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New EC Proposal for a Directive on Bank Recovery and Resolution: Hedge Funds' Concerns about the New Debt Write-Down Tool

By Orestis Omran, Nora Wouters on October 2, 2012

On June 6, 2012 the European Commission (EC) published its proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms. Taking into consideration the lessons learned from the current financial crisis, the proposal seeks to establish a clear and comprehensive bank resolution regime for: ensuring long term financial stability and reducing the potential public cost of possible future financial crises. The resolution will apply to credit institutions and certain investment firms (those that have initial capital of EUR 730,000), financial institutions (when the financial institution is a subsidiary of a credit institution), investment firms, financial holding companies or parent financial companies (covered by the supervision of the parent undertaking on a consolidated basis in accordance with the relevant provisions of Directive 2006/48/EC), parent financial holding companies and branches of institutions having their head office outside the Union in accordance with the specific conditions laid down in the Directive.

It kicks in upon determination by the competent authority that the institution is failing or likely to fail and the application of normal insolvency proceedings might create financial destabilization with regard to the impact that the failure of the institution could have, due to the nature of its business, its size or its interconnectedness to other institutions or to the financial system in general, on financial markets, on other institutions, or on funding conditions. Member States should have adopted by 31st December 2014 all the laws, regulations and administrative provisions necessary to transpose the Directive into their legal orders.

The proposal provides the competent authorities in the EU Member States with a toolkit (such as the bridge bank, the sale of business, the asset separation, the bail-in and debt write down tool) that will allow them to deal with banks in financial distress. Those tools can be used either separately or in combination in order to successfully resolve the entity while avoiding the risk of a chain effect detriment to the economy.

In particular, the bail-in tool seeks to achieve a creditor financed recapitalization of systematically vital functions of an ailing financial institution. The competent resolution authority is provided with the power to write-down debt or convert into equity unsecured and uninsured claims in order to maintain continuity of systemically vital functions, by either recapitalizing the entity that provides these functions, or, alternatively, capitalizing a newly established or bridge institution to which these vital functions have been transferred following closure of the failed entity.

In order to apply the bail in tool, it is necessary that resolution authorities ensure that institutions would have a sufficient amount of liabilities in their balance sheet that could be subject to the bail in powers. The minimum amount is not yet certain, however it will be proportionate and adapted for each category of institutions on the basis of their risk or the composition of its sources of funding. According to evidence from the recent financial crisis and to performed model simulations, an appropriate percentage of total liabilities which could be subject to bail in could be equal to 10% of total liabilities (excluding regulatory capital); however, ongoing discussions involve questions as to whether this should constitute a minimum percentage or a mere starting point.

Many hedge funds investing in European financial institutions will be impacted with regard to the possible implementation of the newly introduced debt bail-in tool. Hedge fund representatives argue that the discretionary character of the application of the bail-in powers constitutes an illegitimate interference with the investors contractual freedom and right of property. In particular, they argue that an investment in a financial institution's debt cannot unconditionally and discretionarily be converted into shares of a new bank since the value of the new shares will be dependent not only on various market conditions but also on the capital requirements that a financial institution has to abide by virtue of the relevant provisions of Directives 2006/48 and 2006/49 of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and the capital adequacy of investment firms and credit institutions respectively and implementing the Basel framework agreement.

They believe that as it stands, this new resolution tool will have detrimental effects for ailing banks in Europe currently looking for new investors. Suggested amendments to the relevant provisions include restrictions on the competent national authorities' discretionary power to convert into equity or write down debt when winding up a bank and the introduction of exceptions and limitations in the use of the bail-in tool to the benefit of certain categories of debt holders. As the proposal now stands write down of derivatives will be included.

Those arguments definitely deserve merit and it remains to be seen whether they will be taken into consideration before the finalization and adoption of the proposal.

Topics: Capital Markets, Credit Institutions, European Commission, Hedge Funds

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