New tool for managing failing banks – bail-in

In June, Europe's finance ministers reached a broad political agreement on the proposed framework for dealing with failing banks[76]– the bank recovery and resolution directive. The directive's final wording is now being negotiated between the EU Council of Ministers[77] and the European Parliament. In short, the bank recovery and resolution directive shall contain provisions on plans and tools so that authorities can intervene when banks are encountering various stages of financial difficulties. In general, the Riksbank is supportive of clear rules for dealing with failing banks and of measures that will impose higher costs on the private sector than at present for doing so. The bank recovery and resolution directive is aimed at reducing the risk of financial instability and minimising the costs to society of dealing with distressed banks. Among other things, it shall provide authorities with a number of tools for resolving banks that are not deemed to be viable. This Box briefly describes one of these tools - the bail-in tool.[78]

During the financial crisis, the public sectors in several EU countries contributed public funds to support banks that were facing severe financial difficulties. This was to prevent the spread of the crisis, thereby mitigating the consequences for society. One purpose of the bank recovery and resolution directive is to provide governments with tools for dealing with distressed or failing banks without having to inject public funds. The bail-in tool is one of those tools.

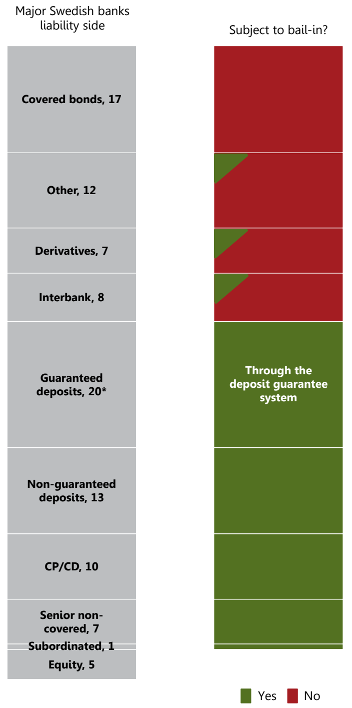
The bail-in tool provides a resolution authority[79] with the right to, in combination with other measures, write down a bank's liabilities to cover losses, or to convert the liabilities to share capital to recapitalise the bank, in order of priority as determined in advance. This means that the need for using public funds to recapitalise the bank can be postponed, reduced or completely avoided. The aim is for the bank's creditors, rather than the taxpayers, to contribute towards the recapitalisation of failing banks in the future. The aim is to recapitalise the bank quickly at the same time as all or parts of the bank's operations can continue to function.

The EU proposal

The proposed bank recovery and resolution directive describes which liabilities can be subject to bail-in (that is to say can be written down or converted to share capital). Furthermore, it includes a method for calculating a minimum requirement, the aim of which is to ensure that banks have sufficient capacity to handle losses in the event of failure and provisions specifying the circumstances under which

[76] The term banks refers to credit institutions and securities companies.
[77] Also known as the Council. It consists, in this case, of economic and finance ministers from the EU countries.
[78] The Swedish translation of the proposed bank recovery and resolution directive translates the term bail-in tool as debt writedown tool. However, the tool involves both the writedown of debts and the conversion of debt to share capital.
[79] Each country is to appoint such a resolution authority with responsibility for planning for financial crises.

Chart B4:1. Liabilities that can be subject to bail-in
Aggregate of the four major Swedish banks, percentage of total debt and equity, September 2013



Note. The illustration is based on the consolidated level, not institute level.

* The percentage of guaranteed deposits for all banks except SEB is an assumption based on calculations from Barclays.

Sources: Bank reports, Barclays research, Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms 11148/13 and the Riksbank

exceptions from using the bail-in tool may be made. These parts of the proposal are described below.

Liabilities that can be subject to bail-in

The basic idea is for all the banks' creditors to be able to contribute towards recapitalisation. However, it has not been considered appropriate to use the tool for all types of bank liabilities, as some of these may be too systemic or too complex for the tool to be applied. The proposed bank recovery and resolution directive means that debts against collateral (for example covered bonds and repos), interbank loans with maturities of less than seven days[80] and certain other liabilities such as debts to employees and suppliers are exempt from bail-in and are thus neither written down nor converted to share capital. The largest part of the derivative contracts on the liabilities side are also exempt[81] (see Chart B4:1 for an illustration of which instruments qualify for bail-in).

According to the proposed bank recovery and resolution directive, to absorb losses and recapitalise the bank, share capital should primarily be reduced or diluted[82] and only secondarily should the bail-in tool be applied, considering the above exceptions and in the following order:

1. Subordinated debt (for example convertibles).
2. Unsecured bonds, certificates and non-guaranteed deposits from large companies.[83]
3. Non-guaranteed deposits from small and medium-sized companies[84] and private individuals as well as liabilities to the European Investment Bank.
4. Guaranteed deposits (can be subject to bail-in through the deposit guarantee system).

As hitherto, guaranteed depositors will continue to be completely protected. In some areas, the new framework will even be an improvement for depositors as it means that a failing bank can continue to function and the depositors will thus continually have access to their deposits without the interruption that can currently arise in the event of a bankruptcy. In contrast, if all other instruments that are subject to bail-in have been written down or converted to shares, the deposit guarantee system may incur losses.

[80] Interbank loans with original maturities of less than seven days correspond to a large part of interbank loans. Liabilities with a remaining maturity of less than seven days that have arisen through participation in systems for the transfer of payments and securities are also exempt.
[81] This is because all netting agreements and pledged collateral will be taken into account, meaning that the derivative amount that can be subject to bail-in is significantly smaller than the amount visible on the banks' liabilities side under IFRS. Under IFRS, a number of criteria must be fulfilled for derivatives under a netting agreement to be netted on the balance sheet. The Riksbank's interpretation is that the proposed bank recovery and resolution directive does not set criteria resembling IFRS and that pledged assets will also be considered, meaning that a very small part of the derivatives presently existing in the major banks' balance sheets (the seven per cent in Chart B4:1) could be subject to bail-in.
[82] Primarily core Tier 1 capital. Other applicable capital instruments are then written down or converted before the bail-in tool is used.
[83] This category also includes the other liabilities not exempted, such as interbank loans with original maturities exceeding seven days.
[84] Microenterprises and small and medium-sized companies according to the definition in Article 2.1 in Recommendation 2003/361/EC.

Calculation of minimum requirement

There is a risk that banks could restructure their liabilities sides in a way that makes the bail-in tool ineffective, for example by only issuing liabilities that are exempt from bail-in. If such a bank then becomes distressed, there would not be enough liabilities to write down or convert to recapitalise the bank via the bail-in tool. Another example is that the banks could choose to obtain funding at short maturities. Investors in debt instruments with short maturities have a tendency to withdraw in times of financial stress and this could also lead to there not being enough liabilities left to write down or convert to recapitalise the bank when it is no longer deemed to be viable.

To counteract this risk and ensure that banks have sufficient capacity to cover losses in the event of failure, each member state is to ensure that its banks, at any point in time, retain enough capital and enough debt instruments with longer maturities that may be subject to bail-in. This will be regulated through a minimum requirement, a ratio, in which the banks must remain above a minimum permitted level. The proposed bank recovery and resolution directive includes a calculation method for this minimum requirement:

$$\frac{(\alpha + \beta + \gamma)}{(\delta + \alpha) - \theta} \geq x$$

Where:

$\alpha = Own\ funds$

$\beta = Unsecured\ liabilities\ with\ a\ remaining\ maturity > 1\ year$

$\gamma = Deposits\ from\ large\ companies$[85]

$\delta = Total\ liabilities$

$\theta = Derivative\ liabilities$

The variable x in the above ratio thus denotes the minimum requirement. The proposal sets no uniform minimum levels for x at the EU level. Instead, this is left up to the national resolution authorities, in consultation with the supervisory authorities. The level shall be determined on a bank-by-bank basis.

Exemptions from bail-in

During negotiations on the bank recovery and resolution directive, it has been argued that bail-in is a relatively untested tool that may possibly be unusable in a systemic crisis due to the risk of contagion effects. An exception has therefore been included in the proposed bank recovery and resolution directive, saying that, under exceptional circumstances, authorities may use alternative solutions, such as recapitalisation of a bank using government funds. However, this may not be done until the European Commission[86] has granted its

[85] Deposits from companies that are not defined as microenterprises or small and medium-sized companies according to the definition in Article 2.1 in Recommendation 2003/361/EC.

[86] The European Commission's task is to propose new laws and monitor member states' compliance with EU legislation.

approval and liabilities and own funds equivalent to at least eight per cent of the bank's total liabilities and own funds or 20 per cent of its risk-weighted assets have been written down or converted to shares.[87] Swedish authorities may use the second alternative, that is to say 20 per cent of the risk-weighted assets.[88]

Possible consequences and timetable

The introduction of the bail-in tool may lead to it becoming more expensive for banks to fund themselves using unsecured debt instruments, but the effect on total funding costs is harder to assess.

The explicit target is for the EU Council of Ministers and the European Parliament to have reached agreement on the bank recovery and resolution directive before the end of 2013. It should also be mentioned that the bail-in tool differs from other resolution tools as regards the timetable for its entry into force. In order to give investors in debt instruments that will be subject to bail-in time to adapt, the current proposal has determined that the tool does not need to be applied until, at the latest, four years after the directive has entered into force. Other parts of the directive should start to be applied as soon as one year after.

[87] In such a situation, the government may contribute capital equivalent to no more than five per cent of the bank's liabilities and own funds.

[88] This is because Sweden has a resolution fund exceeding three per cent of guaranteed deposits. There is no corresponding flexibility for euro area countries with access to the European Stability Mechanism (ESM) or for banks with balance sheets exceeding EUR 900 billion. At present, no country other than Sweden has investments in funds that exceed three per cent of guaranteed deposits. However, in the future, non-euro area countries that have built up their funds may also make use of the 20 per cent of risk-weighted assets alternative.

Glossary

Balance sheet recession A balance sheet recession can arise when a financial crisis has been preceded by a sharp and loan-financed increase in prices on an asset market. The unemployment and the uncertainty about future developments that arises as a result of the crisis may lead households and companies to choose to restore their balance sheets, that is to substantially reduce their debts when the asset concerned falls in value. Consequently, most of their income for some time after the crisis will be used for amortisation rather than consumption and investment, which will further aggravate the crisis.

Basel II: International regulatory framework for financial institutions that mainly regulates banks' capital adequacy, that is how much capital a bank must hold in relation to the risk it takes. The regulations also stipulate requirements concerning the banks' risk management and the disclosure of public information. Basel II was implemented in Sweden in 2007.

Basel III: International regulations for financial institutions that replace the Basel II regulations on the banks' capital adequacy. Compared to Basel II, Basel III entails increased capital requirements and regulations on capital buffers. Basel III also regulates the bank's liquidity management. The Basel III Accord will be progressively phased in by 2019.

Capital conservation buffer: A requirement for a capital buffer consisting of Common Equity Tier 1. If the buffer is not complete, the bank must retain a portion of its profit to improve its capital ratio. The buffer requirement must be fully implemented by January 2019.

Capital market: Generic term for the stock market, credit market and derivatives market.

CDS, **Credit Default Swap:** A contract between agents on the credit market aimed at transferring the credit risk of an asset, such as a bond, from one agent to another. The buyer of a CDS contract buys credit protection from the seller of the CDS contract by paying a premium over the contract's duration or until a credit event occurs. If a credit event occurs, the buyer transfers the insured asset to the seller in exchange for the nominal value of the asset.

CDS premium: Annual cost in basis points for buying a CDS contract.

Certificate: A security for trading in the money market, issued for example by a bank or a company with the purpose of borrowing money. Maturity is a maximum of one year.

CET 1, Common Equity Tier 1 Capital: Stricter version of the core Tier 1 capital, in accordance with the Basel III Accord.

Core Tier 1 capital: Tier 1 capital with deduction for capital contributions and reserves that might be included in the capital base as Tier 1 capital pursuant to Chapter 3, Article 4 of the Capital Adequacy and Large Exposures (Credit Institutions and Securities Companies) Act (2006:1371).

Core Tier 1 capital ratio: Core Tier 1 capital in relation to risk-weighted assets.

Covered bond: A bond whose holder has a special benefit right in the event of a bankruptcy. Covered bonds normally entail a lower credit risk than unsecured bonds, which means that the borrowing costs are lower.

Credit gap: The deviation from the trend in lending by monetary financial institutions to companies and households in relation to GDP.

Credit risk: The risk of borrowers failing to meet their commitments.

Credit terms: The terms and conditions laid down in a loan agreement covering, for example, the interest rate and the repayment schedule. Credit terms can also include the maximum loan-to-value ratio allowed for a mortgage.

CRR/CRDIV, **Capital Requirements Regulation/Capital Requirements Directive IV:** Proposed EU regulation with directives that implement the Basel III Accord. The regulations include stipulations on the banks' capital adequacy, leverage and liquidity.

Currency swap: An agreement to buy or sell a currency at the daily rate and then sell or buy back the same currency on a later date at a pre-determined rate.

Debt ratio: Total household debt in relation to disposable income.

Default rate: The number of bankruptcies divided by the number of companies.

Disposable income: The total of a person's or a household's incomes less taxes and charges.

Earnings: Profits before loan losses.

EBA, **European Banking Authority:** The European Banking Authority establishes joint regulatory and supervisory standards in the EU and conducts stress tests of European banks.

ESM, **European Stability Mechanism:** A permanent international financial institution founded by the euro-area countries to safeguard stability in the euro area. The ESM will replace the earlier crisis management funds such as the EFSF.

ESRB, **European Systemic Risk Board:** The European Systemic Risk Board is responsible for the macroprudential supervision of the financial system within the EU.

Gross margin on mortgage: Difference between a credit institution's lending rate and the cost of borrowing for a mortgage in relation to the amount lent.

Gross solvency: This measure specifies the banks' equity in relation to their total assets less reverse repos, derivatives and insurance assets.

Impaired loans: Loans which will probably not be repaid in accordance with the terms of the loan contract. Impaired loans are listed on the balance sheet at their full amount, even if only parts of the loans are covered by collateral.

Interbank market: Financial market where banks trade interest and currencies with each other.

Key policy rate: Interest rate that a central bank sets for monetary policy purposes. In Sweden, they are the repo rate and the deposit and lending rates to the banking system. The repo rate is the Riksbank's most important policy rate.

LCR, **Liquidity Coverage Ratio:** Liquidity measurement defined by the Basel Committee that measures a bank’s ability to deal with a stressed net outflow of liquidity for 30 days. In simple terms, an LCR of 100 per cent means that a bank’s liquidity reserves are adequate to enable the bank to manage an unexpected liquidity outflow for 30 days.

Liquidity: Measure of the ability of a company or organisation to meet its payment obligations in the short term. Can also describe how quickly it is possible to convert an asset into money.

Liquidity buffer: Funds an institution holds to ensure its short-term debt-servicing ability.

Liquidity risk: The risk of not being able to meet payment commitments due to a lack of liquidity. Liquidity risk in a financial instrument means that an investment cannot be immediately liquidated at all or without falling sharply in value.

Liquidity assistance: Measures that a central bank may take to support the ability of one or more financial institutions to meet payment obligations in the short term with the purpose of avoiding a serious disruption in the financial system and strengthening confidence in the payment mechanism.

Loan-to-value ratio: A borrower’s debt in relation to the market value of the collateral for the loan. For example, a household’s loan-to-value ratio for its home corresponds to the household’s debt collateralised by the home divided by the market value of the home.

Mortgage cap: Finansinspektionen’s general guideline for a maximum loan-to-value ratio of 85 per cent of a property’s value. It only applies to new loans.

Mortgaged assets: Assets to which certain owners of receivables have priority if the borrower should be unable to repay the debt.

Net interest income: Interest income from lending less interest expenditure for funding and deposits.

Net commission income: Income less cost of financial services sold (apart from interest), for example services related to payments, share trading, asset management and card operations.

NSFR, **Net Stable Funding Ratio:** Liquidity measurement defined by the Basel Committee. The measurement puts a bank’s stable funding in relation to its illiquid assets in a stress scenario that covers a period of one year.

Pillar 2: The basic capital requirement (Pillar 1) stipulates that a bank, at any one point in time, shall have a minimum capital base equal to the sum of the capital requirements for credit risks, market risks and operational risks. In addition, the capital base shall also cover the capital requirement for additional identified risks not captured in Pillar 1, so-called supervisory review and evaluation process (Pillar 2). Pillar 2 is an individual capital requirement that varies between different banks. For Swedish banks, the Pillar 2 requirement is determined by Finansinspektionen. While the Pillar 1 requirement is public and affects the risk-weighted assets, the Pillar 2 add-on is not public as yet and does not affect the banks' risk-weighted assets.

Provisions: Provisions for probable loan losses.

Risk premium: The additional return an investor requires as compensation for an additional risk.

Risk weight: In simplified terms, to calculate a bank’s risk-weighted assets, the amount lent is multiplied by a risk weight. The risk weights are determined on the basis of how likely it is that the borrower will be unable to fulfil its loan commitment and thus varies from borrower to borrower – a high risk weight implies a greater risk than a low risk weight.

Risk-weighted assets: Assets recorded in the balance sheet and off-balance sheet commitments valued by credit, market and operational risk in accordance with the capital adequacy regulations (see Basel II and Basel III).

Reversals: Previous quarters' provisions for probable loan losses that are reversed.

Securitisation: A financing process whereby a number of loans (for example mortgages or credit card loans) are bundled together and sold on to a company created specifically for the purpose and financed by issuing securities in the market.

Stibor: Stockholm interbank rate.

Tier 1 capital: Equity less proposed dividends, deferred tax assets and intangible assets such as goodwill. Certain types of subordinated debt, so-called additional Tier 1 capital or hybrid capital, are also allowed to be included in Tier 1 capital.

Unsecured bonds: A bond whose holder does not have a special benefit right in the event of a bankruptcy. Unsecured bonds normally entail a higher credit risk than covered bonds, which means that the borrowing costs are higher.