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Resolution and bail-in tools in capital markets

by Paula Gomes Freire, Benedita Aires and Inês Perez Sanchez, Vieira de Almeida & Associados – Sociedade de Advogados, R.L.

In 2012, even before the Cyprus bail-in, Portugal chose to follow the steps of other countries such as Germany, Netherlands, Ireland or the UK, and to become one of the pioneers in establishing a legal framework which allows for its banking supervisory authority (the Bank of Portugal) to apply resolution measures to large and systemically important banks, while paving the way for the future single resolution mechanism within the EU.

Considering the Financial Stability Board's *Key Attributes of Effective Resolution Regimes* endorsed by the G-20, the new framework was brought up as part of a pack of implementing measures aimed at broadening the range of legal instruments to which the Bank of Portugal could resort to in the eminence of a financial disruption by an ailing bank. Those measures have played a key role in equipping the Bank of Portugal with an agile and swift mechanism able to restore a financial institution in trouble.

The conceptualised legal framework

Past experiences had previously highlighted the importance of having in place mechanisms capable of effectively tackling financial distortions of big banks and the consequential contamination to the financial system. This increasing need led Portugal to implement the 2012 new strengthened framework characterised by a three-stage intervention by the Bank of Portugal.

The general framework is conceptualised in a way that allows banks to fail although in an orderly way, departing from the idea that the complexity and interconnection of the financial players in the financial markets would compromise *ab initio* the systemic risk shield. At the same time, by introducing the principle that private investors shall be the ones first bearing the losses, market discipline is introduced amongst financial players and the so-called moral hazard is tackled as a side effect. Throughout the financial crisis and, on the Portuguese front, after the nationalisation of *Banco Português de Negócios*, there was a generalised expectation within the banking sector that banks could almost blindly rely on public solvency support and that such would be available upon mere call.

The new framework aims at minimising the impacts of a bank failure, while assuring that governments and specially taxpayers are not to be called to contribute financially and be left to bear the losses. In a nutshell, the current legislation focuses now on how to save a bank while letting it orderly fail, without compromising its vital functions, protecting ultimately the depositors, the taxpayers and public monies from carrying such burden.

The Portuguese legal framework – resolution regime

In Portugal, the credit institutions resolution regime has been enacted by Decree-Law no. 31-A/2012, of February 10, 2014, as amended from time to time, which introduced changes into the general banking framework (RGICSF). In order to safeguard the financial strength of a credit institution, the new set of rules (set out in articles 139.º and *seq*. of RCIGSF) portrays a three-stage intervention regime that empowers the Bank of Portugal to decisively interfere in different moments and, accordingly, with different measures when rescuing a credit institution: these are grouped into corrective action (to be applied at an early stage), the determination of an interim administration and the application of resolution measures.

The measures available for the Bank of Portugal to adopt are channelled by general principles of adequacy, suitability and proportionality, although the Portuguese legal framework does not require the previous application of any such measure as preceding another.

Having said this, the adoption of a banking resolution measure is the ultimate, most serious and severe act the central bank can resort to and therefore shall be used when the application of any corrective or other measures is no longer possible or feasible to achieve the financial recovery of the credit institution. In particular, the RGICSF sets out that whenever a credit institution does not meet, or is at serious risk of not meeting the requirements its banking authorisation imposes or when it is not foreseeable that, in an appropriate time-frame, the institution will be able to take the necessary actions to return to adequate solvency conditions and to restore its regulatory compliance, the central bank shall apply a resolution measure to ensure any of the following objectives: continuity of essential financial services; preventing systemic risk; safeguarding public funds and taxpayers' interests; and safeguarding depositors' confidence.

In what concerns the alternative resolution measures available, the Portuguese framework outlines two routes: on the one hand, the total or partial sale of the relevant credit institution's business to another institution operating in the market and therefore authorised for such effect; and on the other hand, the transfer of the assets, liabilities, off-balance sheet items or assets under management to a bridge bank created for that sole purpose, in order to enable the onward sale to another institution authorised to carry on the activity in question within a given time-frame.

The application of any of the abovementioned resolution measures has to seek to ensure that the guiding principles concerning the allocation of losses and the treatment of shareholders and creditors are respected. Therefore, article 145.º B of RGICSF sets the loss bearing hierarchy as follows: shareholders of the credit institution under the resolution shall be the first bearing the losses; secondly, creditors of the credit institution under the resolution shall bear losses in accordance with the priority of their claims at set out by law, the creditors of the same class being required to be treated in an equitable manner; and thirdly, no creditor shall incur in a greater loss than that he would incur in case the credit institution would have been wound down under a normal Portuguese insolvency proceeding (no creditor worse off principle).

This latter principle is effectively a corner-stone in the framework given that the regime also foresees that creditors of the failing institution which have not been transferred to a another institution/bridge bank have the right to recover from the resolution fund an amount corresponding to the difference between what they have effectively received and what they would receive had the failing bank entered into liquidation prior to the application of the resolution measure – such hypothetical amount being determined by an independent assessment at the request of the central bank. Additionally, in the event of a bridge bank solution, upon the onward sale of the activity/bridge bank, any excess of the sale proceeds will be returned to the creditors or insolvency estate of the failing bank, therefore highlighting the equilibrium in the model. The mentioned resolution fund is the tool that has been established under the Portuguese framework to provide financial assistance to the resolution measures adopted by the central bank (being funded by contributions from the banking sector).

The new EU framework: The Bank Recovery and Resolution Directive and EU Regulation 806/2014

After a long period of consultation and negotiations, 2014 is a real benchmark for the kick-off of what truly is believed to be the set-up of a common EU-wide empowering framework for crisis prevention and crisis management – the Single Resolution Mechanism (hereinafter SRM). The new Bank Recovery and Resolution Directive (hereinafter BRRD) was formally adopted in May 2014, followed by the EU Regulation 806/2014 in July.

In a co-ordinated and effective manner, the set-up framework is designed to cater cross-border banking failures and stanch systemic risks that could spread out into the whole European financial sector as a result of the absence of adequate mechanisms to organise an orderly wind-down of a failing institution. At the same time, the mechanism is created in order to ensure that, as in any other business, the shareholders and creditors of an ailing institution shall accept the losses of their own failing institution and therefore if an institution is to be saved then it shall be saved in the first place from the inside-out – i.e., a bail-in should always precede an external bail out.

Moreover, the BRRD sets forth tools and procedures to address financial distortions and, as well as abovementioned for Portugal, divides its set of tools into three kinds of powers designated for such effect: powers of prevention; powers of early stage; and resolution powers. Resolution tools are to be conferred to Resolution authorities in each Member State which shall have the necessary powers to apply them, separately or in conjunction. These resolution tools consist in general terms in: the sale of business tool, the bridge institution tool, the asset separation tool and the bail-in tool.

Commonly acknowledged and not so well greeted, the bail-in tool is more a bail-in system than just a mere tool. It is defined by the directive as the mechanism allowing the exercise by a resolution authority of the write-down and conversion of certain liabilities of an institution under resolution. The recitals of such directive provide some guidance as to its application. It shall not be appropriate, for example, to apply the bail-in tool to claims in so far as they are secured, collateralised or otherwise guaranteed. However, in order to ensure that the bail-in tool is effective and achieves its objectives, it is desirable that it can be applied to as wide a range as possible of the unsecured liabilities of a failing institution and also it is appropriate to exclude certain kinds of unsecured liabilities from the scope of application of the bail-in tool. For example, under the Portuguese framework, article 145.ºH no. 3 sets out that instruments used for own funds purposes of the failing institution, such as subordinated bonds, may not be transferred to a bridge bank and therefore will be kept in the intervened bank, bearing the losses for the failing institution.

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On the other side of this procedure, the single resolution fund mechanism is a paramount piece to be in place as to ensure resolution tools work full aligned with the bail-in system, further reassuring the ultimately or non-recourse to sovereign monies. Each resolution authority from each participating state will have to set out a national compartment of the single resolution fund to which, all the financial players at a national level will have to contribute, according to *inter alia* their size. After a period of eight years these funds will start being pooled together and merged in the single resolution fund – the so-called mutualisation of funds. Funds collected are expected to have reached approximately 1% of the covered deposits of the banks in that country by 2025.

Impacts on the capital markets

As orderly and swift a resolution measure might be there are certainly inherent side effects its application would entail and that cannot be completely avoided, namely considering the urgency of application of such measures. Such could be the case of the triggering of the close-out netting in agreements in which additional termination events like a change of control were set out. To address this issue, one should highlight that article 145.ºI of RGICSF, following the BRRD, accommodates this matter by foreseeing that the application of any resolution measure by the Bank of Portugal determines the suspension – for a period of 48 hours – of the close-out rights enshrined in netting agreements of contracts to which the targeted institution is a party, if the basis for the exercise of that right is to be the resolution measure. Likewise, in what concerns the agreements sold or transferred, upon expiry of the 48 hours period previously mentioned, the close-out rights enshrined in netting agreements cannot be exercised by the credit institution's counterparties based on the application of such measure – which does not preclude any of the counterparties of invoking other motives.

Nevertheless, at an EU level, there are still unsolved questions that remain to be further clarified such as the question whether non-EU agreements are to be subject to this resolution measure. Moreover, if the conclusion is that they are not to be subject to such resolution measure, this could imply the amendment of all non-EU agreements by financial institutions, in order to at least introduce a clause indicating such instrument might be used in the future for bail-in purposes.

Another inherent impact relates to a given uncertainty on the assets and liabilities that have been transferred to a new institution or a bridge bank by the application of resolution measures, all of which have effects on investors' trust and confidence and on the financial markets sentiment as a whole, specifically considering that the resolution authorities have the power to retransfer some assets after the application of the resolution measures and further to having an independent valuation duly carried out.

In a nutshell, despite the deadline for transposition of the BRRD still being underway, this framework brings us to a new era in ensuring equilibrium in the soundness of credit institutions within the EU financial system and equipping supervisory authorities with the required tools to do so.

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