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Proposed EU "Bail-in" Measures May Impact Credit Derivatives Framework

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Background

The European Commission recently launched a consultation on the Technical Details of a Possible EU Framework for Bank Recovery and Resolution[1] (the "**Consultation**"). The Consultation is designed to be read with the Commission's October 2010 communication (the "**Communication**") on an EU framework for crisis management in the financial sector.[2] The Consultation contains technical details which expand on the principles identified in the Communication.

The key focus of the Consultation is to give national regulators powers to deal with failing banks at an early stage, to avoid the use of taxpayer money to bail-out banks. The Consultation covers a wide range of topics including (a) the scope of preparatory and preventive measures and resolution tools; (b) early intervention powers; and (c) resolution tools, powers and mechanisms.

"Bail-in" proposal

The Commission suggests that some institutions (the so-called "too big to fail" banks) may be too large, complex or interconnected to be put into a resolution regime and may have to be dealt with on a going concern basis through the deployment of "bail-in" debt. Two potential approaches have been outlined:[3]

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[1] See http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf. The Commission has also published a press release and frequently asked questions on the Consultation. The press release can be found here: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/10. The frequently asked questions can be found here: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/6&format=HTML&aged=0&language=EN&guiLanguage=en

[2] See http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf

[3] See Annex I of the Consultation

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- the "comprehensive" approach which will permit national authorities to write down or convert to equity all senior debt, subject to certain exemptions;[4]
- the "targeted" approach which will require banks to issue fixed volumes of "bail-in able" debt, which could be written down or converted into equity on a statutory trigger.

In each case, it is proposed that the potential for a write down in accordance with these new powers will be included in the terms of the relevant debt instruments. One of the aims of the proposal is to shield taxpayers from having to bail-out banks in the future – shifting some of the potential losses to senior debt holders.

Effect on credit derivatives framework

Under the Credit Derivatives Definitions published by the International Swaps and Derivatives Association, Inc. ("**ISDA**") (the "**Definitions**"), a reduction in the amount of principal payable at maturity which would otherwise constitute a Restructuring Credit Event would not be treated as such where the reduction is "expressly provided for under the terms of [the relevant] Obligation"[5]. The proposal to include the statutory "bail-in" power in the terms of the relevant debt instruments would likely lead to the conclusion that any reduction in principal as a result of the exercise of such power is "expressly provided for" under the terms of the debt instrument. Such reduction therefore would not meet the criteria for a Restructuring Credit Event and would leave a protection buyer unable to recover under the terms of its credit default swap.

Further, the Definitions provide for various required characteristics for "Deliverable Obligations" – amongst them is the condition that the obligation has an outstanding principal balance that pursuant to the terms of such obligation "may not be reduced as a result of the occurrence or non-occurrence of an event or circumstance"[6] – the "Not Contingent" Deliverable Obligation Characteristic. The proposal to include the statutory "bail-in" power in the terms of the relevant debt instruments thereby requiring the bank to repay principal only if not written down pursuant to the "bail-in" power would arguably result in the debt instrument not meeting the Not Contingent Deliverable Obligation Characteristic. Therefore, even in circumstances where a Restructuring Credit Event had been triggered, a protection buyer would not be entitled to deliver the written-down debt instrument and, in an extreme scenario, may even find that there are no "Deliverable Obligations" under the terms of its credit default swap.

For these reasons, the proposed "bail-in" power may require market participants, in the context of bank debt, to examine the terms of their credit default swap documentation to ensure that it reflects desired protections and consequences.

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[4] Such as swaps, repos, short-term debt and secured debt, including covered bonds

[5] See Section 4.7 of the Definitions

[6] See Section 2.20(b)(i) of the Definitions

Next steps

Responses to the Consultation should be made by 3 March 2011. The Commission intends to adopt a legislative proposal on bank recovery and resolution in June 2011 and has stressed that any legislative changes would be subject to further consultation and impact assessments.

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Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

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