Cross Border Recognition of Bail-in and Overview on Recent Bail-in Case Studies

FinSAC Workshop on Bail-in and MREL

Kolja Stehl, Counsel, Shearman & Sterling LLP

12-13 December 2016
Contents

2. Local BRRD Solution: Banco Espirito Santo 6
3. Precautionary Recap: Piraeus Bank 10
4. Resolution of an Ex-Bank: Heta Asset Resolution 14
5. Asset Relief Measures without State Aid 18
1. Consensual Bail-in: The Co-operative Bank
1. Consensual Bail-in: The Co-operative Bank (1/2)

- Pre-BRRD, but against backdrop that permitted effectively similar actions
- 17 June 2013: Co-op announces capital shortfall. PRA sets deadline of end of year to raise £1.5bn of further Common Equity Tier 1 capital
- End of June 2013: group formed composed of holders of LT2 notes
- July–September 2013: bondholder group attempts to engage with Co-op
- October 2013: bondholder group enters into discussions with Co-op over terms of consensual bail-in and rights offering
- November–December 2013: consensual bail-in and rights offering effected through UK scheme of arrangement
  - Tier 2 debt holders equitized and given restructured Tier 2 instruments
  - Largely domestic resolution, but some cross-border issues
- No law suits filed so far as we are aware
- Rights offering oversubscribed, so no need for use of public funds
1. Consensual Bail-in: The Co-operative Bank (2/2)

- Co-op announces capital shortfall – regulation requirement to raise £1.5 billion CET1 by end 2013 (17 June 2013)
- LT2 Group forms (30 June 2013)
- Co-op announces revised Recapitalisation Plan (4 October 2013)
- LT2 Group enters discussions with Co-op (July-September 2013)
- Co-op announces confirmation of scheme modification (4 November 2013)
- Approval of scheme by Scheme Creditors (4 December 2013)
- Confirmation of Scheme Sanction (17 December 2013)
- Co-op announces completion of LME (18 December 2013)
- Co-op announces completion of LME (20 December 2013)
2. Local BRRD Solution: Banco Espirito Santo
2. Local BRRD Solution: Banco Espirito Santo (1/3)

- Post publication of BRRD but prior to implementation deadline
- Early July 2014: news surfaces of fraudulent conduct at BES' affiliates
- Mid July 2014: Governor of Bank of Portugal announces that BES is sufficiently capitalised
- August 2014: Bank of Portugal splits BES into "good bank" (n/k/a Novo Banco) and "bad bank" (still referred to as BES) under rushed-through BRRD-inspired national legislation
- End of October 2014: first Portuguese legal challenge commenced by LT2 bondholder group. At least 20 more lawsuits have been filed since then
  - Bank of Portugal failed to take appropriate early intervention measures
  - Bank of Portugal did not encourage or facilitate private recapitalisation in a timely manner
- December 2014: bondholder group commences suit before the European General Court seeking to annul the European Commission's decision to approve Portugal's State aid application
  - Investigation of BES resolution insufficient
  - Breach of duty to ensure State aid limited to the minimum necessary
  - Possibility of private capital ignored
2. Local BRRD Solution: Banco Espirito Santo (2/3)

- End of December 2014: the Bank of Portugal issued a ruling stating that a loan granted by a Goldman Sachs-formed vehicle (“Oak”) had not transferred to Novo Banco and remained at BES
- February 2015: Goldman Sachs and a group of funds commenced litigation in the English courts seeking payment from Novo Banco of the Oak loan notwithstanding the Bank of Portugal's position that the debt was a BES liability
  - Key issue being adjudicated upon was whether the December 2014 decision of the Bank of Portugal should have effect in English law
  - The English High Court adopted a strict approach as to which resolution measures will take effect in English law under the mutual recognition requirements of the BRRD
- September 2015: the Bank of Portugal decided to interrupt the sale process of Novo Banco
- November 2015: the Comprehensive Assessment conducted by the ECB revealed a capital shortfall of approximately EUR 1.4 billion
2. Local BRRD Solution: Banco Espirito Santo (3/3)

- End of December 2015: the Bank of Portugal decided to transfer senior bonds of almost EUR 2bn from Novo Banco back to BES
  - The selected bonds (5 series out of 52 senior bonds) were placed with institutional investors. Retail investors holding similar investments did not take any losses
  - The Bank of Portugal justified the selective re-transfer on the basis of public interest and financial stability
  - The original resolution decision expressly provides that Bank of Portugal may at any time re-transfer assets and liabilities between BES and Novo Banco
  - Query whether the BRRD anticipates this type of blanket re-transfer power used by the Bank of Portugal
  - Breach of the principle of equal treatment of creditors and the NCWO principle?
- January 2016: the Bank of Portugal re-launched the sale process of Novo Banco
- April 2016: Institutional investors filed lawsuits against the Bank of Portugal to challenge the retransfer in December 2015
- November 2016: English Court of Appeal reversed the decision of the High Court in February 2015, taking a much broader approach to the principle of mutual recognition
3. Precautionary Recap: Piraeus Bank
3. Precautionary Recap: Piraeus Bank (1/3)

- Greek banks went through a Comprehensive Assessment (AQR and stress tests) conducted by the SSM
- Banks expected State aid to be required to fill the capital shortfall
- As a condition to receiving State aid, "burden-sharing" must occur
  - Holders of equity, hybrid capital and subordinated debt must contribute to reduce the capital shortfall "to the maximum extent" before State aid is granted
  - Eurogroup statement that senior creditors would also be required to burden-share
  - Such burden-sharing could be done mandatorily (e.g. through legislative means) or consensually (e.g. through a liability management exercise)
- Banks wished to fill the capital hole without going into resolution
  - Under the BRRD, receipt of public funds indicates that the bank is "failing or likely to fail", which triggers resolution. However State aid may be received without going into resolution if it is considered "precautionary recapitalisation" under Article 32(4)(d)(iii)
  - This meant raising the AQR and base case through private capital, leaving the adverse case to be met by public funds as part of "precautionary recapitalisation"
3. Precautionary Recap: Piraeus Bank (2/3)

- Limits to burden-sharing through the BRRD mechanism
  - Scope of Article 59 is unclear – uncertainty around whether the write down/conversion power is available outside of resolution.
  - Subordinated instruments did not qualify as relevant capital instruments eligible for write-down or conversion under Article 59
  - SPV subsidiary issuances – even if Article 55 were to apply, BRRD only applies to liabilities of credit institutions and regulated subsidiaries of the group

- Limits to burden-sharing under HFSF law
  - This is the Greek national law that sets out certain powers that can be applied in relation to a credit institution that requests support from the HFSF in order to satisfy burden-sharing requirements under State aid rules
  - HFSF law at the time only allowed for the write down/conversion of "subordinated liabilities" of "credit institutions" – senior liabilities and SPV subsidiary issuances were out-of-scope
  - Measures taken under HFSF law require recognition under CIWUD, which might be subject to legal challenge
3. Precautionary Recap: Piraeus Bank (3/3)

- Greek banks and regulators combined the following steps:
  - LME – consensual conversion of bonds into equity, reducing liabilities and boosting CET1 capital
  - Rights issues – equity exchanged in LME supplied by rights issue. Rights issues also increased equity reserves independently of LME as investors subscribed to new shares
  - State aid – State investment in banks to fill any outstanding capital shortfall
  - Issuer substitution – bank substituted as issuer to bring instruments within the scope of BRRD/HFSF
  - HFSF law amendment to include seniors – brings seniors within the scope of bail-in as envisaged by the Eurogroup statement
4. Resolution of an Ex-Bank: Heta Asset Resolution
4. Resolution of an Ex-Bank: Heta Asset Resolution (1/3)

- Heta is the "bad bank" that was established as a wind-down vehicle to assume and manage large parts of the failed Austrian bank, Hypo Alpe Adria
- As BRRD only applies in relation to credit institutions and certain MiFID firms, the Austrian legislator explicitly made Heta subject to the Austrian BRRD implementation law (BaSAG)
- March 2015: the Austrian Financial Market Authority (FMA) issued an administrative ruling initiating the resolution of Heta under BaSAG and suspending the maturity of certain liabilities of Heta until the end of May 2016
- Since March 2015: Several creditors filed civil lawsuits in Germany and Austria against Heta as well as the region of Carinthia as guarantor
- May 2015: the Munich court of first instance refused to recognize the moratorium on the basis that the application of BaSAG to Heta goes beyond the scope of the BRRD
- January 2016: Carinthia's compensation fund (KAF) made an offer to buy back 75% of the face value of Heta's senior debt and 30% of the face value of Heta's subordinated debt
- March 2016: the Austrian finance minister suggested creditors who accept the offer could reinvest the proceeds in an Austrian government zero bond with a maturity of 18 years granting creditors a repayment of approximately 82%, but the proposals failed to obtain the required acceptance majorities
4. Resolution of an Ex-Bank: Heta Asset Resolution (2/3)

- April 2016: the FMA specified the next steps for the resolution of Heta
  - 100% bail-in for all subordinated liabilities
  - 53.98% bail-in, resulting in a 46.02% quota, for all eligible preferential liabilities
  - Cancellation of all interest payments from the beginning of March 2015
  - Harmonisation of the maturities of all eligible liabilities to the end of December 2023
- Mid May 2016: the Austrian finance minister and a significant number of Heta creditors executed a MoU, providing for a revised buy back proposal which reduces the duration of the zero bonds to 13.5 years
  - The cash offer is unchanged from the failed offer of January 2016
  - Option to re-investment in zero bonds with 13.5-year maturity to be issued by KAF and guaranteed by Austria is said to have a net present value of 90% of face value for senior debt and 45% for junior debt
- September 2016: European Commission confirmed that the settlement does not constitute new State aid
  - The buy back was launched on 1 December 2016, set to continue for 180 days
4. Resolution of an Ex-Bank: Heta Asset Resolution (3/3)

- There is a risk that holdout creditors do not support the settlement and continue to pursue litigation in court
  - However, further to the Vienna Commercial Court and the Federal Administrative Court of Austria, the District Court of Frankfurt am Main referred the question of whether BRRD is applicable to Heta to the European Court of Justice ("ECJ")
  - Similarly, the Constitutional Court of Austria decided to suspend a pending complaint against the BaSAG until the decision of the ECJ
5. Asset Relief Measures without State Aid
5. Asset Relief Measures without State Aid (1/2)

- During the crisis, State aid control acted as the *de facto* resolution framework for the banking sector
- Despite the implementation of BRRD, State aid control continues to play a crucial role
  - The 2013 Banking Communication provides for strengthened burden-sharing requirements, not only in resolution scenarios
  - The granting of State aid implies that a bank is failing or likely to fail and is therefore an automatic trigger for resolution under BRRD with limited exceptions only
- Whether a measure is State aid or not depends on the market economy investor principle
  - It must be demonstrated that a private undertaking, under similar circumstances, would have signed the transaction on the same terms
  - The Commission enjoys broad discretion as to the methodology used for this assessment
- Recent asset-relief measures examined by the European Commission illustrate the challenge in achieving a clear and consistent definition of State aid
- The valuation of any assets transferred to the State and the pricing of any risks otherwise assumed by the State must be in line with the market
5. Asset Relief Measures without State Aid (2/2)

- Asset-relief measures can take the following forms:
  - Asset guarantees
  - Asset purchases
  - SPV model

- Examples of "no State aid" deals are the contemplated assets disposals of HSH Nordbank to the newly established bad bank of the two State owners (hsh portfoliomanagement AöR), the Italian State guarantee on the securitisation of non-performing loans (Garanzia Cartolarizzazione Sofferenze, "GACS") and the creation of the Hungarian asset management company (Magyar Reorganizációs és Követeléskezelő, "MARK")
As one of the first law firms to establish a presence in key international markets, **Shearman & Sterling** has led the way in serving clients wherever they do business. This innovative spirit and the experience we have developed over more than 140 years make us the “go-to” law firm.

From major financial centers to emerging markets, we have the reach, depth and global perspective necessary to advise our clients on their most complex worldwide business needs.