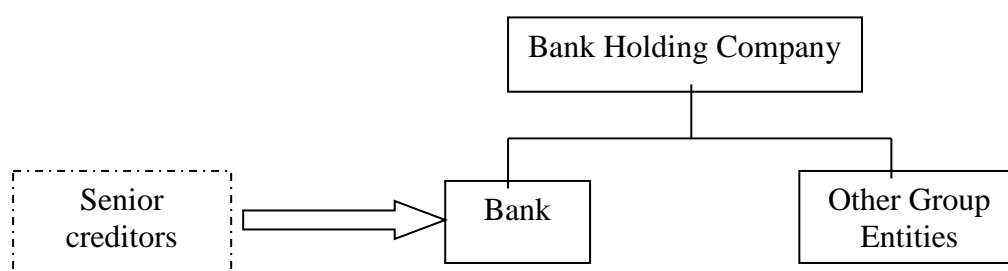
Sometimes one or more of these will conjoin. In the diagram above, the column on the right is most likely to represent a newly acquired subsidiary, where management, systems and legal structure will all – at the point of acquisition – be discrete. However over time the process of integration of such business into the parent group is likely to result in any of the three layers being merged – booking may be transferred to a new legal entity; management may be restructured within the wider group, and IT systems may be integrated. None of these processes are generally related to the others – banks do not generally prioritise legal structures when designing management processes or IT systems, or IT functionality when designing trade booking structures.

The effect of all this, however, is to expose as an illusion the idea that because business is conducted within a particular legal subsidiary, it is therefore segregated – or capable of being easily divided from – the other activities of the group. A subsidiary is, in legal realist terms, simply a few lines in a company registry – the question of whether a particular business can be separated from and easily sold from a group is much more likely to be determined by its management and control structures than by the legal substructure of its contracts.

## 7.2 Bail-in in the Context of Groups

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.

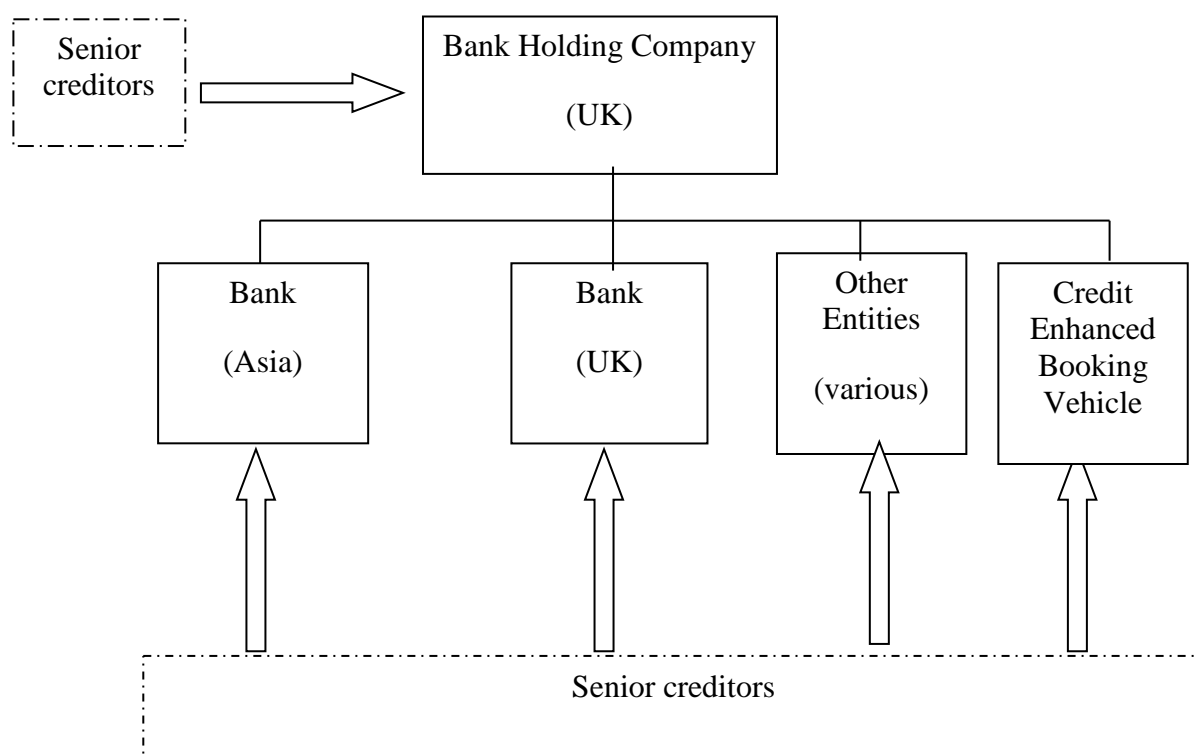
Fig. 1



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

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 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.

### **7.3 Transmission of Capital within Groups**

A further problem potentially arises within groups as regards the transmission of capital. In general, where a member of a group has surplus capital, if another member of the group is in need of capital, a number of mechanisms exist for transferring that capital within the group.

At its simplest, the transferring entity can subscribe for new shares in the transferee entity. However, this is generally not permitted where capital is to be transmitted upwards, since subsidiaries generally cannot buy shares in their own parent. Alternative mechanisms exist - the entity which is in surplus can pay its extra capital up the chain in the form of dividends until it reaches the group holding company, at which point it can be downstreamed again to the entity which is short of capital. Between subsidiaries subscription is possible but can create complexities where subsidiaries of a common holding company have crossholdings in each other.

An alternative is the indirect creation of capital by the forgiveness of intra-group debt. This is an effective mechanism (cancellation of debt results in an automatic increase in shareholders funds), but relies on there being forgivable debt in place, and on the directors of the company which is to forgive the debt being confident that the "giving away" of a company asset is within their powers and duties.

Another alternative is the capital contribution – a straightforward gift of money between one company and another – although there are sometimes accounting difficulties with having capital contributions recognized as capital.

In practice there are a host of tax, accounting and regulatory rules which inhibit the use of any of these mechanisms. These rules are difficult enough in one jurisdiction, but rapidly become a major obstacle when transfers between a number of different jurisdictions are involved.

## **8. Specific Bank Group Structures**

Bank groups are protean – not only are they very different one from another, but also they may change significantly as the business of the bank changes. As should have been clear from the foregoing, generalization about "bank groups" are impossible because each large bank group is to some extent unique, and even simple generalisations about "the holding company" or "the group" are liable to counterexamples. However, it is to some extent possible to separate bank groups into broad types, and we suggest here a taxonomy which may enable some progress to be made in addressing resolution options.

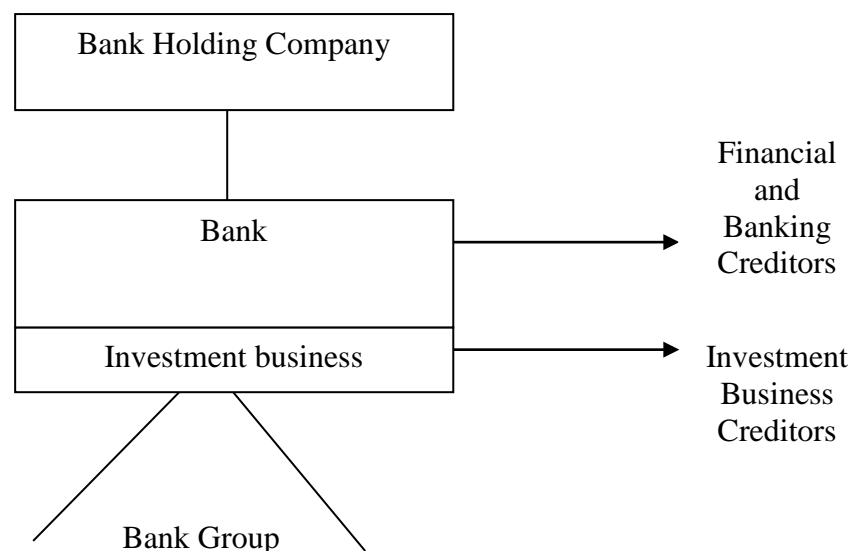
For the purposes of the examples that follow, we have divided creditors into three broad types:-

**Banking creditors;** meaning retail and wholesale depositors and creditors arising out of the provision by the bank of payment and custody services;

**Investment Business creditors;** meaning swap counterparties, trading counterparties, exchanges, clearing systems and other investment business counterparties (including repo counterparties).

**Financial creditors;** meaning long term creditors of the bank, including bondholders and other long-term unsecured finance providers

## 8.1 The "Big bank" model



Here we see a more or less "empty" holding company holding a bank with a large balance sheet. Assets not held within the bank itself will generally be held by subsidiaries of the bank. Funding is likely to be raised primarily at the bank level, since any funding raised at the holding company level is structurally subordinated to funding raised at the bank level. In general the "big bank" is likely to do its derivatives, markets and trading business out of the main legal entity, since this will be the most creditworthy member of the group and will ensure that counterparties have the lowest risk exposure (and therefore the lowest costs of dealing with it). A common variant of this structure is where the bank itself is the holding company for the group.

In the context of this institution two issues arise. One is that it is very unlikely that investment business creditors will be (or can be) included in the bail-in mechanism, and retail bank depositors certainly will not be for policy reasons. The bail-in mechanism will therefore be

applied to non-retail banking creditors, and a question may be raised as to whether these form a sufficiently large part of the exposures of the bank to enable an appropriately sized recapitalization. The answer to this is that it is broadly up to the supervisors of the bank concerned to satisfy themselves that the bank does have sufficient liabilities of this kind – if the institution seeks to reduce its quantum of bail-inable debts by migrating creditors to the status of investment business creditors, it should be free to do so, but the regulator should be expected to respond that if the bank has insufficient bail-in capacity, its capital requirement will be increased to cover the shortfall.

Mechanically, bailing in the big bank model is in some respects the easiest challenge. If creditors are at the level of the bank, it is a relatively simple matter to extinguish their claims on the bank and issue them with new shares in the bank itself. This will have the effect of "crowding out" the holding by the existing parent company, so the transfer of the equity in the bailed-in bank to the bailed-in creditors should occur more or less automatically. Where the bank is itself the holding company (or where there are assets in the holding company which are valuable to the survival of the group), it will be necessary to "crowd out" the old shareholders at the top of the group.

Nonetheless this scenario is not entirely free from difficulty. First of all, the numbers needed to "crowd out" the old shareholders are eyewatering – if a bank has 1bn shares in issue, in order to cram down those shareholders to 1% of the new equity 99 billion new shares would have to be issued (which raises technical issues in those jurisdictions which prohibit shares being issued at a discount to par value). More importantly, it is generally regarded as important in any resolution that the interests of the "old" shareholders should be completely subordinated to the interests of the providers of the resolution funding – if the "old" shareholders are permitted to continue to maintain a substantial interest in the future of the entity this creates the risk of perverse incentives for them in the period running up to crisis<sup>16</sup>.

It seems likely that the easiest solution to this problem would be that the resolution authority of the bank concerned should be given rights under the applicable resolution regime to cancel the outstanding shares and extinguish the claims of the shareholders in the holding company (in conjunction with the issue of the new shares to the bailed-in creditors). Alternatively, the resolution authority could be given powers to acquire the shares of the existing shareholders and either to cancel them (as a prelude to the issue of new shares to the bailed-in creditors) or to transfer them to the bailed-in creditors.

If there are creditors of the holding company, this poses several further difficulties. Creditors of the holding company have voluntarily accepted a position where they are structurally subordinated to creditors of the bank. It is therefore highly arguable that such creditors should be bailed-in first before direct creditors of the bank are affected. However, if there are insufficient of these creditors, the bail-in may have to be extended to the creditors of the bank. In these circumstances it is arguably clear that creditors of the holding company should be extinguished before creditors of the bank are bailed-in at all, since this outcome best reflects the subordination positions which the parties have voluntarily assumed. Where the bank creditors are being compensated with shares in the holding company, then, if the counterfactual is that (absent the bail-in) both the bank and the holding company would have gone into liquidation, it would be necessary to determine what (if anything) the holding

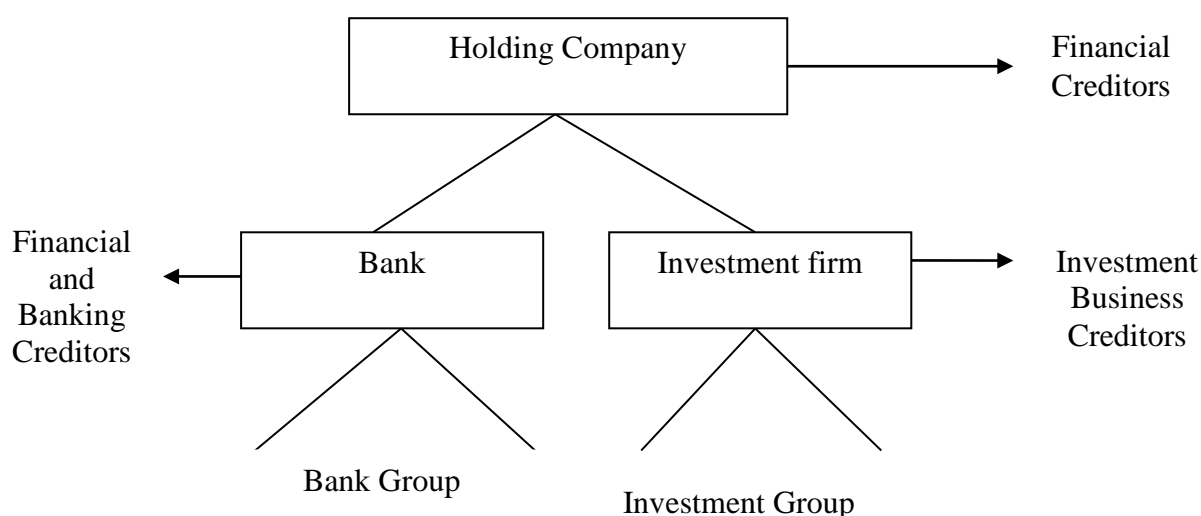
---

<sup>16</sup> In particular, if the "old" shareholders can expect to participate in post-intervention gains they may obstruct new capital-raising by the institution concerned.



company and the bank creditors would have received in that liquidation in order to determine how to compensate them with equity in the holding company while preserving their relative liquidation priorities. This is straightforward, if the claims of the bailed-in creditors of the holding company would be worthless in a liquidation. It is more complex if there is value at the holding company level that needs to be reflected in the allocation of equity compensation for the cancellation or reduction of their claims.

## 8.2 The "Bank/nonbank" model.



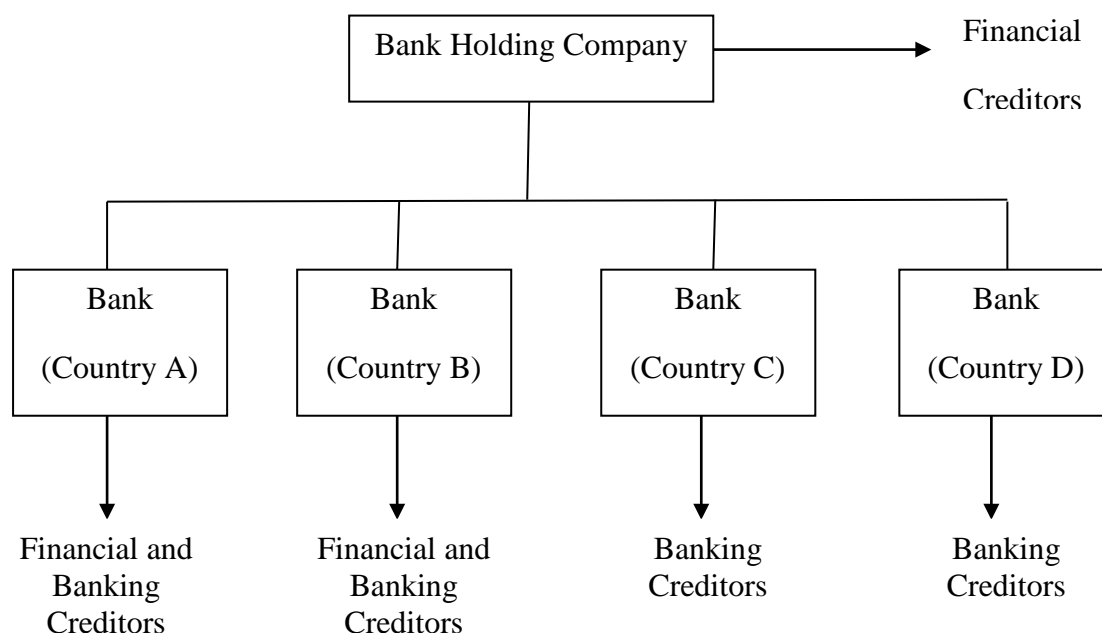
Here we see a holding company which owns a bank and a non-bank investment firm. These activities are likely to be ring-fenced by local legislation into a "bank chain" and a "non-bank chain", with little interaction between the two sides of the group below the level of the holding company. In this case it is more likely that significant funds may have been raised at the parent company level, since lenders at that level will have access to a larger asset pool than lenders to the bank. It is also very likely that significant external debt will have been raised at the bank level. Indeed, it is possible that all three components – the bank, the investment firm and the holding company – may have raised senior debt.

We need to begin with a hypothesis as to where in the group the loss has been incurred. For the purposes of this paper we will assume that the loss has been incurred in the banking part of the group.

At the level of the bank itself, the issues here are no different from the "big bank" model. Considering the position of the investment firm immediately raises the "dead in parts" problem. It should be remembered that in this context it is highly likely that the bank and the investment firm will share the same branding, the same advertising campaign and the same IT, processing and payment systems. As a result, it may well be the case that the survival of the brokerage will be entirely dependent on the survival of the bank. Clearly, if the bail-in can be conducted entirely at the group level that is likely to be the optimal solution. However, if that is not the case, then there may well be scope for the creditors of the bank to argue that they are incurring a cost in respect of which the creditors of the investment firm are beneficiaries, even though those creditors are not paying for that benefit. This point becomes

more difficult still if there are insufficient creditors of the bank capable of being bailed-in, since in that case it will become necessary to consider whether creditors of the investment firm should be bailed-in in order to resolve the bank if that is in fact the only way of preserving the investment firm.

### 8.3 The "global multi-bank" model.



Here a more or less empty holding company owns a number of banks – generally incorporated in different jurisdictions and subject to some degree of restrictions on their interconnection. In this case it is likely that at least some debt has been raised at the holding company level, although it is likely that some (but perhaps not all) of the subsidiary banks will also have raised external financial debt.

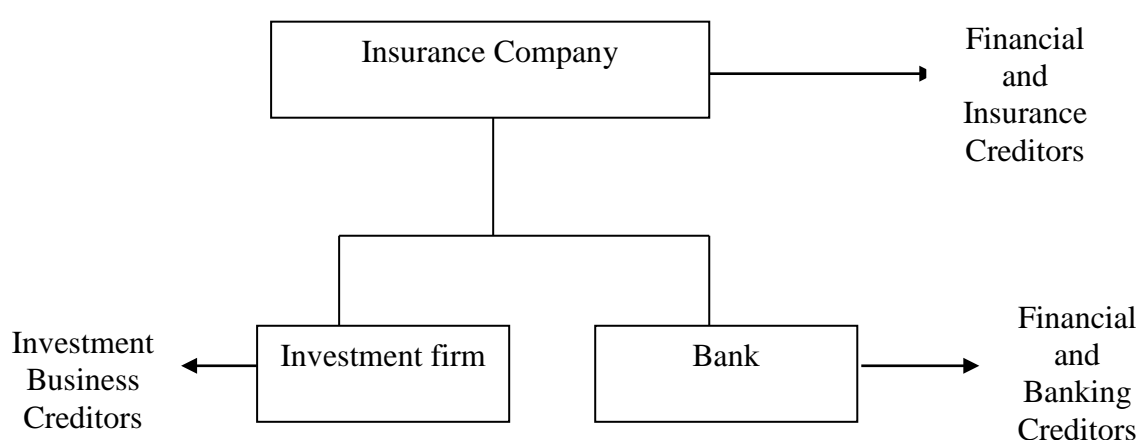
Bailing in the global multi-bank is more interesting than the previous cases. The architecture of the global multi-bank is generally in response to pressures from national regulators who require national business to be undertaken by separately capitalized local subsidiaries. Since we have hypothesized that the holding company is "empty" (i.e. has no economic activity of its own), it must follow that the loss causing the crisis must have been experienced in one or other of the bank subsidiaries. At the holding company level, the effect of a bail-in is therefore to raise new equity which can be employed to create new equity into the bank which has suffered the loss by forgiving intra-group debts owed by the subsidiary to the holding company in respect of funding previously received. However, if there is insufficient debt at the holding company and in the troubled subsidiary bank (or insufficient intra-group debts to be forgiven), there could *in extremis* arise the possibility of bailing-in creditors of solvent bank group members in order to resolve the troubled bank.

The permutations in this regard are complex and difficult. Considering the group above; if Bank A gets into trouble and its own bail-in capital is insufficient to get it out again, should the bail-in-able creditors of Bank B be called on? If they are, how does the capital get transferred from Bank B to Bank A? What if Bank C (which has no bail-in-able debt) gets

into difficulties - should bail-in creditors of Banks A or B be bailed-in to resolve it? To complicate matters further, if the bail-in of bank A results in majority control of bank A being transferred to the bailed-in creditors of Bank A, those creditors may take advantage of their status as controller of the bank to restrain the new capital thus created from being transferred elsewhere within the group.

This will require a good deal of goodwill between the resolution authorities in the various jurisdictions – a commodity which tends to be in short supply in these situations.

#### 8.4 The "financial conglomerate".



Here an insurance company owns the bank parent.

In the context of the financial conglomerate, analysis tends to run into the sands. If the parent of the bank is a regulated entity it is highly unlikely that the creditors of that regulated entity will be permitted to be bailed in in order to resolve the bank. This may be felt to be reasonable, in that even if the parent has provided equity to acquire the bank, it is most unlikely that it will have raised and downstreamed funding. Thus in such cases we might hope to find that the senior funding of the bank had been raised primarily within the bank itself, and if this does indeed turn out to be the case then the outcome will be similar to the "big bank" situation.

It is clear that these are no more than illustrations of broad classes of group structures, and it should also be clear that in each case the theoretical deployment of exposures would be dependent primarily on the type and volume of funding raised at each stage within the group.