

## Information on bank resolutions and bail-ins

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

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

- the EU Bank Recovery and Resolution Directive ("**BRRD**"); and
- the Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (the "**SRM Regulation**").

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

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

*At what point in time might I be affected?*

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

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

*Who is the resolution authority?*

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

In Germany, the competent resolution authorities are the Single Resolution Board ("**SRB**") and the German Financial Markets Stabilisation Agency (Bundesanstalt für Finanzdienstleistungsaufsicht („**BaFin**“)). For reasons of simplicity, we will jointly refer to both authorities as "resolution authorities" below.

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

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

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

*What measures can the resolution authority take?*

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

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

with the objective of maximising their value until subsequent sale or liquidation. Similar to the sale of business tool, creditors will be dealing with a new borrower following transfer.

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

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

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

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

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

The following classes are distinguished for the liability cascade of a bank domiciled in Germany:

- (1) Firstly, resolution actions affect **common equity tier 1 capital**, and hence, the bank's shareholders.
- (2) In a next step, creditors of **additional tier 1 capital** (holders of unsecured, perpetual subordinated debt, or of silent partnership contributions subject to conversion or write-down provisions, which are subordinated to tier 2 instruments) will be drawn upon,
- (3) followed by **tier 2 capital**. this affects creditors of subordinated liabilities (such as subordinated loans).
- (4) The next level within the liability cascade involves **unsecured subordinated financial instruments and claims**, which are not eligible as additional tier 1 capital or tier 2 capital.
- (5) This is followed in the liability cascade by unsecured non-subordinated financial instruments<sup>1</sup>. A debt instrument will fall into this category only if it
  - was issued prior to 21 July 2018 and is neither a structured product nor a money market instrument.

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<sup>1</sup> Debt instruments include bearer bonds, negotiable registered bonds and comparable obligations, that of a kind that is tradable on the capital markets; as well as registered bonds and promissory notes, provided they are not classified as deposits under category (6) or excluded from bail-in.

- has been issued since 21 July 2018, has by its terms a maturity of at least one year, is not a structured product, and the terms and conditions (and the prospectus, if required to be published) expressly indicate that the liabilities rank lower than category (6) below.

Liabilities in this category are also referred to as ‘**senior non-preferred liabilities.**’

- (6) The next category includes other unsecured, non-subordinated liabilities, such as:
- Debt instruments that do not fall into category (5), for example debt instruments that have been issued since 21 July 2018 and that do not include an expressly refer to ranking lower than this category (6).
  - Structured financial instruments and liabilities (e.g. equity index certificates) or liabilities from derivatives. In these cases, the amount of interest or principal depends on an uncertain future event or the transaction is settled on a basis other than cash.

In addition, deposits by corporates exceeding EUR100,000 are included in this category, unless they fall in category (7). Liabilities in this category are sometimes referred to as ‘senior preferred deposits’.

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

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

Liability cascade (simplified display)

**(1) Common equity tier 1 capital**

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

**(2) Additional tier 1 (AT1) capital**

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

**(3) Tier 2 capital (T2)**

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

**(4) Unsecured subordinated financial instruments/claims**

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

**(5) Other unsecured financial instruments/claims ('senior non-preferred')**

- If issued since 21 July 2018, that expressly indicate that the debt instruments rank lower than category (6)
- Maturity  $\geq$  1 year

**(6) Other unsecured non-subordinated liabilities ('senior preferred')**

- Debt instruments not included in category (5)
- Structured financial instruments
- Derivatives
- Deposits of corporates that exceed €100,000 and do not fall in category (7) registered bonds, unless they are subject to preferential treatment as deposits (see below)

**(7) Other deposits**

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

Exempt from  
bail-in  
(not final)

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

**Asset-backed liabilities**

(e.g. covered bonds, Pfandbriefe)

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

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

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

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

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

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

*Disclosure pursuant to Article 41 (4) of the Commission Delegated Regulation (EU) 2017 / 565 of 25 April 2016*

Certain financial instruments issued by credit institutions and investment firms are used to ensure compliance with regulatory capital requirements pursuant to Regulation (EU) 575/2013, Directive 2013/36/EU and Directive 2014/59/EU. These include, in particular, common equity Tier 1 capital, additional Tier 1 capital and Tier 2 capital per categories (1) – (3), the subordinated liabilities described in category (4) and the senior non-preferred debt instruments described in category (5).

These instruments typically yield a higher return than bank deposits, but they are subject to greater default risk in the event of insolvency proceedings or the implementation of resolution measures, as they rank lower in the liability cascade and typically are not covered by deposit protection. In contrast bank deposits, these instruments are generally tradable in the secondary market but it may not be possible to find a buyer or seller in the secondary market (liquidity risk) and the market price may change to the detriment of the investor (market price risk).

Details of opportunities and risks can be found in the product documentation of the specific financial instrument.

*Where else can I find information?*

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

[https://www.bafin.de/EN/Aufsicht/BankenFinanzdienstleister/Massnahmen/SanierungAbwicklung/sanierung\\_abwicklung\\_node\\_en.html;jsessionid=D9318B7738F2FFA135BF67518499530A.1\\_cid390](https://www.bafin.de/EN/Aufsicht/BankenFinanzdienstleister/Massnahmen/SanierungAbwicklung/sanierung_abwicklung_node_en.html;jsessionid=D9318B7738F2FFA135BF67518499530A.1_cid390)