European Union

A transitional phase for bail-ins

■ **Bail-ins, which have been applicable in the European Union since 1 January 2016 under the Bank Recovery and Resolution Directive (BRRD), are designed so that shareholders and certain categories of creditors are the first to bear the losses of a troubled bank rather than member states.**

■ **The 19 July 2016 ruling by the Court of Justice of the European Union (CJEU) concurs that exemptions are possible "when implementing such measures would risk endangering financial stability or lead to disproportionate results".**

■ **It is worth keeping the scope of this ruling in perspective. The upcoming finalisation of MREL (*Minimum Requirement for own funds and eligible liabilities*) and the adjustment of bank liabilities to comply with this new requirement should gradually limit the impact of bail-ins on financial stability and make any exemptions extremely rare.**

The purpose of bail-ins

The bail-in is one of four resolution tools – along with selling or merging business with another bank, setting up a temporary bridge bank, and separating good assets from bad ones – which were introduced by directive 2014/50, the so-called Bank Recovery and Resolution Directive (BRRD) adopted in 2014. National laws transposing the bail-in measures have been in effect since 1 January 2016. They are designed to limit the impact of bankruptcies on public finances while ensuring the preservation of the critical functions of the ailing bank, the failure of which could endanger financial stability, notably in the case of systemically important banks.

When the resolution authority activates a bail-in procedure, bank losses are first absorbed by equity capital. At the discretion of the resolution authorities, junior and senior liabilities – known as bail-inables – will then be converted into equity capital or written off. These liabilities can be ranked by order of loss absorption as follows: core equity tier 1 (CET1), additional Tier 1 equity capital, Tier 2 equity, other subordinated debt, and lastly, other liabilities eligible for bail-ins. This is the order that would prevail in normal insolvency procedures, except for exemptions. Certain liabilities are excluded from the bail-in's scope of application. These include the share of customer deposits covered by deposit insurance schemes (i.e. up to EUR100,000 in the European Union), covered bonds, and interbank loans with an initial maturity of less than 7 days. Lastly, the non - guaranteed share of individual and SME deposits (above EUR100,000) is given preferential status and is ranked higher than ordinary, non-guaranteed, non-preferential debt (such as bonds).

■ Cumulated losses during the financial crisis (2007-2013)

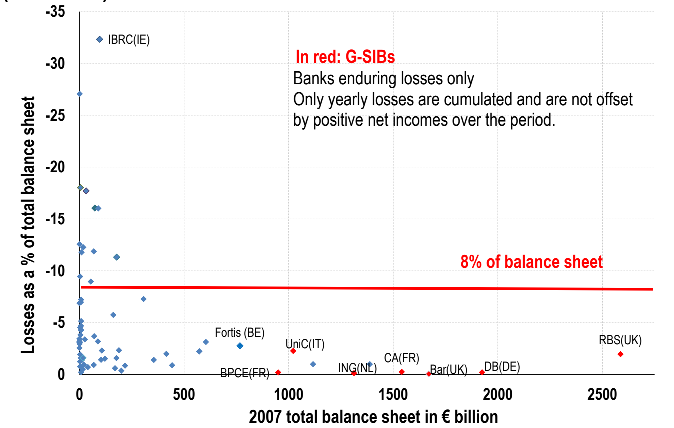

Chart 1 Sources: Bankscope and banks'financial reports, BNP PARIBAS calculations

The principle: bail-ins must cover 8% of the shortfall before any public aid can be given

The absorption of losses through equity capital and bail-inables must cover at least 8% of the bank's shortfall before there can be any state aid. Optionally, resolution funds supplied by the banking sector could provide an extra layer of protection by recapitalising up to a maximum 5% of the ailing bank. The state and the European Stability Mechanism (ESM) can only intervene once the shortfall exceeds the 8% threshold, or 13% in cases when resolution funds are used up to the authorised limit.

These thresholds largely exceed the bank losses observed during the financial crisis. As ECB Vice-President Vítor Constâncio pointed out in a recent lecture[1], the 8% threshold seems to be very high with respect to the losses reported by the banks during the financial crisis. The average shortfall was slightly less than 3%. Similarly, during the Scandinavian financial crisis of the 1990s, the banks reported much smaller losses than the 8% threshold. According to our calculations (see chart), between 2007 and 2013 none of the European banks with assets of more than EUR250 billion were hit by losses exceeding the 8% threshold. Consequently, under BRRD, the probability of resorting to resolution funds, or if needed, to public recapitalisation programmes (national or European) seems to be extremely small.

Austria: the first example of a bail-in

The first application of the European bail-in system occurred in Austria after BRRD was transposed into national law (BaSAG) in January 2015. The bail-in was applied to Heta Asset Resolution AG,

[1] Challenges for the European banking industry. Lecture by Vítor Constâncio, Vice-President of the ECB, at the Conference on "European Banking Industry: what's next?", organised by the University of Navarra, Madrid, 7 July 2016.

a bad bank created after the bankruptcy of Hypo Alpe Adria, which had a EUR7.5 billion shortfall in equity capital. The Austrian Financial Market Authority (FMA), which is also the resolution authority, announced on 10 April 2016 the full write down of Heta's subordinated debt (100%), a 54% write-down of preferred bail-inables (i.e. senior debt), and the postponement of payments on the remaining 46% until 31 December 2023. In addition, all interest payments were cancelled retroactively to 1 March 2015, the opening date of resolution.

Very rare exemptions

BRRD provides for some rare exemptions to the bail-in principle. In article 32.4.d, it allows for exceptions to the resolution principle and authorises "exceptional public financial support (…) to prevent or to remedy severe economic turmoil in a member state and to preserve financial stability (…)". In this case, implementation of state aid falls under the scope of the European Commission's Banking Communication published in 2013, which covers state aid to the financial sector and its compliance with the internal market. This communication states that any state aid is subordinate to the prior absorption of losses by shareholders and subordinated creditors (as long as the 8% threshold has not been reached, or to the contrary, would be surpassed). Even so, it allows for an exemption (which is already an exception to the principle defined by BRRD), "when the implementation of such measures risks endangering financial stability or leads to disproportionate results", as indicated by the CJEU in its 19 July 2016 ruling. In response to one of the preliminary questions asked by the Constitutional Court of Slovenia, CJEU validated the Commission's Communication and warned that the later should comply when examining State aid "or risk being subject to sanctions". In other words, under certain exceptional circumstances, member states conserve the power to waive the prerequisite for shareholders and subordinated creditors to absorb shortfalls, and *a fortiori*, to participate in bail-ins, but in this case they run the risk that the state aid might not be found "to comply with the internal market".

A foreseeable reduction in the scope of bail-in exemptions

The 19 July 2016 ruling opens the door to bail-in exemptions, but we think its importance must be kept in perspective for at least two reasons.

First, the CJEU's preliminary ruling pertains to state aid to five Slovenian banks in 2013, well before BRRD was adopted and implemented. Once BRRD has been transposed into national law, it seems probable that the court would be less inclined to accept these exemptions.

Second, some of the practical problems encountered when implementing bail-ins should be gradually cleared up. BRRD aims to protect taxpayers and certain categories of deposits, but its application creates a practical problem: the order in which losses are absorbed depends on the legal nature of the instrument and not the quality of the bear (in Italy, for example, individuals hold a big share of subordinated debt). Yet it could hardly be otherwise since it is hard to imagine that the risk associated with the ownership of the same instruments could vary depending on the type of owner. In this case, the formation of a mattress of bail-inable resources would provide an indispensable complement to a bail in, by delimiting it to certain instruments that could be easily identified by investors and savers, and by reassuring holders of non-guaranteed deposits, once the 8% threshold has been reached. It will be subject to Total Loss Absorbing Capacity (TLAC), which in 2019 will apply to the 30 systemic banks (G-SIBs) and to MREL, which will concern all banks in the European Union (and not only the G-SIB, which will also have to comply with TLAC).

Forewarned is forearmed

Yet, BRRD does not create an automatic link between the 8% threshold for absorbing losses under the framework of a bail in and the calibration of MREL. As part of the consultation published on 20 July, the EBA proposes that MREL would no longer be calculated based on the total balance sheet, but as a share of weighted assets, like TLAC, with a floor as a balance sheet total. Lastly, BRRD places non-guaranteed senior debt at the same rank as junior corporate deposits (excluding SME and banks). In national bankruptcy laws, the absence of any standardised measures concerning the hierarchy of creditors has led to the creation of specific national instruments. In France, for example, senior bank debt will be split into two categories under the Sapin 2 law[2]. The first "preferred" category will be comprised of unsecured debt issued before the law creating these new instruments. The second, which is subordinate to the first, will be comprised of new debt with an initial maturity of more than 1 year, whose contract must explicitly mention the new rank of reimbursement. The creation and issue of these new instruments will fall between senior and subordinate securities, making it possible for banks to comply more rapidly with TLAC and MREL requirements. This should also facilitate the application of bail-ins.

[2] Currently before the joint commission of the National Assembly and Senate in charge of finding a joint version for the two houses.