Obstacles and potential solutions relating to bail-in of junior bank debt instruments

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Transition Period 2015

- The BRRD applies from 01/01/2015, except for the mandatory liability management (‘bail-in’) tool, which applies from 01/01/2016 at the latest;
- Within resolution, capital instruments (CET1, AT1 & T2) are automatically converted/written down in line with BRRD, while other junior debt might be converted/written down in line with State aid rules, if there is still a capital shortfall;
- In the specific case of precautionary recapitalisations (public support outside resolution), any potential burden-sharing is subject to State aid rules;
- In practical terms this means that, in the year 2015, a partially applicable BRRD is complemented by State aid rules and national provisions on bail-in.

Empirical Approach

- Ca 30 interviews with regulators, bank resolution planners, bank treasurers, bank and independent lawyers, business consultants, rating agencies, investment banks and advisors.

- A number of larger investors (fund managers, insurance companies) were contacted but were found to be generally unresponsive.

- On the official side, the expert met considerable reluctance to discuss implementation issues (of which many are pending, esp. Italy) in much depth and a general refusal to discuss individual bank cases.

Obstacles Summary

- Small number of 'hard' remaining obstacles to junior debt bail-in:
    - legacy instruments regarding adverse contractual language, regarding cross-border recognition of RA powers and generally regarding barriers to the bail-in of Tier 2 and higher ranking junior debt instruments.
    - concentrated in the (explicit) mandatory liability management R&R tool, whereas implicit mandatory liability management through the Good Bank approach seems to be universally enabled (in the case countries, limitations in Italy).
    - inside mandatory liability management, share conversion faces institutional and tax obstacles that may survive full BRRD implementation.
    - an impaired asset management approach fully consistent with both BRRD State Aid rules is still sought for.
    - among the three case countries selected Italy during 2015 will be most at risk in facing hard bail-in obstacles.

- Large number of potential 'soft' legal challenges
    - Including new style instruments, depending on instrument configuration.
    - R&R methods refinement requires developing a European Resolution Handbook.

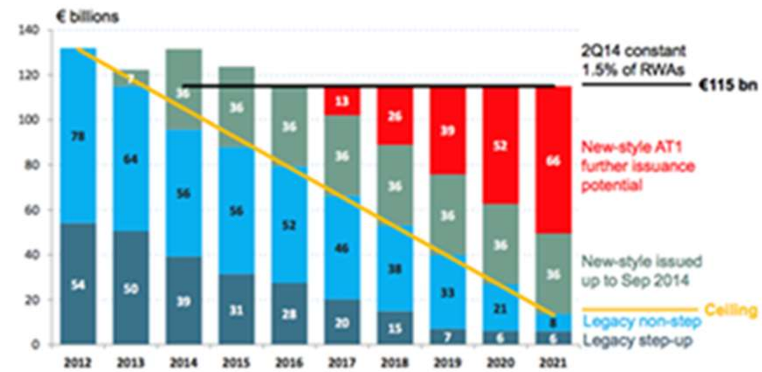
Identified Obstacles and Challenges

Junior Debt Instruments

Legacy vs. New Style Instruments, legal ....and market relevance

Features	Additional Tier 1	Tier 2
Trigger event	Objective pre-specified trigger point (CoCo) Point of non-viability (regulator)	Point of non-viability (regulator)
Trigger level	At least 5.125% of CET1	
Subordinated to	Tier 2 and unsecured creditors	Unsecured creditors
Maturity	Perpetual	Term, at least 5 years
Callability	After a minimum of 5 years	
Coupon	Full discretion by issuer at all times	
Other criteria	No step-ups or other incentives to redeem	No step-ups or other incentives to redeem No acceleration right outside insolvency

European AT1: Legacy Run-off Versus New Supply



- Totals for 25 banks modelled, with €7.7 tn aggregate RWAs
- Estimating €15 tn RWAs for the whole system implies issuance potential ~ €200 bn

Source: CreditSights

Identified Obstacles and Challenges
Legacy Junior Debt Instruments

- Opacity of information
  - Pillar 3 information scarce. Investors and RAs have difficulty to benchmark, identify ranks.
  - Only one bank identified that listed all junior debt instruments, characteristics, classifications and regulatory treatment.
- General RA bail-in powers
  - Contractual features can be overridden in France and Germany, according to RA, not Italy (2015).
  - Interviewed banks are highly sceptical. “Better not to try”. Bond indentures may interpret RA action as default.
- Issuance vehicle construction
  - Historically, offshore SPV with collateralization. German regulator refuses to comment. French regulator rules this out (all legacy deals had to be pre-approved).
- Guarantees
  - Expiring state guarantees in Austria and Germany. The extent regarding junior debt is unclear.
  - Promotional lending banks have reinforced maintenance guarantees (Anstaltslast) recently in order to gain zero risk-weight. Interviewed expert: ‘not bailinable’

Identified Obstacles and Challenges
Legacy Junior Debt Instruments

- Critical contractual features of Tier 1 instruments
  - Capital measures are tied to GAAP, PONV however is likely tied to IFRS (affects e.g. partial write-down);
  - Write-down / conversion language, e.g. write-downs only on certain dates;
  - Mandatory write-up language (e.g. German bank HSH Nordbank);
  - Coupon policy language (dividend stoppers, coupon pushers);
  - Call incentive, lead to implicit seniority.
- Critical contractual features of Tier 2 instruments
  - Acceleration at low capital levels;
  - RA intervention might establish acceleration event.
- Ranking and classification issues
  - F regulator: difficulty to identify rank. Min quorum of identified ranks needed (90%) for a bail-in. F regulations require contractually bailinable instruments to be bailed in before other instruments, mismatch with PONV equal treatment.
- Character of the investor base and investor regulations
  - Sales to retail, esp. in France, Germany. Case DZ Bank.
  - Legacy instruments mispriced vs. new style instruments, if considering PONV bail-in options.

Potential Solutions
Legacy Instruments

- Greater Pillar 3 transparency over legacy instrument features, classifications and ranks. Ideally ordinal ranking instrument by instrument.
- Contractual amendments or exchanges:
  - A keep-it-safe strategy would facilitate contractual amendments or exchanges into new style instruments compliant with CRD/R.
  - Contractual amendments could focus on PONV resolution clauses only, including however cross-border recognition of RA powers. Updates of bond indentures are routinely undertaken by issuers.
  - A contractual amendment strategy is particularly relevant for banks under TLAC rules that will likely extend old instruments.
- Debt exchanges against new style instruments where material clauses stand in the way of recapitalization, in particular mandatory write-up clauses in Tier 1.
  - Lenders under State Aid coupon payment prohibition should be enabled to undertake debt exchanges and reassume coupon payments under certain conditions.
- Instruments with strong legal bail-in impediments, such as guarantees or collateralization, should be derecognized faster and/or exchanged.

Identified Obstacles and Challenges

New Style Junior Debt Instruments

- Legal configuration and product optionality
  - AT1 design is largely undefined via EBA requirements, i.e. at the discretion of the issuer regarding coupon and principal write-down, permanent vs. transitory features.
  - Capital level determination: relative instrument rank changes between trigger level and PONV (pari passu with legacy junior debt). Deep subordination instruments = insurance contracts with perverse incentives for issuers.
  - Coupon cancellation risk: absence of dividend stoppers & coupon pushers (short of mandatory requirement) leads to subordination. Some lenders try to address through language, more typical is compensation through short non-call periods and low triggers.
  - Call and roll-over risk: 5 years is too short! See Spanish example.
- Character of the investor base and investor regulations
  - Priced over PD of the bank only, as LGD almost impossible to price →trend towards temporary write-down products (temporary share conversion is not enabled legally!)
  - Market started with deeply subordinated issues, since mid-2014 first signs of an investor strike.
  - Ban for retail in Spain, UK, likely going forward Italy. France, Germany?
  - Severe limitations for institutions? ESMA warnings.

Identified Obstacles and Challenges

New Style Instruments

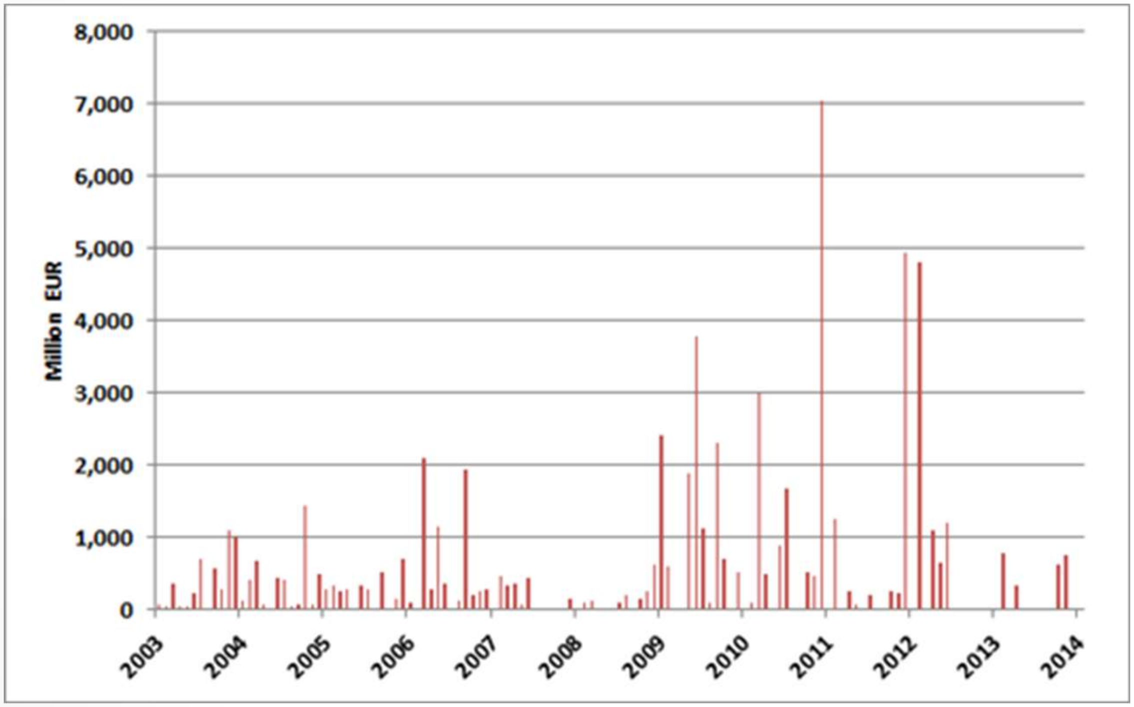
New Style Instruments, are they junior, pari passu or senior to shares?

Bail-in Sequence 1, 2, 3	COUPONS / DIVIDENDS			CAPITAL		
	Subordinated	AT 1 is Pari Passu *To shares*	Senior	Subordinated	AT 1 is Pari Passu *To shares*	Senior
	a	b	c	A	B	C
T2	3	3	3	3	3	3
AT1	1	1	2	1	1	2
Shares	2	1	1	2	1	1

AT1	**All permutations are permitted (dividend stoppers, capital transfer to equity from 0 - 100%) a/A mean inversion !!**	
Old Tier 1	**Limited to b/c + B/C, mix between B and C determined by initial haircut, conversion rates De-facto pari passu situation of coupons/dividends b after EU state aid rules 2009**	
Cases	**Cyprus**	**Intial plan was C (Bank of Cyprus), mix of B and C after KOM review**
	Spain	**Mostly C, mix to reduce legal risk resulting from mis-selling**
Interpretation	**a/A is driven by shareholder interest, least legal safety resulting from extreme LGD levels Leads to pure PD pricing of instruments. c/C most bail-in proof.**	

Identified Obstacles and Challenges
New Style Instruments

A 5 Year minimum non-call period for AT1 is too short, case Spain



Source: Banco de Espana. Series Code DVM2LOSIM0CNEUR.

Note: includes high volumes of sales to retail investors from 2009 and public rescue operations from 2010 onwards.

A 10 year non-call AT1 issued in 2004 would have covered the entire Spanish property price and credit cycle from bottom (2004) to bottom (2014).

A 5 year non-call AT1 issued in the same year has been typically called in 2009, at the top of the property/credit cycle, a point at which regulators hardly had an option to prohibit the call given the absence of write-offs.

Potential Solutions
New Style Instruments

- The new product segment should be reviewed and its design reformed, before the market grows too large with its current defects
  - Reduce cost for issuers and risks for investors while keeping discretionary coupon non-payment and capital bail-in features for issuers and RA fully intact.
- Insurance-type contingent convertible products (high trigger, full write-down) that are deeply subordinated and distort the waterfall should be discouraged !
- Establish seniority of AT1 to shares both in coupon and capital dimensions <u>outside</u> PONV:
  - Remove the no dividend stopper / pusher requirement in favor of a clear ranking of distributable profit allocation.
  - Similarly standardize write-down products, including temporary, as in clear seniority over share capital, share premium both in write-down and write-up, with the same contractual PONV exemption.
- Remove low-trigger Cocos that are de-facto redundant given the RAs PONV powers.
- Extend the minimum regulatory non-call periods from 5 years to a 7 years.
- Develop the institutional investor base →investor regulation !!

Identified Obstacles and Challenges
General Principles of Resolution & Recovery

- Wide mandate of the Resolution Authority in Europe blurs distinction between bonds and deposits. US FDIC.
- Political interference into R&R may lead to alternating mandates (least cost vs. open assistance), unequal treatment of investors in public vs. private banks.
- Lack of systematic bond investor representation and participation.
- Lack of focus on negotiated recoveries (‘pre-packs’) with investors before proceeding to R&R action, conversions and write-downs.
- Deficient asset valuation / transactions methods, violation of the at arm’s length principle leads to compensation claims.
- No creditor worse off principle is not operationalized. Current assumptions likely to be challenged.

Potential Solutions
General Principles

- Refine the mandate of the Resolution Authority
  - Narrow mandate to focused deposit insurance of the U.S. bank resolution authority FDIC.
- Minimize political interference into R&R
  - Least cost as a rule (eliminate precautionary public recap, instead greater flexibility re conversions/write-downs).
  - Special treatment of public banks?
- Create systematic investor representation and participation
  - Bondholders subject to bail-in should be at least informed and represented in relevant processes, as shareholders usually are.
  - An important solution, reducing legal risk across the board, would be the appointment of bond trustees.
- Materially enable negotiated recoveries ('pre-packs') with investors before proceeding to mandatory conversions and write-downs.
  - This requires the legal definition of a negotiation phase protected by super senior liquidity provision and protections against accelerations and redemptions, as well as an understanding over the State Aid conditions of liquidity support mechanisms

Potential Solutions
General Principles

- Improving on asset valuation / transactions methods
  - Time space for due diligence of involved parties
  - At arms' length principle, this may mean to 'create market' for bank assets and parts→main activity of the US FDIC.
  - Revoke perfection of transaction assumption and introduce contingent approaches, may mean revising bank regulation rules.

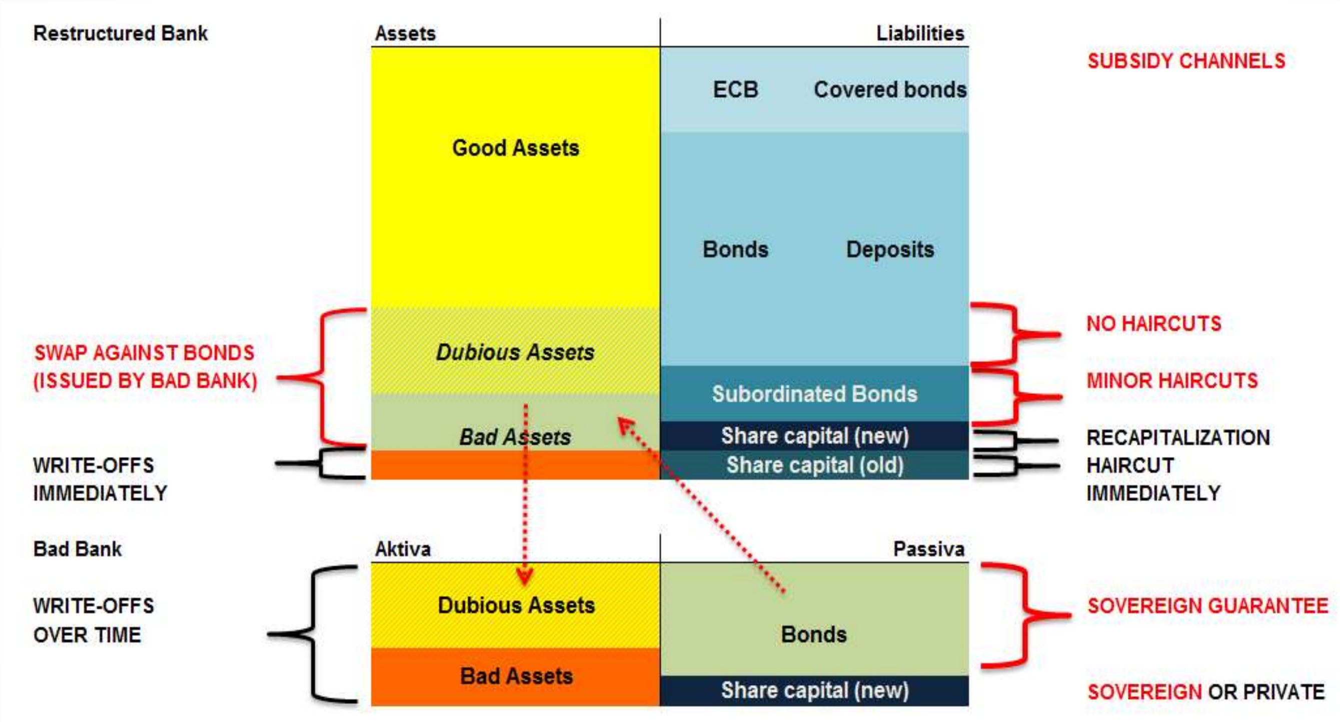
- Operationalizing the no creditor worse off principle
  - The current benchmark for NCWO is bank insolvency, assuming no external liquidity support and fire-selling of assets. This extreme formulation is unlikely to prevail in Case Law.
  - A more realistic benchmark would be a *partial banking license* for bank asset management in the insolvency situation, such as is assumed by the currently prevailing covered bond resolution model, i.e. liquidity access to finance the liquidation process contingent on the availability of quality collateral.

Identified Obstacles and Challenges
Impaired Asset Management

- Adequacy of measures
  - Focus on going concern, risk of resolution delay and creditor rotation. May lead to follow-up litigation by long-term junior debt investors against future bail-in decisions.
  - Delinkage of asset and liability performance, theoretically maximizing legal risk. In practice usually NCWO observed, hence large source of State Aid cases.
- Resolution authority powers
  - Technically outside resolution and private recovery instrument.
- Asset transfer or guarantee pricing, claw back and recovery clauses
  - At arms' length principle is frequently violated.
  - Traditional escape route for junior debt since no or only limited claw back.
- Ownership structure of bad bank, public sector subsidy bias
  - Truly private bad banks in a risk-transfer sense are as a rule internal, i.e. provide internal clawback/recovery options. Case German Coop system.
  - Private AMC/asset servicing rather frequent. Key IAM function.
- Case countries
  - Germany: extensive use, bad bank para language limiting claw back to shareholding has not been revoked.
  - Italy: many AMCs, public-private bad bank plans.

Impaired Asset Measures
(Asset Swap)

Bad Bank Model (Asset Swap Model)



Systematically unties the fate of junior / senior unsecured debt from the fate of assets, i.e. usually static approach.

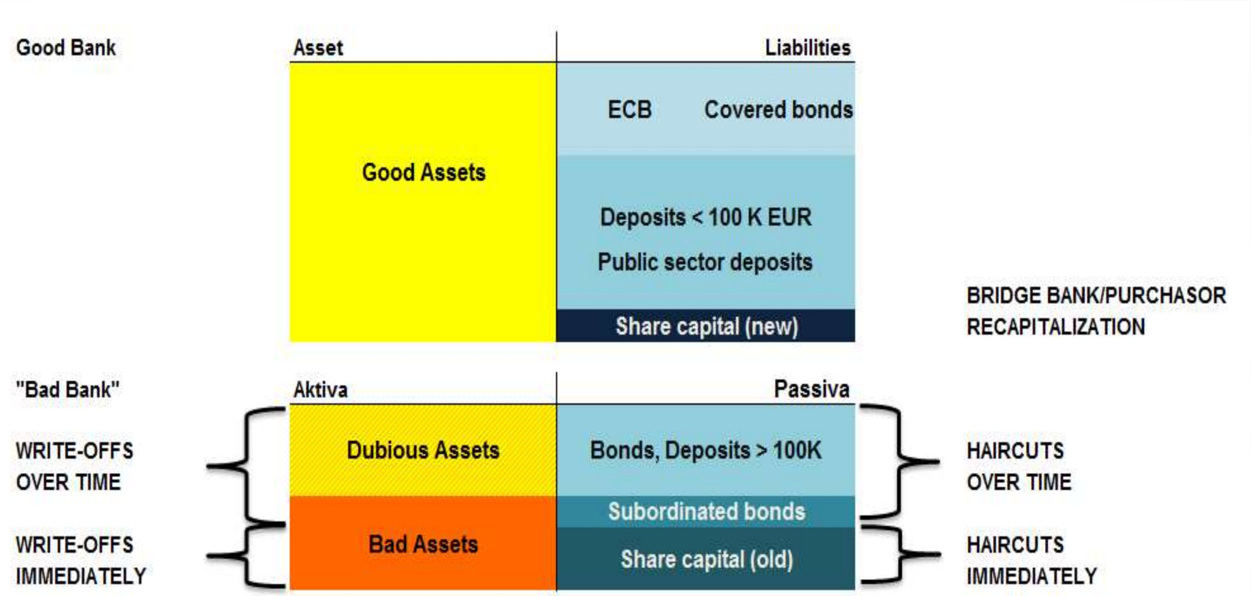
Key economic problem: ex-ante calibrations (transfer pricing) of 'bad' assets.

Potential Solutions
Impaired Asset Management

- Creating a BRRD compatible bad bank concept
  - The principles of no hidden capital relief and of recognition that the ALP principle are almost impossible to comply with in a financial stress situation. This implies that the performance of assets and liabilities ought to remain tied to each other at least to some degree.
  - Force the asset risk transferring bank to create an excess capital buffer from the historic capital structure, to the extent that additional losses from transferred assets can be reasonably be assumed to arise.
  - This approach both preserves the BRRD principles and avoids contingent claims on the transferring bank via future claw back to hit new generations of junior debt creditors.
  - Technically, to render claw back and recovery feasible, the historic equity and junior debt, to the extent not extinguished through the asset discounts, could be endowed contractually with credit-linked note features referring to the transferred assets as an additional PONV feature.

Good Bank Approach
(horizontal balance sheet split)

Good Bank with residual "dead" bank



- **Central FDIC approach, enshrined in most European legislation. Generally dynamic approach tying fate of liabilities and dubious assets.**

- **Key economic problem: determination of sales price for 'good' assets or bank parts under Purchase and Assumption during stress**.

Source: Finpolconsult.
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Identified Obstacles and Challenges
Good Bank Approach

- Adequacy of measures
  - Indirect bail-in through horizontal balance sheet split, tying asset and liability performance. Theoretically optimal resolution approach in a single stage crisis.
  - Provides extension options for liabilities, avoids direct calibration of haircuts.
  - Risk of excessive focusing on small banks creates resistance.
- Resolution authority powers
  - Purchase and assumption power = maximal invasion into owner rights.
  - Potentially safer bail-in avenue for legacy junior debt even if mandatory LM is enabled.
  - Legal risk if P&A is enabled, but mandatory liability management not? Case: HETA.
- Asset transfer methods and pricing, bridge bank alternative
  - Requirement to price bad assets is replaced by requirement to price good assets. Easier in crisis?
  - Illiquid markets require active 'market making' by RA. Central FDIC task during crisis. How good will Europe perform? Case Piraeus.
  - Otherwise bridge bank, what is the NCWO benchmark?
- Structuring claw back and recovery
  - Dead banks are often too small to permit clawback, esp. in two stage crises. Case: Banco di Napoli, without transfer of junior debt.

Identified Obstacles and Challenges
Good Bank Approach

- Structuring claw back and recovery
  - Instrument performance can be tied through shares (against transferred portfolio) or warrants or credit linkage in the buyer/portfolio. Two way risks. Case Laiki transfers to Piraeus Bank (no shares/warrants) and Bank of Cyprus (excessive number of shares).
- Ranking and granularity of debt classes
  - Large pari passu debt classes are split between Good and dead bank. Ideally more granular classes.
  - Prohibition of separate share classes may impair bridge bank capitalization and force Good Bank sale when economically disadvantageous.
  - Junior debt may be forced into the dead bank where economically dubious. Case BES.
- Ownership and management of the dead bank
  - Unwinding vehicle is capitalized, but not owned by debt investors.
  - Owners may not be written down and retain effective control. Case WestLB, HGAA/HETA.
  - Management is appointed by the RA, which is a conflict of interest since litigating against the RA's Good Bank split is a key asset of the dead bank. Case WMI.
- Case countries
  - Method implemented in all case countries.
  - DE – forced Good Bank split avoided in WestLB case, despite existing legal basis.
  - IT – dead banks are calibrated too small. Method implemented since the 1990s. Creditors can oppose asset transfers, hence so far have not been affected.

Potential Solutions
Good Bank

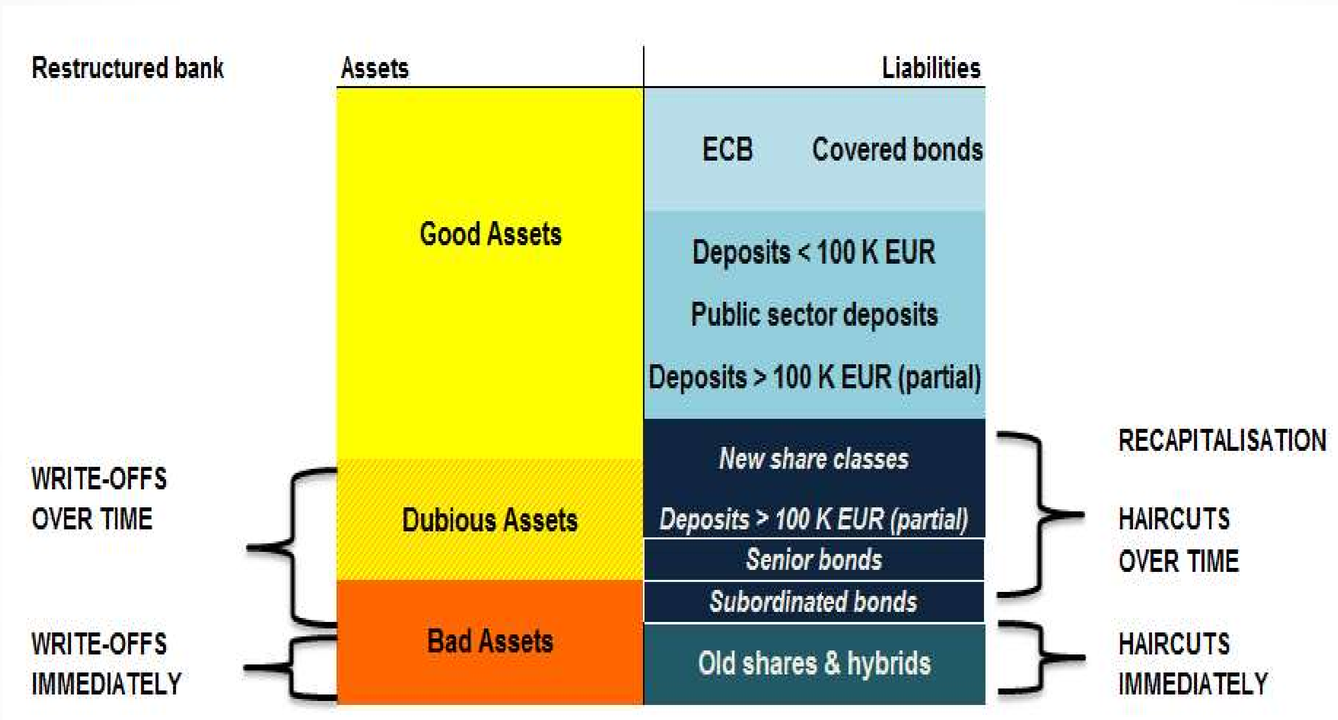
- Improving on Good Bank split operations
  - The SRB and national RA should establish a roaster of sales advisors that can arrange an ALP selling process efficiently and create a sales rulebook.
  - Measures should be sought that maintain a sufficiently high number and solvency of bidders, ideally regulated banks.
  - These might in systemic crisis also include permitting banks under State Aid measures to do bidding under suitable restrictions. Case Piraeus.
  - The risk of non-ALP transactions and asset and liability transfer mispricing can be significantly mitigated when cash funds are made available to capitalize a bridge bank that would permit to reduce the speed of sales to third parties. Define conditions.

Potential Solutions
Dead Bank

- Creating an operational dead bank
    - A sufficiently large dead bank will ensure that claw back by the buyer of assets from the dead bank works in case the initial discounts have been too small.
    - The need to fine tune the calibration of the dead bank speaks in favor of addressing pari passu issues in large non-granular creditor classes (such as e.g. all unsecured bonds) through greater granularity or divisibility and extension of claims.
    - Dead banks need proper governance (RA has conflict of interest). Investors should be given voting or no-objection rights in the dead bank.
    - In case of certain losses, former equity investors and the most junior debt parts should be sufficiently written down to avoid inversion in voting rights that is not materially covered by assets.

Mandatory Liability Management

Bank of Cyprus – Debt Equity Swap



- **New approach of the BRRD, innovation for most European bank resolution regimes.**
- **Mandatory LME at the PONV by regulator, haircut or share conversion.**
- **Key economic problem: ex-ante calibrations.**

Source: Finpolconsult.

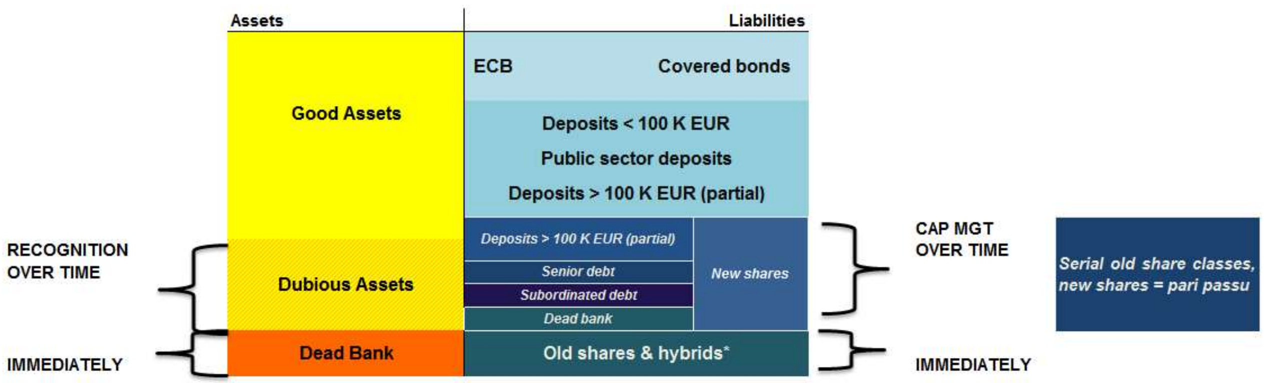
Identified Obstacles and Challenges
Mandatory Liability Management

- Adequacy of measures
  - Mainly recovery tool, Good Bank tool avoids many legal risks of mandatory LM.
  - Focus on immediate regulatory capital, no NPV-based restructuring (extension, coupon reduction). Conflict with recovery concept.→negotiated restructuring/pre-pack.
  - Risk to avoid hard restructuring decisions (esp. in presence of Cocos).
- Resolution authority powers
  - Currently severe limitation in Italy. Company law does not permit share conversion without votes and pre-emption rights.
- Liability management calibration
  - Ex-ante calibration required, both re haircuts and share conversion factors. Hence high likelihood of errors.
  - Single share class conversion requirement may generate major waterfall distortions. Lower ranking debt classes are likely to receive preferential treatment, unless severely haircut.
  - Recovery focus of instrument speaks in favor of preserving upside for investors
- Claw back and recovery
  - Temporary write-down, to mimick share characteristics.
  - Temporary conversion, to reduce institutional bias against the share instrument (Case MPS/Italy).

Identified Obstacles and Challenges
Serial vs. Parallel Equity Classes?

Stylized balance sheets

Strategy A **Debt Conversion into Serial Equity Classes**

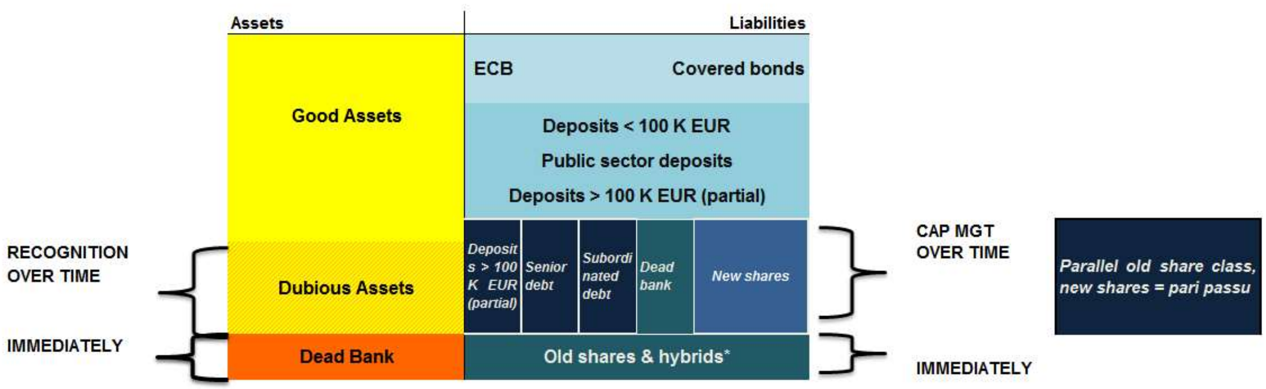


Numerical Example

Serial Equity Classes

EVENTS				
Time of event	T	T + 1	T + 2	
Type of event	Conversion	Loss recogn 2.5 billion New shares 1 billion	Recovery 1 billion	
BALANCE SHEET	EUR bln	EUR bln	EUR bln	LGD A
LIABILITIES	95.0	95.0	95.0	0%
Deposits > 100K EUR	2.0	2.0	2.0	0%
Senior debt	1.0	0.5	1.0	0%
Subordinated debt	1.0	0.0	0.2	80%
Dead bank	1.0	0.0	0.0	100%
New shares		1.0	1.3	-29%
CAPITAL	5.0	3.5	4.5	
TOTAL ASSETS	100.0	98.5	99.5	

Strategy B **Debt Conversion into Parallel (Pari Passu) or Singular Equity Classes**



Parallel or Singular Equity Classes

EVENTS					
Time of event	T	T + 1	T + 2		
Type of event	Conversion	Loss recogn 2.5 billion New shares 1 billion	Recovery 1 billion		
BALANCE SHEET	EUR bln	EUR bln	EUR bln	LGD B	vs. A
LIABILITIES	95.0	95.0	95.0	0%	
Deposits > 100K EUR	2.0	1.0	1.3	36%	>>
Senior debt	1.0	0.5	0.6	36%	>>
Subordinated debt	1.0	0.5	0.6	36%	<
Dead bank	1.0	0.5	0.6	36%	<<
New shares		1.0	1.3	-29%	=
CAPITAL	5.0	3.5	4.5		
TOTAL ASSETS	100.0	98.5	99.5		

Identified Obstacles and Challenges
Mandatory Liability Management

- Ranking and granularity of debt classes
  - Change of initial ranking or classifications may defeat the concept (Cyprus, Netherlands). At least time distance.
  - Partial waterfall application between neighboring debt classes (Spain)
- Institutional issues
  - Voting rights, charter issues. Savings and cooperative banks prefer write-down instruments. > 50% bail-in ratio may prompt charter change. Pre-emption rights of the group internal deposit insurance funds.
  - Fungibility and liquidity of shares, e.g. vinculated name shares, prohibition of new share classes, illiquidity of shares when main ownership rights are not traded. Case DZ Bank.
  - Tax treatment. France with capital gains tax on write-down gains, banks prefer share conversion instruments.
- Case countries
  - France: strong resistance by banks against single share class, fully calibrated conversion requirement.
  - Not enabled in Italy until 2016, even though civil code paragraphs enable court to cancel both shares and Tier 1.Company law generates pre-emption rights by shareholders.

Identified Obstacles and Challenges

Tax Issues

Table 1 Tax Treatment of AT 1 and T2 Capital Instruments

Table 1: Additional Tier 1 capital

Additional Tier 1 capital raised in	(a) Deductibility of coupon for corporate income tax purposes	(b) Withholding tax	(c) Taxes on issuance or transfer	(d) Tax charge on trigger events
Belgium	Yes	No	No *	Write-down: Yes Conversion: No
France	Yes	No	No	Write-down: Yes Conversion: No
Germany	Yes *	No *	No	Write-down: Yes * Conversion: Yes *
Ireland	No	No	No	Write-down: No Conversion: No
Italy	Yes	No	No	Write-down: No * Conversion: No *
Portugal	Yes	No *	No	Write-down: Yes Conversion: No
Spain	Yes	No *	No	Write-down: Yes Conversion: No
Sweden	*	No	No	Write-down: * Conversion: *
Switzerland	Yes	No *	No *	Write-down: Yes Conversion: No
The Netherlands	Yes *	No	No	Write-down: Yes Conversion: No
United Kingdom	Yes	No	No	Write-down: No Conversion: No

* Refer to detailed text below.

Table 2: Tier 2 capital

Tier 2 capital raised in	(a) Deductibility of coupon for corporate income tax purposes	(b) Withholding tax	(c) Taxes on issuance or transfer	(d) Tax charge on trigger events
Belgium	Yes	No	No *	Write-down: Yes Conversion: No
France	Yes	No	No	Write-down: Yes Conversion: No
Germany	Yes	No	No	Write-down: Yes * Conversion: No
Ireland	Yes	No	No	Write-down: No Conversion: No
Italy	Yes	No	No	Write-down: No Conversion: No
Portugal	Yes	No *	No	Write-down: Yes Conversion: No
Spain	Yes	No *	No	Write-down: Yes Conversion: No
Sweden	*	No	No	Write-down: * Conversion: *
Switzerland	Yes	No *	No *	Write-down: Yes Conversion: No
The Netherlands	Yes	No	No	Write-down: Yes Conversion: No
United Kingdom	Yes	No	No	Write-down: No Conversion: No

Source: Ernst & Young (2014), status per May 2014.

Potential Solutions
Mandatory Liability Management

- Choosing between write-down and conversion policies
  - Share conversion leaves both liquidation value, with liquidity support, and option value for investors on the table. Preferable from a legal challenges aspect.
  - Both type of bail-in options will materially converge under Case Law to either prioritize share conversion or approximate share conversion outcome.

- Preserving the waterfall, reducing error in write-down and conversion policies
  - Ex-ante conversion calibration is be a key source of litigation. Create temporary new share classes for converted debt that would preserve the waterfall.
  - New share issuance could be enabled through pari passu or senior status to the converted historic classes.
  - Partial waterfall observation, i.e. incomplete write-downs of capital and debt classes before proceeding to the next class should be discouraged.
  - Taxation bias between write-down and share conversion strategies tb corrected.

Potential Solutions
Mandatory Liability Management

- Completing the liability management toolkit
  - Currently exclusion inter alia of coupon reductions and debt extensions (in case of Tier 2) as well as debt exchanges.
  - Within a generalized definition of recapitalization policies under a net present value concept such options could be included. An obstacle are current bank accounting and regulation rules.
  - A fundamentally alternative mechanism would be credit linkage of junior debt to the asset portfolio funded at the time of the first RA intervention (esp. Tier 2 and higher).

Obstacles & Potential Solutions
Group Structure Issues

- Preserving neutrality on banking concern structure while improving operability
  - General intention of the BRRD (Recital Nr. 80) to allocate loss absorption to sources of loss generation. Likely outcome some form of modified SPE concept of first loss protection at the subsidiary level and catastrophic risk protection at the group level.
  - Developing technical solution here are multiple trigger AT1 instruments issued at the group level but with references to subsidiary capital levels.
  - Also, other loss absorption and capital allocation mechanics esp. the treatment of intra-group credit. Demoting the rank of these currently senior unsecured positions to senior subordinated has the appeal that subsidiaries could still be forced to issue sufficiently Tier 2 and Tier 1 debt on its own while senior unsecured investors remained protected. Larger capital requirements at the mother or holding level would be the result..
  - Regulation of holding companies: if a legal person takes banking risk it should be regulated as a bank, including holding companies with banking subsidiaries. US?
- Improving bail-inability across the group
  - The basic impacts of resolution planning should be made public to clarify investor positions in the bail-in hierarchy.→Interest to keep recovery planning secret?
  - Contractual provisions focused on the PONV. This implies either amendments to legacy instrument indentures or specification in new instruments ex-ante

Potential Solutions
Germany

- Legacy instruments
  - There is a great variety of products and major transparency problems. RA and banks contradict each other regarding the ease of bail-in. It could not be verified whether historic abusive issuance practices have been given up.
  - It would be advisable to facilitate contractual amendments for the PONV and support junior debt exchanges, including for banks under State Aid rules.
- New style instruments
  - In new style instruments there has been very limited issuance so far. In order to facilitate the AT 1 market in a very conservative and historically politically powerful investor base it is important to remove the risk of subordination to shares systematically.
  - Cooperative and savings banks groups should be motivated to undertake joint issuance.
  - The investor protection framework needs development. Adverse selection of retail investors could become an issue when depositories or their apexes start issuance.
- General R&R principles
  - Common challenges to R&R are significant. The traditional bond investor protection mandate of deposit insurers and deep public bailouts have de-facto substituted for the development of bondholder representation, only the covered bond (Pfandbrief) is more advanced here.

Potential Solutions
Germany

- General R&R principles ctd
  - There is a high risk of public bank bias in R&R action. Sales of portfolios or bank parts are frequently limited to intra-group buyers, i.e. violate the ALP principle. A high level of legalism leads to over-determination of R&R processes and inflexibility e.g. regarding claw back / recovery policies.
- Impaired asset measures
  - The abusive use of impaired asset measures of the past requires a new positive definition model (high priority for FMSA).
  - Explicitly address junior debt bail-in in the 'bad bank law' FMStFG, which has not been materially changed.
- Good Bank approach
  - Good Bank splits have been introduced under different law, leading to biased implementation. Good bank transfer processes feature significant ALP problems (mostly intra-group). The dead bank policy has empowered public shareholders, not debt holders. Improve dead bank governance.
- Mandatory liability management
  - At the PONV share conversion will remain de-facto limited to private banks.
  - Temporary share conversion and temporary write-down/write-up options may help to overcome the resistance with other banking groups.
  - Clearly define State Aid limits in the case of pre-emption rights of group deposit insurers over share conversion.

Potential Solutions
France

- Legacy instruments
  - Legacy instruments play a more limited role than in Germany and are implicitly standardized by the regulator/RA. Yet RA and banks contradict each other regarding the ease of bail-in and transparency is deficient. This speaks in favor of at least contractual amendments focused on the PONV.
- New style instruments
  - For new style instruments there is an active market promising fast substitution of legacy instruments. Systematic subordination features to shares should be removed and mixed signal Coco instruments (often mix of subordinated/senior characteristics) be discouraged. The investor protection framework for junior debt is undeveloped, raising the risk of retail investors becoming adversely selected.
- General R&R principles
  - There have been both a wide RA investor protection mandate and fiscally costly implicit protections of junior debt in the past. There is less risk of public bank bias than in Germany. However, the historically closely interwoven public and private roles in asset sales and risk transfer transactions have violated the ALP principle.

Potential Solutions
France

- Impaired asset measures
  - So far bad bank not tested.
  - Stealth IAM via public banks should be addressed and replaced by a BBRD-compatible bad bank concept.
- Good Bank approach
  - The Good Bank concept has not been tested. Currently, technical issues (large pari passu debt positions, rank identification problems) could hamper their implementation in the short-term.
- Mandatory liability management
  - Write-downs and conversions are enabled under national resolution legislation with bail-in of contractually convertible instruments coming first at the PONV.
  - There is a tax bias against write-downs.
  - Share conversion is unlikely to be resisted by most banks, yet a temporary share conversion concept and better waterfall preservation would be welcome by banks.
  - Relaxing the single share class conversion constraint is of high relevance.

Potential Solutions
Italy

- Legacy instruments
  - Legacy instruments so far dominate the Italian junior debt market, and transparency is of mixed quality. Extension risk is very high and bail-inability, even after BRRD implementation in late 2015, remains questionable. The conclusion would be to facilitate both contractual amendments focused on the PONV and junior debt exchanges.
- New style instruments
  - In new style instruments there is only subdued issuance activity so far and suboptimal 'mixed signal' instruments are likely to prevail. It is a sine qua non for many Italian mid-sized and smaller banks to remove subordination to shares, given issuance cost and volatility in the market and a very conservative domestic investor base. Joint issuance vehicles for these banks should be motivated. An investor protection framework should be defined. Solutions for the unsecured 'retail' bond market are also urgent in order to ease resistance against junior debt bail-in.
- General R&R principles
  - Common challenges to R&R are significant. There have been a wide RA investor protection mandate and strong implicit protections of junior debt in the past. The public bank bias of RA is as relevant as in Germany. Yet, there is some routine regarding NPL and good bank sales processes with an established investor base, reducing the ALP violation risk in these transactions. Practical experience should facilitate flexibility in defining claw back and recovery provisions.

Potential Solutions
Italy

- Impaired asset measures
  - Regarding impaired asset measures it is urgent to provide guidance to the pending large bad bank project from a State Aid perspective (pushed also by the IMF). This may be the first practical test case for a BRRD compatible bad bank concept in Europe.
- Good Bank approach
  - The Good Bank method has been applied in the past. However there are before BRRD implementation legal limitations regarding creditor ability to oppose both good bank parts transfers and their allocation into the dead bank.
- Mandatory liability management
  - Write-downs and conversions during 2015 are legally ‘impossible’ for Tier 2 and ‘difficult’ for Tier 1 at the moment.
  - After BRRD implementation, share conversion at the PONV will remain a last resort for cooperative and savings banks.
  - Clearly defined temporary share conversion and write-down/write-up policies can help to overcome the resistance. To that end, again, addressing the single share class issue is of high relevance.

Potential Solutions
Role of State Aid Agent DG COMP

- Junior debt instruments
  - The priority here should be legacy instruments with the focus
    - to create greater transparency, in particular over ranks and existing protections, such as guarantees or collateral, including under Pillar III to manage investor expectations, and
    - to explore options to realize contractual amendments in order to enable bail-in at the PONV and in cross-border situations.
  - The initiative here should be spearheaded by EBA, with stimulation from DG Competition.
  - **DG Competition might consider reviewing State Aid rules under the aspect of facilitating junior debt exchanges against new style instruments (e.g. permit coupon payments).**

Potential Solutions
Role of State Aid Agent DG COMP

- Resolution and recovery methods
  - The Good Bank approach seems to work universally as an implicit bail-in instrument, including among the case countries in Italy during 2015. DG Competition could take action on two levels:
    - formulate conditions for the management of Good Bank splits regarding the ALP transactions principle, i.e. **improving the competition situation in the buyers markets. This could again imply revisiting conditions for banks as potential bidders that are currently under State Aid rules.**
    - formulate restrictions to the role of government in dead bank management from the perspective of improving legal safety of bail-in as well as potentially competition aspects.
  - The expected large Italian ‘bad bank’ project could be a welcome opportunity for DG Competition to further specify conditions in the direction of both a BRRD- and State Aid compatible asset risk transfer concept.
  - Regarding the temporary share conversion and single share class questions raised, DG Competition could together with EBA explore routes to permit temporary separate share classes that are compatible with the CRD/CRR.