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from	• A failed or failing bank may need an extra injection of capital in order to make an orderly resolution possible • Bailing-in existing creditors is now seen as the way to prevent this capital injection having to come from taxpayers • The mechanics and market consequences of bail-in still need clarification

Regulators have new powers, and are tasked with implementing bail-in proposals, but they have encountered difficulties in turning theory into practice...

‘Bail-in’ is essentially a way for regulators to make banks’ capital structures able to better absorb losses in a crisis, so that bank creditors take losses before taxpayers are called upon to ‘bail-out’ failing institutions. The initiatives have arisen from perceptions that during the recent crisis the ultimate downside risks did not reside sufficiently with those who should have held them: private investors seeking returns.

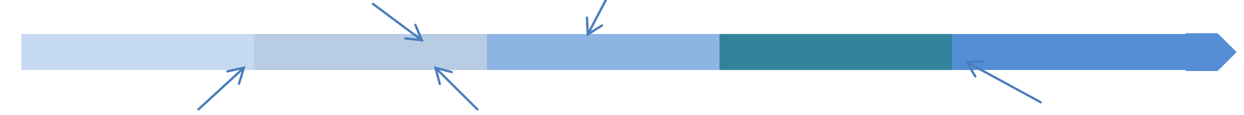
Banks are required to hold capital against possible losses they may make on investments. Losses should be absorbed according to the creditor hierarchy, with equity capital taking first losses, followed by other sources of regulatory capital, and more senior debt taking losses only

Industry groups question the funding implications of bail-in, pointing out that investor appetite for bail-in-able instruments may be weak when funding is already tight...

creditors. As such, senior unsecured creditors holding bank debt could have this debt converted to equity to keep the bank running through resolution. This new equity will then be capable of taking losses far more easily than in its former guise as debt.

Academics and economists have been integral to the formulation of bail-in ideas, and stress its importance as a complement to other initiatives...

Implementing a bail-in regime will have profound consequences for banks’ abilities to fund themselves. Bail-in is an attempt to remove implicit taxpayer support, which if successful, may lead to credit downgrades. Furthermore, the credit profile of senior unsecured debt will be altered, changing the investor base. A significant outstanding question remains: who will buy bail-in-able debt? In conjunction with the many other reforms to banking regulation underway globally and in individual countries, a new bail-in regime is another pressure on banks which are already facing a difficult economic environment.



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Bail-in within resolution refers to the process by which resolution authorities will trigger a conversion of some classes of creditors' claims on a bank into equity. It is therefore important to distinguish bail-in from contingent capital. The former is subject to trigger by external agencies, while the latter is a private sector instrument subject to a contractually agreed trigger, most likely set at an earlier point than the bail-in trigger.

> **"Credible bail-in measures are essential elements of the post-crisis regulatory landscape. However, much work still has to be done to reach workable solutions, particularly in crisis situations with cross-border ramifications. Identifying and publicising trigger points for intervention will be very sensitive issues."**
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> **Dr Richard Reid**, Research Director at ICFR

However, there are two competing views of what bail-in should aim to achieve. According to one vision, which predominates in the United States, bail-in within resolution should be undertaken once a firm has entered receivership with the Federal Deposit Insurance Corporation (FDIC), and the equity generated by the bail-in should be used to fund orderly resolution and provide capital for a new institution created by the FDIC. That is, bail-in should be reserved for firms that are at the point of non-viability, and should not be used to restore the existing institution to health. Another vision, found within the European Commission's recent proposals, suggests that in some circumstances a bail-in could be triggered during resolution with the intention of restoring a firm to the point of viability, essentially saving the firm from failure. Economists at the International Monetary Fund (IMF) have put forward the view that the latter is the essential aim of bail-in.

Bail-in will not suit all banks in the same way; some banks simply do not have the requisite classes of liabilities to be bailed-in, and different banks are structured in different ways, meaning that a bail-in would have to be performed at different levels. This is complicated by the sheer number of subsidiaries (measured in the thousands) that large multinational banks operate in dozens of jurisdictions. Of course, the cross-border nature of such institutions means that bail-in is vulnerable to the same problems as resolution more generally, in that insolvency regimes are not currently harmonised internationally. The lack of coordination of insolvency regimes may remain a significant obstacle to achieving an effective bail-in, especially for the largest firms.

The debate over which classes of liabilities should be subject to bail-in is contentious, to say the least. Regulators are grappling with issues around the creditor hierarchy, which may be distorted by a bail-in. The European Commission's latest proposals say that resolution authorities should have powers to bail-in all liabilities, but that certain forms should be exempted *ex ante*, such as deposits that are guaranteed under deposit guarantee schemes, secured liabilities, and liabilities with a residual maturity of less than one month. The Commission said that derivatives liabilities could be excluded where there is a "justified necessity".

The European Commission published its proposals on bail-in in June 2012 after significant delays and an exceptional 'mini consultation' targeted at bail-in. The Commission has set a 2018 implementation date for its bail-in proposals. The UK will be subject to European rules, but the UK government has already made clear its commitment to pursue bail-in as part of the loss-absorbency package recommended by the Independent Commission on Banking. In the United States, the Dodd-Frank Act set up the 'Orderly Liquidation Authority' (OLA), which the Federal Deposit Insurance Corporation (FDIC) can invoke to override bankruptcy at its discretion, and under which it can perform a bail-in during the process of resolution. In Japan, there is already a well developed regime for dealing with large bank failures as a result of a financial crisis in the late 1990s, and the appetite for introducing bail-in seems small. This fragmented approach to bail-in is likely to be a significant hurdle to an effective regime for cross-border banks, as bailing in a cross-border bank will require significant international cooperation.

Bail-in is certainly not a panacea. It should be seen as one policy tool among others in a more full set of resolution techniques. It is also largely untested, with few robust quantitative impact studies having been published. Its capacity as a tool to achieve the aims policymakers have for it remains to be proven, and its precise form in practice under the pressures of crisis are yet to be seen.

The G20 endorsed recommendations of the Financial Stability Board (FSB) that resolution authorities should be able to bail-in bank creditors in November 2011. The FSB included in its *Key Attributes for Effective Resolution of Financial Institutions* the recommendation that all resolution authorities should have bail-in amongst their resolution tools. There is a widespread commitment to implement the *Key Attributes*, which therefore entails an in-principle commitment to bail-in. However, regulators appear to be struggling to come up with implementable proposals for a bail-in regime. A number of seemingly sensible routes would throw the process open to legal challenges, and they are being asked to come up with proposals during a period of macroeconomic and market stress. In January 2012, Michel Barnier said that the European Commission was delaying proposals until the "worst of this crisis" is past, so that proposals could be presented "at the right moment." However, the Commission issued its proposals in June 2012, during a period in which the crisis appears to have intensified.

In jurisdictions where there is an existing commitment to bail-in in principle, officials tasked with writing the practical implementing rules have described bail-in as one of the most tricky policy areas they have been presented with. There is continuing consultation on bail-in, and many of the details remain unclear.

Regulators in different jurisdictions appear to have differing views of what bail-in should aim to achieve. In the US, under the Dodd-Frank Act, after a large bank fails, all its assets and liabilities will be transferred from the Bank Holding Company into FDIC receivership. Some of these assets and liabilities will then be transferred to a 'bridge' company, at which point some of the failed bank's creditors may be bailed-in in order that a new company can be created and capitalised. This new company would be a new and different bank. The FDIC has been clear that it does not view bail-in as a way to restore a failing institution to health. However, the European Commission's recently published proposals suggest that in some circumstances, it may be possible to initiate resolution, perform a bail-in, and thereby restore the existing institution back to health, in conjunction with other resolution activities such as asset sales. However, in all cases, regulators have recognised that bail-in is essentially uncharted territory.

Like any proposal which could mitigate the disastrous consequences of the failure of a large bank, bail-in has received support in principle from many areas of industry, including from the Institute of International Finance, (IIF) which represents over 450 financial services firms from a range of sectors, including many of the banks who would be affected by new rules. The IIF emphasises the importance of engaging the investor community, and indeed the views of investors are of particular importance for bail-in, as they form the 'buy-base' for bail-in-able instruments.

It is interesting to note in that respect that the Association of British Insurers has said that "only high yield investors are likely to be interested in the risk/reward profile of contingent capital or bail-in bonds", and asks: "what is wrong with equity?" Buy-side groups point out that there is little point creating such instruments if no-one is prepared to hold them: if no-one buys bail-in bonds, there will be no bonds to bail-in. Institutional investors form a significant part of the buy-base for bank debt, and if bail-in bonds are perceived to be almost as risky as equity, these investors may not be able to invest in such instruments. Banks themselves have emphasised this point, pointing to already tight funding conditions as a reason not to impose a bail-in regime too rapidly.

Investors have also expressed concerns about the consequences for the creditor hierarchy. Uncertainty about the priority of claims in the event of insolvency creates problems for pricing the respective debt instruments. There is concern in some quarters about the ways in which regulators will act in the midst of a crisis, indicating distrust between industry and regulators over stated intentions; some industry participations have expressed concern that regulators are merely paying lip-service to the importance of the creditor hierarchy, while they will in subvert it in a real life case if they perceive it to be necessary.

As with resolution in general, industry has concerns surrounding cross-border aspects, particularly on the issue of consistent treatment by home and host authorities. There are considerable uncertainties surrounding cross-border resolution in general and bail-in in particular, as national authorities are not all endowed with the same range of powers. This creates uncertainty for firms, and may entail duplicative work across jurisdictions in order to satisfy regulators and supervisors who have to work with different legal regimes for insolvency.

The terminology of 'bail-in' has been used for well over a decade, although its origin was in relation to sovereign debt crises, as discussed for instance in the work of Nouriel Roubini, Barry Eichengreen and others in the early 2000s. There is a body of academic and economic literature examining bail-in in this sense around the Brady Plan of the 1980s as well as the sovereign debt crises of the late 1990s. The conceptual underpinning in the sovereign case is essentially the same as in bank resolution: private sector involvement through creditor write-downs in order to reduce liabilities and avoid taxpayer funded bail-outs.