Rabobank

Position Paper: Bail-in and the Resolution Fund

1. Introduction

In preparation for the Bank Recovery and Resolution Directive (BRRD), the European Commission proposed in a consultation paper in 2012 that it should investigate the possibility of including the bail-in of senior debt as part of the resolution process. Two basic models are being proposed: the comprehensive approach, whereby (virtually) all debt (including senior unsecured debt) could be written off on the basis of legislation, and as an alternative, the targeted approach, whereby certain specific bail-in instruments could be written off on a contractual basis, and senior debt would be excluded[1]. Both methods respect the hierarchy of claims, whereby first equity and (heavily) subordinated debt have to be written off before the specific bail-in instruments become eligible for write-off (under the targeted approach), or the senior debt as well (under the comprehensive approach). Rabobank supports a comprehensive approach in which (virtually) all senior debt is included in the measure and grandfathering would be avoided. In this paper we explain why.

The European Commission goes a step further in its further elaboration of April 2013, introducing an authority for the Member States to exclude certain categories under the comprehensive approach, such as savings in excess of EUR 100,000 and items relating to derivative instruments. In addition, the Member States may themselves decide the minimum size of eligible bail-in-able liabilities and have the option under the comprehensive approach of requiring a certain size of contractual bail-in instruments. Rabobank supports further harmonisation and opposes powers being given to Member States to determine the categories of bail-in-able liabilities themselves. The exclusion of categories for bail-in together with the power to set the minimum level of bail-in-able liabilities could lead to the base for the bail-in contribution by bank creditors being significantly eroded. This will be to the detriment of other banks as contributors to the Resolution Fund, as well as the ESM if such cases arise. The option of contractual bail-in instruments is not desirable.

The European Commission is proposing a Resolution Fund (RF) at Member State level based on minimum harmonisation rules (regarding target level, the term within which it must be funded, lending between RFs and the possible use of a DGS fund within an RF). Rabobank supports further harmonisation here as well, and does not support freedom of choice being available to Member States.

1) A further distinction concerns the way in which the bail-in obligation is determined. This obligation can be either established in law (statutory obligation), or on the basis of a clause included in the individual contract (contractual obligation). A comprehensive approach would normally entail a statutory obligation, and this is also Rabobank's preferred option.

2. The bail-in proposal

2.1 Comprehensive versus targeted

In its discussion paper, the Commission gives further details of the bail-in tool and has focused only on the comprehensive approach as part of the Bank Resolution and Recovery Directive ("BRRD"). This measure may be introduced together with other resolution measures, such as the sale of all or part of a bank, the transfer of all or part of a bank to a public body and the transfer of toxic assets to an asset manager who will effect further settlement. The purpose of the resolution mechanism is to ensure that in the future, no taxpayer money is needed to keep financial institutions afloat; losses have to be borne by shareholders and creditors. The targeted approach is not further elaborated in the BRRD, since in the event of serious losses it may still be the case that the buffer is too small and unsecured senior debt will therefore still be unaffected in practice. Under the targeted approach, there would be the implication that unsecured senior debt has protected status, which is politically undesirable.

Moreover, there is uncertainty with regard to the depth and liquidity of the market for specifically bail-in-able debt paper, so that banks may not be able to create large enough buffers and this type of paper will thus become more expensive. Lastly, such a measure could be interpreted as the imposition of even higher capital buffers after the CRD IV proposals.

2.2 How bail-in would work

The existing hierarchy of claims will be respected so that stability can be safeguarded. This means that:

1) all the equity must be written off first;
2) subordinated debt would be next in line;
3) lastly, unsecured senior debt would be written off.

The bail-in process would commence at the moment of 'failing or likely to fail', the 'point of non-viability'. This is when one or more of the following occurs:

1) the bank no longer has sufficient capital available in the short term,
2) when the assets are less than the liabilities,
3) the bank can no longer meet its obligations, or
4) the bank receives government support other than in the form of liquidity. It is therefore intended to be the last rescue measure before bankruptcy.

The intention is that after write-off a financial institution's affairs can be settled in an orderly fashion without public funds being needed and without the bank's public retail operations being threatened. It has become clear that insolvency procedures are unnecessarily lengthy, and that they can threaten financial stability. The proposal is that the bail-in measure will apply at group level, but an institution can also be required to meet the conditions at individual level. The basic principle is that the moment of point of non-viability comes immediately prior to the moment of bankruptcy. This means that the Probability of Bail-in will be virtually the same as the Probability of Default and the impact of spreads on senior debt should be limited.

2.3 Scope

The proposal in the 2012 discussion paper is to include all senior debt (with certain exceptions) in the measure. The exceptions concern debt covered by assets (such as covered bonds) and repo transactions, but also savings covered by the Deposit Guarantee System ("DGS") and money that is managed for third parties (fiduciary assets). The DGS claim by the DGS fund is now within scope, although whether preference should be given to this claim is still under discussion. Salaries, pension obligations, liabilities to creditors for the provision of goods and services including IT, as well as tax and social insurance contributions will be excepted. In the most recent proposal in April 2013, Member States will be given the option of making certain debt that previously would have qualified for one of the eligible senior unsecured debt categories ineligible for bail-in. This concerns savings in excess of EUR 100,000 held by natural persons and SMEs, and items relating to derivatives. Lastly, current liabilities with an original term to maturity of one month or less relating to payment, clearing and settlement systems would be excepted in order to safeguard the continued operation of the financial institution and avoid serious liquidity problems.

The above creates the potential for significant differences between the Member States regarding the capacity of bail-in. If cases arise, additional funds will be needed from the Resolution Fund (either by borrowing from other RFs or not) or from the taxpayer and/or the ESM at an earlier stage. Rabobank therefore does not support this option.

2.3 Minimum amount of bail-in-able instruments

Since certain debt instruments will be excepted, according to the regulator there needs to be oversight to avoid a situation in which banks fund themselves only with instruments that are excepted. The banks must therefore hold a minimum amount in bail-in-able instruments. Financial institutions, and each of their subsidiaries, must at all times hold a minimum amount of qualifying or eligible bail-in-able instruments that has to be established by the resolution authority. In the introduction to the discussion paper, a minimum of 10% of the total debt or liabilities (as calculated under IFRS) is proposed. There is also a proposal that financial institutions that are not of systemic importance should be excepted. Monitoring of this would be carried out by the local supervisor.

The proposal for taking the total liabilities as the basis instead of the risk-weighted assets (RWA) originates from the notion that the actual losses may be greater than as indicated by the RWA (based on risk models). The concern is that this is an underestimate. The percentage is established on the basis of historically observed losses: 10% of the total liabilities should be adequate to cover the observed losses. There is also the point that an even higher percentage would raise the cost of funds for banks to extremely high levels. Rabobank endorses this position.

The further elaboration of April 2013 proposes that the Member States should themselves be able to determine the minimum size of the eligible bail-in-able liabilities. This would allow significant differences between Member States with respect to the capacity of bail-in, in terms of both scope and minimum size. If cases arise, additional funds will be needed from the Resolution Fund (either by borrowing from other RFs or not) or from the taxpayer and/or the ESM at an earlier stage. Rabobank therefore does not support this option.

2.4 Optional contractual bail-in instruments

Lastly, the further elaboration of April 2013 proposes that Member States be allowed to choose to require a certain amount of contractual bail-in instruments in addition to the comprehensive approach. This would be possible through the imposition of an additional requirement regarding the size of own funds and/or contractual bail-in instruments as a proportion of the total liabilities.
The objection, besides that of an uneven playing field, is that when cases arise banks may be forced to place expensive and illiquid bail-in-able paper or to raise additional equity (Tier 1 and Tier 2). Rabobank does not support this option and would prefer to see a harmonised rule.

2.5 Coco vs. bail-in

Rabobank sees benefits in the issuance of so-called coco (contingent capital) instruments, since these going-concern instruments increase the robustness of the organisation in times of serious stress on the basis of contractually established conditions. These instruments should not be confused with bail-in instruments, since cocos can be converted or written off at an early stage. In the case of a bail-in, this happens at the "point of non-viability", it is part of the resolution and occurs on the basis of legislation.

3. Resolution Fund

3.1 Temporary Resolution Fund

The European Commission is proposing a Resolution Fund (RF) at Member State level based on minimum harmonisation rules (regarding target level, the term within which it should be funded, lending between RFs and the possible use of a DGS fund within an RF). This is intended as a first step towards a future fully harmonised European Resolution Fund (as part of the Single Resolution Mechanism). Rabobank supports a more harmonised RF, with at least equal requirements with respect to size (target level) and the period within which this size is to be attained.

3.2 Mutual lending

The current proposals include a procedure for Member

States to decide whether or not to grant loans to another RF. Lending is an option, not an obligation. Rabobank considers the lending facility to be premature, and that this would only work once a European Resolution Fund has been introduced. Only then can adequate pro rata burden sharing occur, in a system led by the European Resolution Authority.

3.3 Ranking of covered deposits/DGS fund

It is proposed that covered deposits or the DGS fund should be given a higher ranking in subrogation than unsecured senior debt. Rabobank does not support this, because it goes against the principle of the broadest possible basis for the comprehensive approach and will therefore reduce the primary base for bail-in.

4. The European solution

The introduction of the BRRD can be seen as the prelude to the proposals for a EU Resolution Authority and an EU Resolution Fund. The Commission has indicated it intends to come up with proposals for this in the near future (the summer of 2013). The structure is expected to largely mirror that of the SSM (the supervisory mechanism). In our view, the current BRRD proposals should set a clear direction for the forthcoming fully harmonised proposals. Unfortunately, we note that many of the actual decisions regarding design and structure and specific definitions have been left to the individual Member States. We moreover strongly support further harmonisation and think that this should be more clearly represented in the BRRD proposals.

For these reasons, our minimum proposals for the BRRD are:

- Not to include the authority to except liabilities from the definition of 'eligible liabilities' (Section 38, sub 3a);
- To include a minimum harmonised size of the 'eligible liabilities' (Section 39);
- Not to include the authority to set a minimum size for own funds + contractual bail-in instruments (Section 39a);
- To state explicitly that lending between Resolution Funds is neither obligatory nor strongly encouraged.

5. Conclusion

Assuming that at the time the bail-in tool takes effect all the outstanding unsecured debt qualifies as bail-in debt under the BRRD, Rabobank supports the comprehensive approach. Grandfathering for existing creditors should not be applied, since Rabobank would then be forced to issue new bail-in debt paper at higher spreads. In addition, the number of excepted instruments (short-term money, DGS claims and certain categories of deposits) should be limited as far as possible. This will spread the potential loss given default over the widest possible base of unsecured senior debt.
With the comprehensive approach, Rabobank will have the possibility of differentiating its capital ratios, thus mitigating the risk of bail-in as far as possible. Indeed, the bail-in obligation could be wholly or partially made up of Tier 1 and Tier 2 instruments. Rabobank is already anticipating the potential effects of the proposed bail-in tool in the composition of its buffer capital.

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