Information concerning bank resolution and creditor participation ("bail-in")

In response to the experiences of the financial crisis, regulations have been introduced which, in the future, will allow banks at risk of default to be resolved without involving the taxpayer. Instead, in the case of default or the risk of default, the shareholders and creditors of the bank shall also be involved in the losses as part of the resolution process.

1. Legal bases:

EU Directive 2014/59/EU for the recovery and resolution of credit institutions and investment firms (BRRD – Bank Recovery and Resolution Directive) and the European 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") entered into force on 1 January 2015. This introduced a uniform provision for all European countries when it comes to preventing crises and managing crises on the part of banks.

The BRRD was implemented into Austrian law with the *Bundesgesetz über die Sanierung und Abwicklung von Banken* [Federal act concerning the recovery and resolution of banks] (BaSAG). As a resolution authority, the BaSAG presents the *österreichische Finanzmarktaufsicht* [Austrian Financial Market Authority] ("FMA") with a set of tools for recovering or resolving banks which find themselves in financial difficulty. In doing so, the aim is to prevent systemic risks.

One important, practical resolution tool concerns the participation of creditors: as part of the so-called "bail-in", the FMA can "write off" liabilities from institutions or companies up to their full value.

2. Resolution tools:

The aims of resolution are: to guarantee that critical functions continue, to avoid considerable negative effects on financial stability, to protect public funds, to protect depositors and investors and to protect clients' money and financial assets.

The BaSAG standardises the provisions which must be satisfied cumulatively in order for the FMA to be able to initiate a resolution procedure:

- The bank defaults, or its default is probable.
- Reasonable judgement shows that there is no prospect of alternative measures from the private sector or the supervisory authorities (e.g. early intervention measures) being able to prevent default within a reasonable space of time.
- Resolution measures are required to protect public interest.

Where the above provisions are satisfied, a resolution procedure will be introduced. In this case, the resolution authority then has the following resolution tools at its disposal:

- Sale of business

Here, shares, financial assets, rights or liabilities belonging to the bank which is faced with resolution are completely or partially transferred to a specific purchaser. Insofar as shareholders and creditors are affected by the sale of the business, they are faced with another, existing institution.

- Bridge institutions

The resolution authority can transfer shares in the bank, other titles of ownership for the bank or all or individual financial assets in the bank, including their liabilities, to a so-called bridge institution. This may affect the bank's ability to fulfil its payment and delivery obligations to creditors, and may reduce the worth of shares in the bank.

- Asset separation

As part of this instrument, the resolution authority can issue the order to transfer the financial assets, rights or liabilities of an institute undergoing resolution to one or more special purpose entities which have been established specifically to manage assets (wind-down entity). In doing so, the financial assets should be managed with the aim of maximising their value upon their later sale or liquidation. In a manner similar to the sale of business, a creditor is faced with a new debtor after transfer.

- Bail-in

The resolution authority can write off financial instruments from and claims against the bank – either in part or in full – or turn these into equity capital (stocks or other company shares) in order tostabilise the bank, compensate for losses and to recapitalise.

The resolution authority can apply these resolution instruments individually or as a combination. However, the resolution authority may only apply the asset separation instrument together with another resolution instrument.

3. The “bail-in” resolution tool

The most important resolution tool in BaSAG is the so-called “bail-in”. This tool aims to guarantee that, initially, it is the owners (e.g. shareholders) and the unsecured creditors who must pay for losses and stabilisation costs for the institute faced with resolution and not the state and/or the taxpayer. “Bail-in” procedures mean that, on the one hand, existing shares in the bank belonging to shareholders are either proportionally reduced or are completely written off while, on the other hand, creditors must partially or completely renounce their claims and, where applicable, receive property rights to the bank in exchange. This transformation of borrowed capital into equity capital serves to recapitalise the bank.

The “bail-in” distinguishes between different groups of creditors. While some creditors are completely excluded from “bail-in”, others are brought in according to a precisely-defined order (the so-called “loss absorption waterfall” or “liability cascade”). Loss absorption takes place in stages, i.e. the creditors from the next level will only be called upon when the rights of the previous level of creditors prove insufficient when it comes to covering losses.

Within the scope of a “bail-in”, financial instruments and claims are divided into various classes and held liable in accordance with a statutory order of precedence (the so-called “liability cascade”). When it comes to the involvement of shareholders and creditors, the following rules apply:

Loss absorption takes place in stages. It is only once a complete class of liabilities has been called upon and it becomes clear that this is not enough to sufficiently compensate for losses to stabilise the bank that the next class of liabilities in the liability cascade can be written off or converted.

1. First, the resolution measures affect Tier 1 capital and, with it, the shareholders (i.e. owners of shares and other equity instruments)
2. Following this, use is made of the creditors of additional core capital (e.g. owners of unsecured, unlimited, subordinated bonds).
3. This is followed by calling in supplementary capital. This affects creditors with subordinated liabilities (e.g. owners of subordinated bonds)
4. Next in the loss absorption waterfall are the unsecured, subordinate liabilities which do not meet the requirements of the additional core capital or the supplementary capital (e.g. credit, bonds, profit participation rights)
5. The creditors of unsecured and insubordinate financial instruments and claims (e.g. investors in bearer bonds, structured bonds, derivatives, as well as uncovered deposits from large companies which are greater than EUR 100,000.00) are called upon to cover the remaining losses.
6. The last parties in the loss absorption waterfall are the remaining liabilities able to be taken into consideration (e.g. uncovered bonds, uncovered deposits from large companies, uncovered deposits from natural persons).

The following in particular are **excluded from “bail-in” proceedings**:

1. Deposits up to EUR 100,000.00 which are protected by deposit insurance e.g.: savings deposits, account balances, fixed deposits and term deposits)
2. Covered bonds
3. Liabilities from client asset management or trust management (e.g. the contents of bank safe deposit boxes, securities or funds which are stored and managed in a securities account and for which segregation and separation rights apply)

6. The consequences of resolution measures for creditors

Whether or not creditors are affected by the “bail-in” resolution measure depends on the scope of the prescribed measure, as well as on the class (see above) into which your financial instrument or your claim is to be assigned.

If the resolution authority orders or adopts a measure in accordance with these rules, the creditor may not terminate their financial instruments and claims based on this measure alone, nor may they assert any other contractual rights. This applies for as long as the bank fulfils its major obligations from the conditions concerning financial instruments and claims, including payment and service obligations.

Should the resolution authority take the measures described, the total loss of the shareholders’ and creditors’ invested capital is a possibility.

With this, shareholders and creditors of financial instruments and claims may lose the purchase price spent to acquire the financial instruments and claims in its entirety, plus any other costs which were connected with the purchase. In the event of bank resolution, shareholders and creditors should not be put in a worse position than if the bank were to undergo normal insolvency proceedings.

However, should the resolution measure lead to shareholders or creditors being put in a worse position than they would be during regular insolvency proceedings, this will lead to the shareholder or creditor having a claim for compensation.

7. Further information

The Austrian Central Bank and the Austrian Financial Market Authority both provide information concerning the recovery and resolution regulations which apply in Austria:

Österreichische Nationalbank:
https://www.oenb.at/finanzmarkt/drei-saeulen-bankenunion/einheitlicher-abwicklungsmechanismus.html

***Österreichische Finanzmarktaufsicht*:**
https://www.fma.gv.at/bankenabwicklung-in-oesterreich/