



Obligation of investment service providers to inform their customers on the resolution procedure under the European Bank Recovery and Resolution Directive, BRRD¹ [ESMA²/2016/902]

As a reaction to experience made during the financial crisis in 2008, many countries adopted rules designed to resolve a bank at risk of default without involving taxpayers in the future. As a result shareholders and creditors of banks under resolution may have to participate in the losses of those banks. The objective is to ensure the resolution of a bank without the use of public funds.

To achieve this, the European Union adopted the following legislation:

- the Bank Recovery and Resolution Directive (“BRRD”) and
- a 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 (“SRM Regulation”).

The BRRD requires each EU member state to establish a national resolution authority with certain rights for the recovery and resolution of credit institutions. These measures may have a negative impact on banks’ shareholders and creditors.

The details of the measures the resolution authorities may take on a national level may differ. Below, we explain possible resolution measures that may be applied Germany as an example. Resolution procedures in other countries, in particular outside Europe, may deviate and be more incisive.

In which case will I be affected?

You may be affected as a shareholder or creditor of a bank if you hold financial instruments issued by the bank (e.g. shares, bonds or certificates) or have claims against the bank as a contracting party (e.g. transactions subject to a master agreement for financial derivatives transactions).

Securities, held in a custody account and not issued by the custodian bank, are not subject to a resolution measure against this bank. In the case of the resolution of a custodian bank, your proprietary rights in these financial instruments booked in the securities account remain unaffected.

Who is the resolution authority?

In order to ensure a controlled resolution in the event of a crisis, resolution authorities have been established. Under certain resolution conditions, the resolution authority responsible for the affected bank has the power to order resolution measures.

The Single Resolution Board (“SRB”) and the German Federal Agency for Financial Market Stabilisation (“FMSA”) are the responsible resolution authorities in Germany. For ease of reference, we will not differentiate between the SRB and the FMSA in the following.

When will bank resolution and bail-in occur?

The resolution authority may order certain resolution measures in the event of the following resolution conditions:

¹ Bank Recovery and Resolution Directive

² European Securities and Markets Authority

- The affected bank's existence is endangered. This assessment is made in accordance with legal requirements and applies if the bank no longer complies with the legal requirements for obtaining authorization for the taking up of the business of credit institutions due to losses suffered.
- There is no prospect of preventing the bank's default with alternative measures in the private sector or other measures from the resolution authorities.
- The measure is required in the public interest, i.e. necessary and proportionate, and liquidation in regular insolvency proceedings is no viable alternative.

Which measures may the resolution authority take?

If all resolution conditions are met, the resolution authority can adopt – prior to insolvency – comprehensive resolution measures that may have a negative effect on the bank's shareholders and creditors:

- The **bail-in tool**: The resolution authority may, as a whole or in parts, write down and/or convert into common equity (stocks or other company shares) certain financial instruments or liabilities of the bank in order to stabilize the bank.
- The **sale of business tool**: The resolution authority may transfer shares, assets, rights or liabilities of the failing institution as a whole or in parts to a third party. To the extent shareholders and creditors are affected. To the extent shareholders and creditors are affected by the sale of business, their new counterparty will be another existing institution.
- The **bridge institution tool**: The resolution authority may transfer shares in the bank or parts or the whole of the bank's assets or liabilities to a so-called bridge institution. This may affect the bank's capability to meet its payment and delivery obligations vis-a-vis the creditors and it may reduce the value of shares in the bank.
- The **asset separation tool**: Assets, rights or liabilities are transferred to an asset management vehicle. Assets are to be managed with the objective of maximizing their value until their future sale or liquidation. Similar to the sale of business tool, the creditor will have to deal with a new debtor after the transfer.

The resolution authority may amend the terms and conditions of financial instruments issued by the bank by means of an official order as well as existing receivables, for example due to a change in the maturity date or the interest rates at the expense of the creditor. Furthermore, payment and delivery obligations may be modified so that they can be temporarily suspended. Termination and other contractual rights that arise for creditors from financial instruments or liabilities may also be temporarily suspended.

In which case does bail-in affect me as a creditor?

Whether you as a creditor are affected by the bail-in resolution tool depends on the scope of the ordered measure and on the category your financial instrument or liability can be allocated to. Within the scope of bail-in, financial instruments and liabilities are distinguished in different categories depending on a legal order of priorities in terms of liability (so-called liability cascade).

For the shareholders and creditors involved in the respective categories, the following principles apply: Only if a category of liabilities has been used completely and this is insufficient to compensate for losses in order to stabilize the bank, the following category in the liability cascade may be written down or converted.

Certain types of financial instruments and liabilities are legally exempted from bail-in. These include deposits of up to EUR 100,000 covered by the statutory deposit protection scheme and secured liabilities (e.g. covered bonds). Liabilities subject to bail-in are also referred to as **eligible liabilities**.

In the **liability cascade** of a bank located in Germany the following categories have to be distinguished as from January 1 2017:

- 1) The resolution measures first apply to the Common Equity Tier 1 capital and thus the bank's shareholders (owners of stocks and other company shares).
- 2) Then, creditors of Additional Tier 1 capital are involved (owners of unsecured perpetual subordinated bonds and silent partnerships that may be written down or converted and are subordinated to Tier 2 capital).

- 3) This is followed by Tier 2 capital. This applies to creditors of subordinated liabilities (e.g. owners of subordinated loans).
- 4) In the liability cascade, unsecured subordinated financial instruments/liabilities that do not meet the Additional Tier 1 capital or Tier 2 capital requirements are the next to be used.
- 5) These are followed by unsecured unsubordinated financial instruments and liabilities (“other unsecured financial instruments/liabilities”).

- (a) These include **non-structured financial instruments/liabilities** such as
 - non-structured bearer bonds [Inhaberschuldverschreibungen], order bonds [Orderschuldverschreibungen] and comparable rights tradable on the capital market, and
 - registered bonds [Namenschuldverschreibungen], promissory note loans [Schuldscheindarlehen] unless covered by category (6) as deposits or exempted from bail-in.

These also include financial instruments and liabilities where the amount of interest payment exclusively depends on a fixed or variable reference interest rate.

- (b) This group also includes liabilities in the form of structured, unsecured, unsubordinated financial instruments and liabilities (“**structured financial instruments/liabilities**”). In this category, structured financial instruments/liabilities are only used if non-structured financial instruments/liabilities are insufficient to compensate for losses in order to stabilize the bank. For structured financial instruments and liabilities (e.g. certificates on stock indices or liabilities from derivatives), the amount of repayment or interest payment depends on an uncertain future event or settlement is effected in ways other than monetary payment. Furthermore, this also includes deposits above EUR 100,000 from companies that are not part of category (6).

- 6) Finally, deposits held by natural persons, micro-enterprises or small and medium size enterprises may also be used if they exceed the statutory deposit protection scheme of generally EUR 100,000 (“**other deposits**”).

Not covered by the bail-in (non-exhaustive list):

- Deposits pursuant to the statutory deposit protection scheme up to strictly EUR 100,000
- Secured liabilities (e.g. covered bonds)

Which consequences may the resolution measures have for me as a creditor?

If the resolution authority orders or takes a measure following these rules, creditors are not permitted to terminate the financial instruments and liabilities based on this measure alone or claim any other contractual rights. This applies as long as the bank complies with its substantive contractual obligations from the terms and conditions of financial instruments and liabilities, including payment and delivery obligations.

If the resolution authority takes the measures described above, a total loss of affected shareholders' and creditors' investment is possible. Shareholders and creditors of financial instruments and liabilities may therefore completely lose the price paid for the purchase of financial instruments and liabilities plus other costs related to the purchase.

The very possibility of resolution measures to be ordered alone may complicate the sale of a financial instrument or a liability on the secondary market. This could mean that the shareholder and creditor can only sell the financial instrument or liability at a considerable discount. Even with existing repurchase obligations from the issuing bank, there is the risk of a significant discount in the event of a sale of such financial instrument.

In the event of bank resolution, shareholders and creditors are not to be placed in a less favorable position than in normal insolvency proceedings affecting the bank.

If resolution measures nonetheless lead to a situation where a shareholder or creditor is placed in a worse position than would have been the case in the bank's normal insolvency proceedings, the shareholder or creditor is entitled to compensation from the fund established for resolution purposes (restructuring fund or Single Resolution Fund, “SRF”). If there is entitlement to compensation from the SRF, there is the risk that payments arising from this may be made significantly later than would have been the case if the bank properly complied with the contractual obligations.

Where can I get more information?

The German Federal Financial Supervisory Authority (“BaFin”), the FMSA and the German Bundesbank published information on the recovery and resolution rules applicable in Germany. Details are available at:

https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2016/fa_haftungskaskade_bankenabwicklung.html

The FMSA, the BaFin and the Bundesbank published a joint interpretation guide that contains further references as to how money market instruments can be determined and which debt instruments are part of category (5)(a) or (5)(b) as structured or non-structured financial instruments/liabilities:

https://www.fmsa.de/de/oeffentlichkeit/b_bankenabwicklung/Auslegungshilfe/Auslegungshilfe.html

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