

## ***The Case for Bail-ins***

Thomas F. Huertas\*

The case for bail-ins is simple. Bail-ins are superior to bail-outs, and bail-ins are superior to insolvency and liquidation. Bail-ins are potentially a powerful resolution tool, that can help make banks, even the largest and most complex banks, 'safe to fail'. Bail-ins can potentially help assure that investors, not taxpayers, bear the cost of bank failure. And bail-ins can materially help reduce both the social cost and the disruption to markets that insolvency and liquidation could cause. So bail-ins deserve a place in the resolution tool kit that should be at authorities' disposal, if a bank fails to meet threshold conditions and needs to be resolved. But for bail-ins to be effective, they will need to be combined with other tools, and both banks and authorities will need to take preparatory measures.

### ***Bail-ins are superior to bail-outs***

Too big to fail is too costly to continue. Bail-outs strain the public finances.<sup>1</sup> Bail-outs distort competition. Bail-outs undermine market discipline. Bail-outs are therefore not an option.

Accordingly, G-20 leaders asked the Financial Stability Board (FSB 2011a) to develop a policy framework that would "address the systemic and moral hazard risks associated with systemically important financial institutions (SIFIs)". One of the cornerstones of this policy framework is to develop a resolution regime that would make banks, including SIFIs, 'safe to fail' in the sense that they could be resolved without taxpayer support to the bank's solvency and without causing significant disruption to the financial system.<sup>2</sup> In October 2011 the Financial Stability Board set out the key attributes for such a resolution framework. This included a recommendation that countries establish special resolution regimes for banks and that such resolution regimes include bail-in as one of the stabilisation options

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\* The author is Partner in the Financial Services Risk Practice at Ernst & Young LLP. A preliminary version was presented in May 2012 at a conference at the Institute of Law and Finance, Johann Wolfgang von Goethe University, Frankfurt. I am grateful to D. Wilson Ervin and Reto Schiltknecht for comments. The opinions expressed here are those of the author and do not necessarily represent the position of Ernst & Young.

<sup>1</sup> As Tucker (2012) writes "if the risk of banking is not incorporated into the yields of bonds issued by the banks themselves, then it will be reflected in higher sovereign borrowing costs." In this regard Ireland is Exhibit A. In 2008 it bailed out its banks by guaranteeing banks' liabilities (including bonds issued by the banks). This caused the government budget deficit to soar and sovereign debt to rise to the point where Ireland had to seek restructuring assistance from the EU and the IMF.

<sup>2</sup> Other elements of the policy framework include requirements for resolvability assessments, for recovery and resolution plans, for increased capital (the so-called SIFI surcharge) and for more intensive supervision of SIFIs. For details see (FSB 2011a). For a general discussion of the issues relating to resolution see (Huertas 2011a), (International Institute of Finance, 2012) and (Randell, 2012).

available to the resolution authority (FSB 2011b). The EU Commission has followed the recommendation of the FSB, and its proposed Crisis Management Directive (EC 2012) has included bail-in as one of the tools that resolution authorities should have at their disposal, so that investors, not taxpayers, can pay for bank failures. In the United States, the FDIC is developing proposals for resolution under its Orderly Liquidation Authority that envision what amounts to bail-in of investors at a bank's parent holding company (Gruenberg, 2012).<sup>3</sup>

### ***Bail-ins are superior to liquidation***

Bankruptcy doesn't work for banks. The very essence of banking is making commitments to pay – depositors at maturity, sellers of securities due to settle, borrowers who wish to draw on lending commitments, derivative counterparties who contracted with the financial institution for protection from interest rate, exchange rate or credit risks. Putting a stay on payments to such creditors is equivalent to stopping the institution's operating business. Unlike airlines, retailers or automobile companies, banks cannot readily operate in bankruptcy. So bankruptcy for a bank is tantamount to liquidation (Huertas 2011a).

But liquidation destroys value. It diminishes the recovery that creditors can make. More importantly, liquidation increases contagion and assures that stress will spread from the failed institution to financial markets and to the economy as a whole. These effects are particularly grave, if the institution is large and/or complex. Indeed, avoiding such immediately adverse systemic effects is the principal reason that authorities have decided in the past to bail out systemic institutions (FSB 2011a)(Guynn, 2012, pp. 123-4).

Bail-ins promise to be superior to liquidation. Essentially, they amount to a pre-pack recapitalisation of the bank that the authorities can invoke at the point of intervention. This reorders and stabilises the capital structure of the bank and offers the prospect (provided other complementary tools are utilised as well) that the authorities can resolve the bank in an orderly fashion as a going concern. That reduces losses to creditors of the failed bank and reduces disruption to financial markets and the economy as a whole.

### ***Bail-ins in concept***

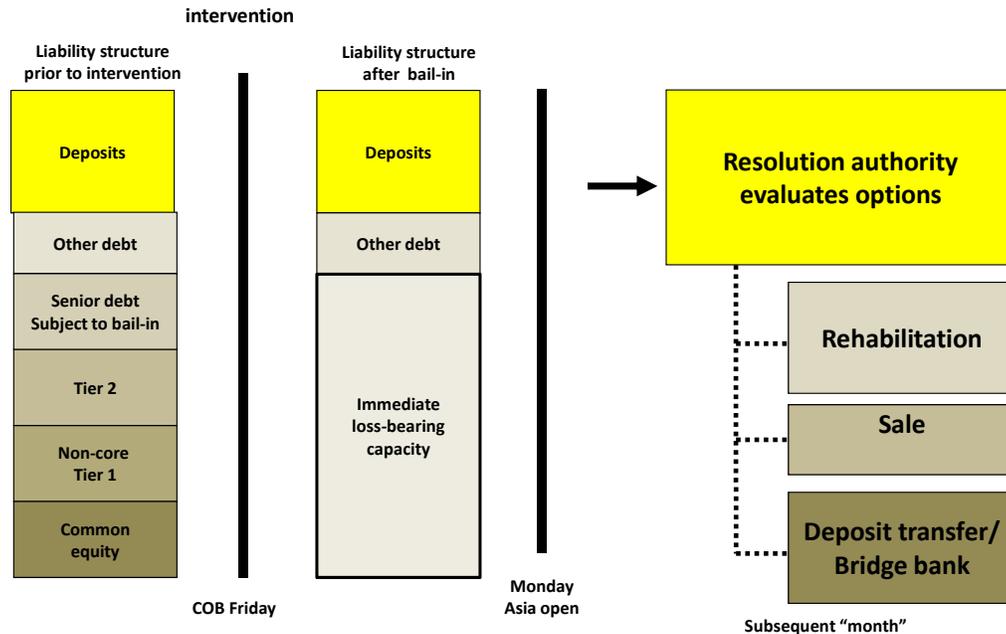
In concept, bail-ins are straightforward. If a bank fails, the resolution authority would write down or convert into equity some or all of the instruments subject to bail in. That increases the immediate loss-bearing capacity of the bank and enables the resolution authority to conduct an orderly wind-down of the institution. Following the bail-in the resolution authority would decide how to wind down the institution as a going concern. This could lead to a rehabilitation of the institution, the sale of all or

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<sup>3</sup> Switzerland also empowers the supervisor (as resolution authority) to bail-in certain instruments if the bank enters resolution.

part of the institution to a third party, a wind down of one or more its business lines, the creation of a bridge bank or the transfer of its deposits (along with a matching amount of good assets) to a third party (see Figure 1).

**Figure 1**  
**How bail-in could work**



In fact, banks have employed much the same approach to resolution in the securitisation structures that they have developed. These are designed to go into orderly wind-down, if cash flows or asset quality criteria breach certain triggers. Cash flows are allocated to liability holders in order of strict seniority, and losses are taken in reverse order. If losses exhaust the amount of stub outstanding, then losses are allocated to progressively more senior tranches. In effect, tranches are progressively bailed-in. Importantly, the super-senior tranche continues to perform as long as the assets generate sufficient cash to pay those obligations.

The securitisation structure avoids bankruptcy costs and allows the structure to execute an orderly wind-down without fire sales of the assets. Holders of subordinated and mezzanine tranches do not receive the right to accelerate their claims if the structure breaches its triggers and goes into wind down. They must stand still. They will receive cash if and only if the structure's assets generate enough cash to pay super senior and senior obligations in full.

### ***What is needed to make bail-ins work?***

Bail-in for banks attempts to bring the approach employed in securitization to the resolution of the bank itself. However, several things are needed in order to make bail-ins work.

The first is a special resolution regime for banks (FSB 2011b).<sup>4</sup> The jurisdiction must have one, and this special resolution regime must give the resolution authority statutory power to impose bail-in.<sup>5</sup> A special resolution regime empowers the resolution authority to initiate resolution and to direct the affairs of the failed bank in much the same manner as an insolvency practitioner would be able to direct the affairs of a company in administration.<sup>6</sup> The trigger for that intervention is generally a finding by the bank's supervisor that bank no longer meets the threshold conditions necessary to maintain its banking license and is unlikely to be able to meet such conditions in the future.<sup>7</sup> This is effectively the point at which the bank is no longer viable in private markets, or as Paul Tucker (2012) put it, a bank "should go into resolution when its time is up".

The special resolution regime sets out the "tool kit" that the resolution authority may employ to resolve the failed bank. This generally includes liquidation, deposit transfer, sale of the failed institution, the authority to create a bridge bank and, in some cases the authority to take the bank into temporary public ownership. If bail-in is to be workable, the special resolution regime must include bail-in in the tool kit that the statute gives to the resolution authority. This can and should be supplemented by contractual provisions in the instruments subject to bail-in [see below], but contractual bail-in alone will not make bail-ins work.

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<sup>4</sup> For an explanation of why special resolution regimes are necessary see (Huepkes, 2003). The regime should include provisions that govern how the resolution authority would resolve the failed bank as well as provision to assure that banks can only be resolved under the special resolution regime. For example, the proposed EU Directive (Art. 79) states that "Member States shall ensure that normal insolvency proceedings under national law may not be commenced" for banks.

<sup>5</sup> See for example EC 2012, specifically Articles 31 and 37-50.

<sup>6</sup> See for example EC 2012 Article 56.

<sup>7</sup> EC 2012 Article 27 (1) states  
Member States shall ensure that resolution authorities shall take a resolution action ...  
only if all of the following conditions are met:

- a) the competent authority or resolution authority determines that the institution is failing or is likely to fail;
- b) having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector or supervisory action, other than a resolution action taken in respect of the institution, would prevent the failure of the institution within a reasonable time frame;
- c) a resolution action is necessary in the public interest [could not be achieved through the use of normal insolvency proceedings]

The second precondition for bail-ins to work is obvious. There must be an amount outstanding of instruments subject to bail-in that is sufficient to recapitalise the institution.<sup>8</sup> Collectively, instruments subject to bail-in should be sufficient to recapitalise the bank, even if the bank's entire common equity had to be written off. This suggests that the minimum amount of instruments subject to bail-in should be on the order of 7% to 10% of the bank's risk weighted assets. That would be enough to restore the bank's common equity Tier 1 capital to its minimum level. However, a higher amount (perhaps 7 to 10% of the bank's total assets) would be necessary if bail-in is to restore confidence in the bank.

Instruments subject to bail-in should include any instrument that counts as capital for the bank. In particular, it would include non-core Tier 1 capital instruments such as preferred stock as well as Tier 2 capital instruments such as subordinated debt. Indeed, under Basel III such instruments should be subject to write-down or conversion at the point of non-viability (in other words subject to bail-in), if they are to continue to count as capital (BCBS 2011).<sup>9</sup>

Extending bail-in beyond capital instruments poses challenges. There are two approaches. One is what might be called a 'waterfall' approach. This creates a further class of instruments subject to bail-in (write-down or conversion) at the point of intervention.<sup>10</sup> The further class of instruments subject to bail-in would be senior to subordinated debt but junior to deposits and other customer obligations such as derivatives. The write down or conversion of such instruments at the point of non-viability would not trigger cross default with customer obligations. This would effectively amount to Tier 3 capital for the bank.<sup>11</sup>

If coupled with depositor preference (see below) such a step would go a long way toward creating two distinct classes of liabilities: investor capital (instruments subject to bail-in) and customer obligations (instruments that enjoy preference over investor capital and which can be expected to continue to be serviced even if the bank goes into resolution). With a sufficient buffer of investor capital, such customer obligations would enjoy the AAAA certainty that customers seek (Merton and Perold 1993).

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<sup>8</sup> The IMF (IMF 2012) recommended that banks be required to have a minimum amount of instruments subject to bail-in outstanding, and the EU has adopted this recommendation (see EC 2012 Article 39). See also (DG Internal Market, 2012).

<sup>9</sup> EC 2012 Articles 51 and 52 requires the Member States to enact these provisions into national law.

<sup>10</sup> Under this approach the requirement to maintain outstanding a minimum amount of instruments would also have to be integrated with the criteria for threshold conditions. See (Randell, 2012, p. 27).

<sup>11</sup> The UK is proposing that UK deposit-taking institutions be required to maintain "primary loss-absorbing capacity" equivalent to 17 to 20% of the institution's risk weighted assets (HMT 2012). To the extent that the institution's equity and non-equity capital fell short of this level, the balance would have to be made up of unsecured debt with a remaining maturity of at least 12 months. This debt would be subject to a primary bail-in power. See (Randell, 2012, p. 27).

The alternative is a 'carve-out' approach. This extends bail-in throughout the entire liability structure of the bank but creates carve-outs for certain obligations. However, carve-outs from bail-in are problematic unless they formally confer some type of preference on the instrument afforded the carve-out privilege.<sup>12</sup> The carve-out from bail-in confers economic (but not legal) preference. So creditors in the same class will receive different treatment. Those subject to bail-in will fare worse than those carved out from bail-in. Unless some outside party assumes the losses that would otherwise have accrued to the carved out liabilities, the carve out will increase the probability that creditors subject to bail-in but pari passu to the carved-out liabilities will fare worse than they would have done under normal insolvency procedures. This raises the likelihood that compensation will be due to such creditors from the resolution fund if the special resolution regime contains a clause promising creditors that they would be "no worse off" than they would be under insolvency/liquidation.<sup>13</sup>

Depositor preference represents a way to strengthen each of the two approaches. It effectively gives priority to the bank's primary customer obligation and increases the certainty and continuity of such obligations. Depositor preference also simplifies the application of other resolution tools, such as deposit transfer, that the resolution authority may wish to employ subsequent to bail-in. Depositor preference also materially reduces the risk to the deposit guarantee scheme.

Whatever approach is adopted, the issuing bank should be able to make clear to investors the risk that the instrument entails (IIF 2012). The prospectus and other information provided to investors should make clear to investors that the bank is subject to a special resolution regime, state whether or not the instrument is subject to bail-in and make clear that all instruments, even those not subject to bail-in, are subject to loss in the event that a bank goes into resolution. Exemption from bail-in does not imply any form of guarantee. Unless explicitly guaranteed (e.g. via a deposit guarantee scheme), the only entitlement that a liability holder has is the amount that s/he would have received had the bank been put into liquidation. This is the basis for the "no creditor worse off" provision generally included in special resolution regimes.

A third precondition for bail-ins to work is the provision of liquidity to the firm in resolution (IIF 2012, pp. 38-41). Although bail-in may recapitalise the firm, it will not produce a 'Lazarus effect'. The bank in resolution is likely to require liquidity, akin to a debtor in possession financing in a corporate bankruptcy. Funding will need to be

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<sup>12</sup> The proposed EU crisis management directive takes the carve-out approach and suggests that debt with a maturity of less than one month should be exempt from bail-in. However, the proposed directive does not give such debt preference (nor does it propose to give deposits preference). See EC 2012 Article 38. As Randell (2012, p. 26) remarks, "defining the seniority of debt by reference to its tenor would be a novel departure from the creditor hierarchies of most jurisdictions".

<sup>13</sup> See EC 2012 Art. 67. If the creditor is worse off, the EC Directive envisions that industry-financed resolution funds (Art. 91) would be used to pay the compensation due to the disadvantaged creditor. For a discussion of the "no creditor worse off provision see IIF (2012, pp. 23-28).

provided to the parent bank as well as its branches and subsidiaries if the bank in resolution is to remain in operation and continue to meet customer obligations. As a practical matter, this can only come from central bank(s) or the resolution authority itself, and the special resolution regime will need to make provision for such liquidity facilities.

The framework for such a liquidity facility needs to be put in place well in advance of the bank being put into resolution. The framework should cover four factors:

- (i) the priority of the liquidity facility relative to other liabilities on the bank in resolution. As a practical matter, liquidity facilities to the bank in resolution will need to be on a super-senior basis so that they would have priority in liquidation over all other unsecured creditors.
- (ii) the pool of collateral backing the facility. As a practical matter this should be a charge over the unencumbered assets of the bank in resolution, including without limitation the investments of the parent bank in its subsidiaries. Any proceeds from asset sales should go toward repaying the facility.
- (iii) the allocation of loss, should the bank in resolution fail to repay the facility and the liquidation of the collateral prove insufficient to repay the facility. Provision may need to be made to recoup from the industry any loss that the resolution authority/central bank might suffer.
- (iv) how and where the bank in resolution might draw on such a liquidity facility.

For the framework to be practical, measures must be taken to assure that the bank in resolution will actually have unencumbered assets that might serve as collateral for such a liquidity facility. As a result of resolution planning, it can be anticipated that authorities will place an increasing emphasis on controlling asset encumbrance at banks. Measures should also be taken to assure that the central banks providing liquidity to the bank in resolution are able to smoothly and immediately replace private lenders, should it become necessary to do so. This involves not only providing funds to the bank in resolution so that it can repay private lenders, but also arranging for the central banks to take control of the collateral that the bank in resolution had previously pledged to private lenders.

With a minimum amount of investor capital (instruments subject to bail-in) and provision of liquidity to the bank in resolution, the bank in resolution (but not in insolvency/liquidation) would be in a position to continue to service its customer obligations (instruments not subject to bail-in). This will help assure continuity of critical functions and avoid excessive disruption to markets or the economy at large.

How can such continuity of customer obligations be assured? There should be a clear dividing line between instruments subject to bail-in upon initiation of resolution and those who would only be subject to loss, if the bank went into formal liquidation or insolvency. The instruments subject to immediate bail-in amount to investor capital and should be subordinated to customer obligations. Customer obligations should continue, and the bank in resolution should meet these obligations as they fall due. That will protect depositors and limit disruption to markets and to the economy as a whole.

As customer obligations continue, they should not be subject to acceleration upon the bank's entering resolution. Specifically, derivative obligations should not be subject to close out (unless there is a payment default on a maturing obligation), and repo counterparties should not be able to sell the collateral pledged by the bank in resolution unless the bank in resolution fails to repurchase the securities as scheduled.<sup>14</sup> This reduces the need for fire sales of the failed bank's assets and limits the contagion from the failed bank to other participants in the financial markets.

Fifth, measures will have to be taken to assure that the bank in resolution does not disrupt financial market infrastructures. This requires steps on the part of the infrastructures themselves as well as the authorities dealing with the bank in resolution. Infrastructures need to become robust, in the sense that they could withstand the simultaneous failure of two of their largest participants. CPSS-IOSCO (2012) has set out the conditions that infrastructures will need to meet in order to accomplish that objective. But infrastructures, banks and the resolution authorities also need to think through how the infrastructure will treat the bank in resolution. If one of the aims of bail-in is to assure continuity of critical economic functions and continuity of customer obligations, some measures will have to be taken to assure that the bank in resolution continues to have access to payment, settlement and clearing infrastructures, not only to clear and settle transactions initiated prior to the date the bank entered resolution but also to assure that the bank in resolution can continue to send and receive payments, settle transactions and process collateral.

Sixth and perhaps most fundamentally, for bail-ins to work banks and the authorities will have to establish reliable parameters with respect to how investors will be treated in resolution.<sup>15</sup> Investors will need to have some idea of the range of possible outcomes and the process that the resolution authority will follow, if they are to invest in instruments subject to bail-in. If banks are to issue instruments subject to bail-in, should the bank go into resolution, a prospective investor should want to estimate

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<sup>14</sup> Note that this approach goes much further than the temporary stay on contracts envisaged in many special resolution regimes. It posits that instruments subject to bail-in do not trigger cross-default with derivatives contracts or repurchase agreements. This can potentially be accomplished where the special resolution regime takes a waterfall approach to bail-in, but is unlikely to be realisable under a carve-out approach.

<sup>15</sup> For a discussion of investors views see IIF 2012, pp. 55-59.

both the probability that the bank will enter resolution (fail to meet threshold conditions) and the expected loss given resolution to which the instrument will be exposed.

To determine the latter, investors in instruments subject to bail-in will want some indication of the level of assets that the banks might have at the point at which it is put into resolution as well as a good sense of the priority of their particular claim on the assets of the bank in resolution. Although special resolution regimes generally call for an independent valuation of the bank to be conducted as a basis for making resolution decisions,<sup>16</sup> this is only a first step toward providing the assurance that investors seek. Such a valuation at the point of resolution merely establishes the extent of the losses that need to be incurred. It contains no assurance that the intervention will actually occur at a point where the bank still has positive net worth.

That assurance can only come, if the supervisor fulfils its function as monitor<sup>17</sup> and initiates resolution in a timely manner, i.e. at a point where the institution has fallen below minimum capital requirements but still has positive net worth. This will help assure investors in instruments subject to bail-in that they may receive positive proceeds from the bank in resolution so that their loss given resolution will be less than 100% of the amount of their investment.

In addition, investors will want to know how the resolution authority will treat each element in the bank's capital stack during resolution. As indicated above, the resolution authority will need to commit to the principle that no creditor should be worse off in resolution than it would have been if the bank had been liquidated.<sup>18</sup> Given the large losses in value that liquidation causes, this criterion should be relatively straightforward. The resolution authority should also commit to the principle of strict seniority, or conversely commit to imposing losses in reverse order of strict seniority. This may require the resolution authority to spell out in advance how it would actually implement bail-in.

Finally, all of the above needs to be accomplished at great speed. If the supervisor places the bank into resolution at the close of the business day, bail-in and the arrangements to assure continuity of customer obligations have to be in place by the start of the next business day. That generally leaves the authorities with at most 36 to 48 hours (elapsed time between close of business on Friday and opening of business on Monday) to complete all the tasks required to make resolution

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<sup>16</sup> See for example (EC 2012) Article 30.

<sup>17</sup> For a description of the role of the supervisor as monitor and minder see Huertas (2012). Disclosure to the market as well as to the supervisor should help assure that the supervisor does in fact initiate resolution in a timely manner.

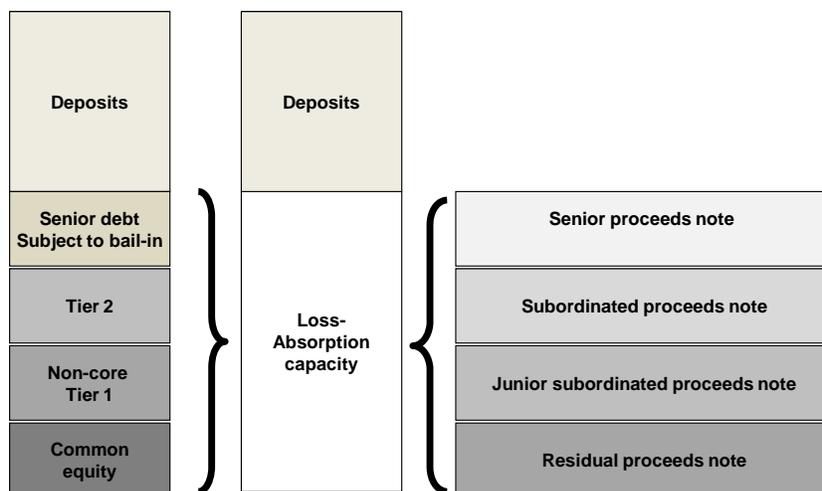
<sup>18</sup> See for example (EC 2012) Article 67.

successful.<sup>19</sup> To do so requires considerable advance planning and preparation, and resolution plans are an important step in this direction.

***Bail-in via stay on investor capital***

Broadly speaking, there are two alternative methods to implementing bail-in. The first imposes a stay on investor capital; the second converts bail-in instruments into common equity. Both have the effect of raising the amount of capital that is immediately available to bear loss, and that is the key to stabilising the bank in resolution so that it can continue to operate its critical economic functions and continue to meet customer obligations.

**Figure 2**  
**Bail-in via stay on investor capital**



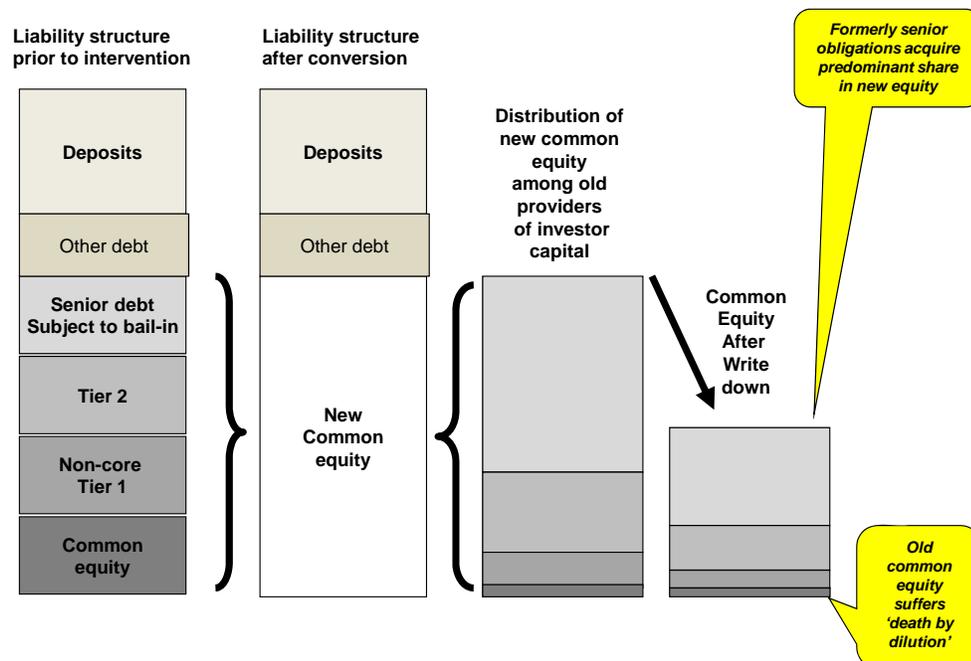
<sup>19</sup> Although special resolution regimes limit the requirement for the resolution authorities to seek prior judicial approval of their actions [see for example (EC 2012) Article 78], the regimes impose various requirements that may impede the ability of resolution authorities to complete their actions within a 36 to 48 hour time frame. Such requirements in the EU include the need to consult the ‘resolution college’ and for the European Banking Authority to mediate possible objections to the group resolution plan proposed by the home country authority [see (EC 2012) Article 83]. In the United States such requirements include a determination that the institution should not be resolved under Title I of the Dodd Frank Act (this envisages the use of normal corporate bankruptcy proceedings) but under the Orderly Liquidation Authority of Title II. The Secretary of the Treasury may make such a determination “in consultation with the President of the United States” and with the concurrence of 2/3 of the Federal Reserve Board and 2/3 of the Board of the Federal Deposit Insurance Corporation. In addition, the Secretary of the Treasury must obtain an order from the US District Court of the District of Columbia before appointing the FDIC as receiver under Title II.

Broadly speaking, bail-in via a stay on investor capital would work as follows (see Figure 2). Upon a finding by the supervisor that the bank failed to meet threshold conditions, the resolution authority would impose a stay on all payments to all instruments subject to bail-in, including at a minimum common stock, non-core Tier 1 capital (e.g. preferred stock) and Tier 2 capital (e.g. subordinated debt). Contractual payments on such instruments would be cancelled and such instruments would be fully available for loss absorption.

The resolution authority would continue to operate the bank in resolution as a going concern and continue to service customer obligations. Holders of instruments subject to bail-in would receive certificates entitling them to proceeds from the wind down/run-off of the bank in resolution. These proceeds would be distributed according to strict seniority, with senior debt being subject to bail-in being paid first, then Tier 2 capital, then non-core Tier 1 capital, and, finally, if any proceeds remained, common stock. In economic terms, this is analogous to what might be achieved in a corporate bankruptcy proceeding, and should be superior to what might be achieved under liquidation and a fire sale of the assets.

***Bail-in via conversion to common equity***

**Figure 3**  
**Bail-in via conversion**



Bail-ins can also be implemented via converting the instruments subject to bail-in to common equity (see Figure 3). Under this method, at the intervention point the

resolution authority would convert non-core Tier 1 capital, Tier 2 capital and senior debt subject to bail-in (Tier 3) into common equity. This would increase the total loss-bearing capacity of the bank. The resolution authority would then order the bank to realise losses from bad assets. This would cleanse the balance sheet and reduce the value of the equity to a lower but credible level.

The conversion should be conducted in a manner consistent with strict seniority. Each euro of preferred stock (non-core Tier 1 capital) should receive a lower number of common shares than a euro of subordinated debt (Tier 2 capital), and each euro of subordinated debt should receive a lower number of common shares than a euro of senior debt subject to bail-in. If instruments subject to bail-in had specified to investors the conversion ratio that would be used if the bank were to go into resolution, the resolution authority should agree to utilise the ratios specified in the prospectus for the issue in question.<sup>20</sup>

### ***Bail-in under different bank structures***

The structure of a bank may affect the ability of the authorities to execute bail-in and/or the steps that firms would have to take to make bail-in feasible.

Banks predominantly employ two structures. In the first, a bank is the top-level or parent organisation and this bank has subsidiaries and branches. In the second, a holding company is the top level or parent organisation. This has no direct operating business, but owns one or more bank subsidiaries, each of which may have branches or subsidiaries. For the moment assume that the bank under each of these structures operates entirely within one country.

Bail-in where the bank is the parent entity. The principal issue with respect to bail-in where the bank is the parent entity lies in avoiding the bail-in triggering the default of customer obligations. Such a default would potentially push the bank into liquidation, cause loss of value to creditors, disrupt financial markets and harm the economy at large – exactly the result that a special resolution regime should seek to avoid.

One possible approach is to distinguish more clearly between customer obligations and investor capital, make the former senior to the latter and require the bank to have a minimum amount of the latter outstanding. Investor capital would clearly be on notice that it would be bailed in, if the bank were to go into resolution, and the resolution authority should make clear to investors that it would implement bail-in in a manner consistent with strict seniority. To accomplish the above, the statute should make clear that the resolution authority has the ability to bail-in the instrument and the contract for the instrument should make clear to investors that the instrument is subject to bail-in. Additionally, language in customer obligations would have to be revised to exclude bail-in on an instrument subject to bail-in as an event of default so

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<sup>20</sup> Provision should also be made to assure that the bank has sufficient authorised share capital to accommodate the number of new shares that might be issued, if conversion were to occur under resolution. See (EC 2012) Article 49 (1).

that bail-in would not trigger cross default on such customer obligations. Finally, either the resolution authority or the central bank will have to provide a liquidity facility to the bank in resolution secured by the unencumbered assets of the bank.

With such a liability structure in place, it should be possible for the resolution authority to conduct bail-in over a weekend. This would stabilise the institution and allow the resolution authority to work out – possibly in conjunction with the investors in the instruments subject to bail-in – the future course that the institution should take.

Bail-in where the parent entity is a holding company. Different issues arise where the parent entity is a holding company. Start with the case where the parent organisation is a pure holding company that owns 100% of the equity of the bank subsidiary. Where should bail-in occur – at the bank level or at the level of the parent holding company?

If it is to occur at the holding company level, the special resolution regime must give the resolution authority the right to include the parent holding company and the right to impose bail-in on the liabilities of the parent holding company. Under the assumptions given, all such liabilities would be investor capital and all such liabilities would be structurally subordinated to obligations at the bank subsidiary level. So bail-in at the parent holding company would not necessarily trigger cross-default clauses on the liabilities issued at the bank level. Theoretically, bail-in at the parent holding company need not trigger the insolvency or administration of the bank subsidiary.

In practice, however, the loss that causes the group to fail is likely to occur at the bank subsidiary level, not at the parent holding company. Bail-in at the parent does not itself recapitalise the bank subsidiary (see Table 1). Provision has to be made to accomplish this.<sup>21</sup>

To examine more closely why this is the case, look at the parent only balance sheet (see Table 1). On the asset side it contains equity in the bank subsidiary as well as investments in the preferred stock, subordinated debt and senior debt of the bank subsidiary. It also contains investments in third-party assets, such as marketable securities. On the liability side, it includes equity, preferred stock, subordinated debt and senior debt, all of which is held by third party investors.

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<sup>21</sup> Steps also have to be taken to provide liquidity to the operating bank subsidiary as outlined above.

Table 1

Bail-in at parent does not necessarily recapitalise the bank subsidiary

<b>Parent holding company</b>			
<b>Assets</b>	<b>Prior to intervention</b>	<b>At Intervention</b>	<b>After Bail-in at parent</b>
Marketable securities	100	100	100
Senior debt at bank subsidiary	50	50	50
Subordinated debt at bank subsidiary	25	25	25
Preferred stock at bank subsidiary	25	25	25
Common equity in bank subsidiary	100	0	0
<b>Total</b>	<b>300</b>	<b>200</b>	<b>200</b>
<b>Liabilities</b>			
Senior debt	100	100	0
Subordinated debt	25	25	0
Preferred stock	25	25	0
Common equity	150	50	200
<b>Total</b>	<b>300</b>	<b>200</b>	<b>200</b>
<b>Bank subsidiary</b>			
<b>Assets</b>			
Loans	700	600	600
Other assets	300	300	300
<b>Total</b>	<b>1000</b>	<b>900</b>	<b>900</b>
<b>Liabilities</b>			
Deposits	650	650	650
Senior debt	200	200	200
Subordinated debt	25	25	25
Preferred stock	25	25	25
Common equity	100	0	0
<b>Total</b>	<b>1000</b>	<b>900</b>	<b>900</b>

Take the case where the bank subsidiary suffers a loss that wipes out the equity capital of the bank subsidiary.<sup>22</sup> The parent must write off its investment in the

<sup>22</sup> It is not clear how the FDIC proposes to handle the recapitalisation of a bank subsidiary that suffers losses which cause the bank subsidiary to fail to meet threshold conditions. In his description of the so-called single point of entry approach, Martin Gruenberg (Acting Chairman FDIC) stated in May 2012 that the FDIC intended to put the parent holding company into receivership and transfer the parent's equity in solvent subsidiaries to a bridge holding company. This would allow the operating

common equity of the bank subsidiary. This need not wipe out the parent's own equity, but it will certainly reduce it.

Bail-in at the parent level will effectively enable the parent's non-equity liabilities (preferred stock, subordinated debt and senior debt) to bear additional loss immediately. But bail-in at the parent does nothing to recapitalise the bank subsidiary. For this to occur, the resolution authority must also be empowered to direct the holding company to inject additional equity into the bank subsidiary. This can be done either in kind (e.g. through the transfer of the parent's marketable securities at conservative values into the bank subsidiary in exchange for new equity in the bank subsidiary), through write down or conversion of the parent's holdings in non-equity instruments in the bank subsidiary or in cash (if the parent holding company can borrow such cash from the resolution fund). Any recapitalisation facility has to be consistent with the liquidity facilities that are provided to the operating subsidiaries.<sup>23</sup>

From the standpoint of the creditors of the operating bank it is imperative that such a recapitalisation of the operating bank be highly certain to occur (i.e. that the resolution authority not only be empowered to direct the holding company to make the investment necessary to recapitalise the bank but that such an investment would actually be made). It is also important that such a recapitalisation investment be made quickly.

To this end, it is worthwhile asking whether bail-in at the parent level should be accompanied by bail-in at the level of the operating bank subsidiary. This would seem relatively straightforward for instruments that qualify as regulatory capital at the bank level, as these should be subject to conversion or write down at the point of non-viability, particularly where all such instruments issued by the subsidiary bank are held by the parent holding company. It could be more problematic, if the bank subsidiary had issued capital instruments to third parties as well as to the parent holding company. It would also be more difficult to bail-in the parent's holdings of senior debt issued by the bank subsidiary unless the parent were willing (or forced) to accept a subordinated status relative to third party holders of senior debt issued by the bank subsidiary.<sup>24</sup> Finally, if bail-in at the parent holding company is to be accompanied by bail-in at the bank subsidiary, does this imply that the bank subsidiary should have issued to the parent in advance amounts of investor capital

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subsidiaries so transferred to continue in operation. But Gruenberg was mute on how an insolvent or undercapitalised subsidiary would be treated. See (Gruenberg, 2012).

<sup>23</sup> The recapitalisation facility should be subordinated to the liquidity facility. This will structurally be the case, if the liquidity facilities are extended at the level of the operating subsidiaries and the recapitalisation facility is extended at the holding company level.

<sup>24</sup> See (International Institute of Finance, 2012, pp. 25; 55-57) for a discussion of the importance of creating clarity with respect to how intra-group exposures would be treated in resolution.

sufficient to effect a recapitalisation of the bank, if it failed to meet threshold conditions?

The situation is considerably more complicated, if the parent holding company owns less than 100% of the common equity in the bank subsidiary. Where the parent owns 100% of the common equity of the bank subsidiary, it can be argued that the creditors of the parent holding company can be held responsible for losses at the subsidiary bank (via write down or conversion of their own claims on the parent holding company and the infusion of new equity into the bank subsidiary as described above). However, where the bank subsidiary has third party shareholders the procedure outlined above potentially breaks down. Compelling the parent holding company to make an investment in the subsidiary bank sufficient to recapitalise the bank may run afoul of the “no creditor worse off” provision that the creditors of the parent holding company should receive under the special resolution regime.

### ***Resolution of G-SIFIs***

The discussion to this point has referred to a banking group that operates in a single jurisdiction. But the most important financial institutions – the so-called G-SIFIs (globally systemically important financial institutions) – are both global and complex. Although they are headquartered in one jurisdiction, they are active in fifty or more, and they run their different businesses through a variety of subsidiaries and branches. What complications arise, when an institution operates in two or more jurisdictions? Can these be overcome, so that bail-in can become an effective resolution tool for global organisations? The following highlights some key issues that the home-host cooperation agreements mandated by the FSB will have to address.

Issuance of instruments to foreign investors and/or issuance of instruments under foreign law. Even if a bank has no branches or subsidiaries outside its home country, it may issue instruments subject to bail in to foreign investors and/or issue such instruments under foreign law. To assure that such investors in such instruments cannot challenge the bail-in executed by the home country resolution authority, the statutory basis for bail-in (as reflected in the home country’s legislation that establishes the special resolution regime) should be reinforced by disclosure to investors and incorporation into the contracts for such instruments.<sup>25</sup> If possible, host countries should amend their own legislation to give recognition to bail-in (IMF2012, pp. 17-18).

Foreign branches of the bank. If a bank has foreign branches, it is important that the host country authority refrain from seizing the bank’s branch in that country and

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<sup>25</sup> See for example (EC 2012) Article 50 (1).

putting it into liquidation.<sup>26</sup> The declaration by the home country regulator that the bank fails to meet threshold conditions should not automatically trigger the host country putting the parent bank's branch in that country into liquidation. Such restraint by the host country will allow the home country resolution authority to run the resolution of the bank on a global basis. This should maximise the value of the assets and retain the franchise value of the bank in resolution. As a practical matter, however, the host country is only likely to agree to such restraint if it has the legal authority to do so and if the home country takes responsibility for providing liquidity to the bank in resolution and has made arrangements in advance with the host country that would assure that liquidity could be provided to the branch in the host country if needed to meet the obligations of the bank that mature in the host country.<sup>27</sup>

Foreign subsidiaries within the group. If there are foreign subsidiaries in the group, either as direct subsidiaries of the parent bank or direct subsidiaries of the parent holding company, two issues stand out. First, how bail-in at the parent affects the subsidiary in the host country, and second, how liquidity would be provided to the subsidiary whilst the group is in resolution.

As outlined above, bail-in at the parent holding company does not necessarily result in the recapitalisation of any subsidiary. Viewed solely from the perspective of the home country, the home country resolution authority might like to assure that it retains control over solvent and viable foreign subsidiaries whilst retaining its option to walk away from an insolvent foreign subsidiary. Such an approach is hardly likely to appeal to host country supervisors and resolution authorities. The host country authorities could react by refusing to approve the change in control of the subsidiary to the home country resolution authority or asserting their right to initiate local resolution proceedings the moment the parent went into resolution.<sup>28</sup> Prior to resolution, the host country authorities could insist that subsidiaries under their jurisdiction issue to their parent (or third parties) an amount of investor capital

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<sup>26</sup> For example, under US law the US authorities would be entitled to take control of the US branch of a foreign bank upon entry of the foreign bank into resolution. The US authorities would then liquidate the branch as if it were a subsidiary incorporated in the US. This amounts to ex post ring fencing (see (Randell, 2012)). The proceeds of the liquidation would be used first to pay the creditors of the US branch of the foreign bank. If these proceeds were insufficient, the US authorities would place a claim on behalf of the creditors of the US branch on the estate of the failed foreign bank. Such a territorial approach to resolution practically forces the entire bank into liquidation. For bail-in at the parent bank level to work, the host country authority must refrain from invoking its right to implement such ex post ring fencing, at least where the home country resolution authority sees the possibility of implementing a group resolution.

<sup>27</sup> For example such a liquidity facility might be on a global basis with a single collateral pool with the home country central bank responsible for any credit loss that might be realised if the bank in resolution could not repay the facility and the liquidation of the collateral proved insufficient. The host country central banks would act as agents for the home country central bank.

<sup>28</sup> In an extreme case the host country could seize even a healthy subsidiary without immediate compensation to the home country.

(instruments subject to bail-in) that would be sufficient to recapitalise the subsidiary. That would allow the host country to trigger bail-in at the subsidiary level and the host country would be responsible for assuring that the subsidiary in resolution had access to adequate liquidity (this would have to be provided by the resolution authority and/or central bank of the host country). Such an approach amounts to a multiple point of entry approach to resolution, and this may be practical, if the banking organisation is in fact structured as a series of separately capitalised, separately funded subsidiaries (Financial Stability Board, 2012, pp. 13-28).

But few groups are actually structured that way. Many if not most global SIFIs operate as integrated global enterprises with business lines that span several different legal vehicles in many different jurisdictions. Such institutions are global in life, and this enables them to serve clients more effectively and to improve the efficiency of global trade, global investment and global markets.

The question arises as to whether such institutions can be global in resolution as well. This would require a single point of entry approach coordinated by the home country (Financial Stability Board, 2012) . Note that this can redound to the benefit of the creditors in the home country, if such a global approach creates greater assurance that the home country resolution authority will continue to be able to control and derive value from solvent subsidiaries in host countries.

If such a global single point of entry approach is to be attempted, the home country resolution authority will have to act together with its central bank as the leader of what might be called a resolution syndicate. This should make clear to host country authorities that the home country resolution authority will cause the parent holding company in resolution to act as a source of strength to subsidiaries in the host country and that the home country will arrange a global liquidity facility for the group in resolution. The framework under which the parent holding company in resolution would inject capital into the host country subsidiary should be specified in advance at least for material subsidiaries as should the basis on which the host country resolution authority/central bank would participate in any global liquidity facility. Ideally, the relevant authorities would establish such a framework as part of the institution-specific cooperation agreements that they are developing for the FSB rather than attempt to negotiate this on the weekend following the entry of the bank into resolution. A convention, such as the one proposed by the International Institute of Finance (International Institute of Finance, 2012) could provide a further underpinning to such institution-specific cooperation agreements.

### ***Conclusion***

In sum, bail-in is potentially an extremely useful tool for a resolution authority to have in its tool kit. It can effect what amounts to a pre-pack recapitalisation of the bank and contribute to the stabilisation of the bank. This helps assure that investors not taxpayers bear the cost of resolving the bank. If combined with provision of liquidity

facilities to the bank in resolution by the central bank, bail-in can allow the resolution authority to resolve the bank in an orderly manner, maintain the continuity of customer obligations and critical functions and minimise losses to creditors, disruption to markets and damage to the overall economy.

However, to achieve these benefits several pre-conditions need to be fulfilled. First, the bank's home country must have a special resolution regime and this must include bail-in as one of the tools in the kit given to the resolution authority. Second, for instruments subject to bail-in documentation and other communications with investors should reinforce that instruments are subject to loss (unless explicitly guaranteed under a deposit guarantee scheme) and subject to bail-in. Third, the amount of instruments subject to bail-in should be sufficient to recapitalise the bank if they were written down or converted to equity at the point of non-viability (intervention). Fourth, bail-in needs to be supplemented by liquidity to support the bank in resolution, akin to debtor in possession financing. This can only come from the resolution authority and central banks. Fifth, measures need to be taken to assure that bail-in does not trigger events such as cross-default clauses, close-out of derivative contracts, sale of collateral provided to repo counterparties and closure of access to financial market infrastructures that would obstruct the ability of the bank in resolution to continue meeting its customer obligations. Finally, for banks that operate in more than one jurisdiction all of the above has to be done in coordination and with the agreement of host country authorities. And, it all has to be so well prepared that it could be executed within 48 hours.

That is a tall order. Filling it is the objective of resolution plans and firm-specific cooperation agreements.

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