The Systemic Safety Net: Pulling failing firms back from the edge

August 2010
AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association through the GFMA (Global Financial Markets Association).

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.
The Systemic Safety Net: Pulling failing financial firms back from the edge

1. **Executive summary** .......................................................... 5

2. **Contingent Capital** .......................................................... 7
   a. Background ................................................................. 7
   b. Trigger ................................................................. 8
   c. Ratings ............................................................... 10
   d. Developing a market in contingent capital bonds .................. 10
   e. Conclusion .......................................................... 10

3. **Bail-in** ........................................................................ 11
   a. Introduction ........................................................... 11
   b. Mechanics ............................................................ 12
   c. Classifying instruments subject to bail-in ......................... 14
   d. Acceleration of financial contracts ................................. 14
   e. Liquidity .............................................................. 15
   f. Lehman as case study ............................................. 15
   g. Cross-border implications ........................................ 17
   h. Impact on capital resources and debt pricing .................. 18
   i. Potential feedback effects and market discipline ............... 20
   j. Summary ............................................................. 21

ANNEX 1 ................................................................................. 22

ANNEX 2 ................................................................................. 23
1. Executive summary

AFME supports the authorities’ objective of strengthening bank capital and improving resolution regimes to eliminate the need for taxpayer recourse in any future crisis; and their work to develop clear, harmonised and cost-effective policies in the major jurisdictions to establish recovery and resolution plans in support of this objective.

We support both the optional use of contingent capital as part of a firm’s recovery plan and giving national regulators the authority to implement a fast-track recapitalisation via debt-equity swaps executed just prior to (and in lieu of) receivership or liquidation (a “bail-in”). The G-20 has charged the Financial Stability Board (FSB) with addressing both of these options for the 2010 Seoul summit. With the aim of generating a wider debate among policymakers and industry, this paper sets out the issues for consideration when developing proposals for contingent capital or bail-in.

“Contingent capital” is a recovery (rather than resolution) tool that serves to replenish a firm’s capital by converting a debt instrument to equity (or effecting a write-down of the debt instrument) well before a firm becomes distressed. The prospect of dilution or a write-down incentivises management to monitor the firm’s solvency and take corrective action earlier. We believe that appropriately structured contingent capital could serve as a bridge between the prudential benefits of higher capital levels and the negative growth consequences of increased capital requirements.

Lying between the traditional concepts of recovery and resolution, “Bail-in” differs from receivership in that it would look to preserve normal customer activities and maintain the firm as a going concern. In this way, it is similar to a consensual corporate reorganisation undertaken to maximise recoveries to investors beyond what they would receive in a liquidation. For the bail-in to succeed, it must not constitute a trigger for bankruptcy, accelerating debt instruments, nor the unwinding of financial contracts.

The restructured firm could still be liquidated or sold off if that were the most favourable outcome, but a bail-in would expand options available in the event of distress. It would be used in cases where it is likely to achieve a better outcome for counterparties, creditors, the wider market and the taxpayers. We believe bail-in could foster market discipline by shifting the burden of losses first to shareholders and then to unsecured creditors, using a fair, transparent and rules-based process.
Neither contingent capital nor bail-in would require taxpayer capital injections to improve the firm's capitalisation. However, neither directly addresses a notable feature of the recent crisis – liquidity runs. Liquidity should not be a significant problem under contingent capital if the conversion is structured to occur well in advance of significant distress. In contrast, a bail-in is designed to occur much later, when the firm *is* under significant distress.

While a newly recapitalised firm should be in a much stronger position to attract private sector financing, most (but not all) firms undergoing a bail-in would need a strong plan to address liquidity concerns as a temporary matter. A range of tools should be considered for supporting the firm early in the transition to address the period when market fears are likely to be significant. Such tools could include bank consortium support or allowing the use of super senior “DIP-style” financing; further liquidity tools could also incorporate direct or indirect central bank procedures.

As for implementation, the conversion of contingent capital into equity is self-operating pursuant to the terms of the instrument. A bail-in, on the other hand, would require new legislation. The firm would maintain the necessary information for a bail-in in its resolution plan (e.g. its capital and legal structure and debt:loss ratio) and, as insolvency neared, the firm and the regulators would use this information to determine the overall viability of a bail-in.

The ultimate decision to implement the bail-in, and its terms, would rest solely with the regulators and be subject to (or protected from) the same challenges by stakeholders as a firm undergoing any other resolution action by the authorities.
2. Contingent Capital

a. Background

1 Contingent capital is debt that provides a firm with a loss-absorbing layer of capital by converting into common equity or by effecting a “write-down” of all or part of the principal amount of the issuer’s debt upon the occurrence of a pre-determined trigger related to the issuer’s financial strength.

2 Historically used by the insurance industry to provision against large, one-time losses, since the financial crisis several AFME member firms, including Deutsche Bank, Lloyds Banking Group, Rabobank Group and Unicredit, have issued contingent capital to strengthen their balance sheets.¹

3 Like debt convertible into equity, a write-down replenishes the issuer’s equity capital but in a different way. Instead of diluting the existing shareholders no new shares are issued. The value of the aggregate equity capital increases by virtue of the corresponding reduction in the firm’s outstanding debt (and corresponding decrease in value in the contingent capital security).

4 A firm’s decision to structure contingent capital as an equity convertible or write-down will depend on which form is more efficient from the perspective of implied capital structure costs. Structural and legal factors may also drive the form. For example, write-down might be used by a firm without outstanding equity shares (such as a mutual), or if it is unable to secure a waiver of shareholders’ pre-emption rights under local company law. In this paper, the terms “contingent capital” and “conversion” encompass both the issuance of new equity and the write-down of debt, unless the context indicates otherwise.

5 Contingent capital is not considered a resolution tool as conversion occurs well before a firm becomes insolvent. It would not be legally imposed on firms, nor would it constitute an insolvency event for purposes of accelerating debt or unwinding derivatives. Regulators would not be involved when the trigger occurs.

¹ The attached Annex 1 shows two recent examples of contingent capital instruments issued by Lloyds and Rabobank, in each case creating core capital in a going concern.
Contingent capital must be characterised as debt for two reasons: first, to meet the requirements of fixed-income investors who will be needed to absorb supply; and second, to allow the issuer to receive tax-deductible treatment on the payment of interest, which lowers the cost of capital.

The Basel Committee, FSB and the Institute for International Finance are studying contingent capital as part of their reform packages. The G20 Toronto Communiqué stated support for the Basel Committee’s work on contingent capital in “strengthening market discipline” and noted that “consideration of contingent capital should be included as part of the 2010 reform package.” Among its broad range of prudential powers, the US Dodd-Frank Act empowers the Federal Reserve to set firms a minimum level of contingent capital that is convertible into equity in times of financial distress.

b. Trigger

1. The trigger for conversion must be clear, transparent, fixed at time of issuance and easy to determine when it occurs.

2. A trigger based on a core capital ratio set above the minimum core tier 1 capital requirements under the re-invigorated Basel III capital standards would meet these criteria. Firms should have the discretion to set the trigger in accordance with their own objectives to achieve the optimal balance between prudential and economic considerations. Factors the issuer might consider in setting the trigger are:

a. To receive treatment as going concern capital the trigger should activate before any breach of the firm’s minimum regulatory capital requirements, or any other circumstances giving rise to regulatory intervention.

b. The probability of breach needs to be low enough to attract a credit rating as debt and, as such, near to subordinated debt for purposes of pricing.

3. To ensure clarity in the market regulatory intervention must not be required to activate trigger.

4. The level of dilution (or write-down of debt) would be at the discretion of the issuer and driven by available pricing in the market and the impact on the issuer’s financial flexibility.
5 There could be a dual trigger structure whereby one trigger is set at the minimum core tier 1 capital level and a second trigger, which can be invoked by management at its discretion, is set above it. There is a view, however, that the inability of the market to predict management’s exercise of discretion would make the instrument too expensive to issue. The capital ratios could be disclosed on a quarterly basis in conjunction with the quarterly financial reports.

6 A trigger based on market metrics or a determination of impending systemic risk (made by a regulator) would not be effective. In addition to creating marketability issues, a trigger based on share price or market capitalisation is subject to manipulation and will almost certainly foreclose a proactive capital raise because it may fail to move the firm a safe enough distance from the trigger, which in turn will generate further negative price spirals. A trigger based on a determination of systemic risk is also unattractive, partly because it could not be used in cases of idiosyncratic risk. Waiting until firm-specific risk has spiralled into systemic risk is destabilising.

7 A trigger based on a forward-looking “stress tested” capital ratio is seen by many experts as too subjective and too complex. Under this scenario, financial institutions would run a quarterly stress test based on parameters set by national regulators and standard across all firms issuing contingent capital within that jurisdiction, which would evaluate the impact on balance sheets of major macroeconomic and financial stresses.

8 Another approach considered too complex and subjective is a disclosure-based trigger whereby firms would be required to publish extensive disclosures about their balance sheets and the impact of expected losses under certain specified scenarios. In effect this would operate as a public version of the stress test.

9 An argument for stress test-based triggers is that contingent capital could serve a prudential purpose beyond providing a source of equity capital alone, if it were designed to instil market discipline. The trigger could act as a virtual “electric fence” where the threat of significant dilution incentivises shareholders and management to take corrective action well before insolvency. Critics of this approach question whether this is practically achievable and whether there may be unintended consequences. A particular concern is that the threat of dilution may actually inhibit an equity raise at an earlier stage where the potential investor risks being significantly diluted in the near term. This firm also would reject
write-down as counterproductive to improving market discipline because shareholders are actually rewarded upon the write-down instead of penalised.

c. Ratings

1 Rating agencies may not rate contingent capital instruments for various reasons, including the equity nature of the instrument and the difficulty of predicting the occurrence of the trigger (as opposed to the issuer’s default under the instrument).

2 Unrated bonds will have difficulty attracting investors, particularly those whose investment parameters require them to invest in rated securities, and particularly in the US market where investors are less accustomed to unrated securities.

3 A non-investment grade rating would not preclude investor interest but it would dampen issuance volumes where investors face mandate limitations and their own increased capital requirements.

4 The working group is seeking feedback from the rating agencies on the rateability and structuring of the instruments.

d. Developing a market in contingent capital bonds

Investor demand will be driven by:

- the structure and terms of the instrument;
- the holder’s capital treatment for holding the contingent capital security; and
- the security’s inclusion in indices for benchmark purposes, and the like.

AFME is assembling a buy-side working group to provide investor feedback on these issues.

e. Conclusion

Effectively structured contingent capital could be an effective recovery tool, operating well before institution-specific problems could spiral into a systemic crisis, and could serve as a bridge between the negative economic growth consequences of increased capital requirements and the prudential benefits of greater capital levels.
3. Bail-in

a. Introduction

1. We agree with the authorities’ policy objective of eradicating the moral hazard of ‘too big to fail’ and avoiding the need for government bailouts in the future.

2. Existing insolvency procedures (such as administration in the UK and Chapter 11 in the US) do not work for large financial firms, except as a prelude for a disorderly liquidation, which can have catastrophic consequences. Financial firms depend critically on continuous market confidence. Such confidence will not persist through a lengthy and uncertain wind-down. Liquidation is typically an inefficient, destructive option for large companies – and is generally rejected by creditors in most industries in favour of a recapitalised going concern.

3. There have been significant steps since the crisis to expand the resolution powers available to the authorities, including transfer to a private sector purchaser, a bridge bank or temporary public sector ownership under the UK Banking Act and the US Dodd-Frank Act. Helpful as these measures are, other approaches could provide investors with a better economic outcome than a liquidation and avoid the challenges associated with government receivership or public ownership.

4. Bail-in is an approach that lies between “recovery plans” (e.g. equity issuance, asset divestiture, contingent capital) and “resolution plans” (e.g. receivership or liquidation). It would recapitalise the firm as a going concern by converting a sufficient amount of debt to equity without using any government capital injections. Execution would be fast-tracked; given the time pressures, results would be imposed (not negotiated) via a clear and fair protocol that would be transparent to investors. The legal claims of creditors would be reduced in exchange for overall value maximisation similar to a corporate restructuring. Business operations would continue normally but management would likely be changed by the regulator (as is typical for companies under statutory restructuring proceedings designed for company rescue).

5. A bail-in could produce an economic outcome similar to a consensual restructuring, but the legal procedures would need to occur far more quickly, e.g. over a weekend. If such a framework was designed in a convincing, transparent and fair
The Systemic Safety Net

manner, it could offer significant advantages over existing choices. The principal issues of a bail-in are:

c. the mechanics of implementation;
d. classifying the instruments eligible for conversions;
e. the triggers for regulatory intervention; and
f. avoiding acceleration of financial contracts and liquidity.

It would also require a coordinated change of law in major financial jurisdictions as well as understandings among the regulators of such jurisdictions. These are discussed below, together with a case study on Lehman, the cross-border implications, the impact on capital resources and debt pricing, potential feedback effects and market discipline.

b. Mechanics

1 The procedures needed to execute the bail-in would be directed by the lead regulator. Firms would be responsible for supplying information sufficient for the regulator to implement a bail-in (such as liability schedules by priority class), and to assist the regulator in the exercise of its powers as necessary. Third party advisors would also probably be needed (e.g. for valuation) given the considerable work involved in a short span.

2 The lead regulator would first need to determine that the firm no longer satisfied the conditions for continued operation in that jurisdiction, and was subject to potential seizure. For example, in the UK the trigger would be if the firm was failing, or likely to fail, the threshold conditions for its FSA permissions to carry on regulated activities, which relates to undercapitalisation and liquidity. Annex 2 lays out the triggers for the exercise of resolution powers under UK, US and Swiss law for illustrative purposes.

3 The regulator would next determine whether a going-concern outcome through a bail-in would be likely to achieve better value for investors. If these conditions were in place, then the regulator would initiate bail-in procedures.

4 There would be three primary steps in execution:

---

2 In many large bank failures, the estimated going concern value would exceed liquidation value but there are potential exceptions - for example, where management has been engaged in fraudulent activity. In other situations, the firm’s funding model may make it unsuitable for a bail-in - for example, a firm financed exclusively with equity and insured deposits.
i. Assets would be written down (or reserves taken) to put the balance sheet to a more conservative position that has market credibility.

ii. The amount of new equity required to support a going-concern company would be estimated. This would likely be an amount greater than simply restoring the status quo ante. A conservative estimate is needed to be convincing to the market and to avert the need for a further recapitalisation later.

iii. These overall requirements would need to be translated into specific impacts on individual classes of investors. In general, write-downs would be applied to the most junior classes, starting with equity and progressing in strict order of creditor priority (up to, and including if necessary, senior unsecured debt). Conversions of creditor claims into equity would then progress, from the remaining junior classes up to senior unsecured classes, as needed, to achieve the desired overall capital ratio. All members of a given class would be treated equally.

5 The authorities will need to adopt rules to govern bail-ins, such as (i) the identification of the classes of instruments that could be subject to bail-in, and (ii) the elimination of requirements for consent from creditors, shareholders, listing authorities, etc.

As a check and balance on the authorities’ ability to impose a bail-in unilaterally, lawmakers should consider safeguards such as equal treatment of all holders of a class, clarity of rules for investors ex ante, and robust transparency to affected investors, as well as the protection of property rights. In some jurisdictions, this would require that investors be entitled to receive an amount estimated to be no less than what they would receive in liquidation.

6 Lawmakers would also need to consider legal principals under local law whereby transactions can be unwound for the benefit of the firm’s creditors, such as fraudulent conveyance or unfair preference. A guideline might be that a bail-in be subject to (and protected from) the same types of claims and causes of actions as any firm to which the authorities have exercised resolution powers, i.e. receivership, transfer to a third party or liquidation. A framework under local law for allowing (or not allowing) challenges to the valuation supporting the bail-in could be
similarly modelled on how that jurisdiction treats valuation challenges under other resolution scenarios.

c. **Classifying instruments subject to bail-in**

1. The overall approach of a bail-in is to adopt a procedure analogous to an industrial recapitalisation – the unsecured capital structure would be reorganised but liabilities that arise in the course of franchise activities would be protected (to the extent possible) in order to maximise value.

2. The standard unsecured capital sources subject to bail-in would include equity, preferreds, unsecured bonds and other similar debt, and hybrid capital instruments.

3. Franchise activities are those that a bank carries out in the ordinary course of business, such as transaction payments, settlement flows, prime services and normal derivatives. To preserve the customer franchise for the benefit of investors, liabilities associated with these activities would not be subject to haircuts. (In addition, imposing haircuts on this category would create significant practical difficulties in many large banks, given the high number of transactions that would need to be altered in a short timeframe).

4. Bail-in would also avoid haircuts to secured liabilities (i.e. normal fully-secured repo) or protected funding (insured deposits) that have been protected by historic policy.

5. Grey areas where classification might require further study include institutional deposits and short term funding. While it is possible to consider different alternative regimes, these decisions would need to be made clear as part of the bail-in regime *ex ante* (i.e. they cannot be decided on an *ad hoc* basis).

d. **Acceleration of financial contracts**

1. A bail-in would need to avoid any insolvency-based events of default under the 1992 or 2002 versions of the ISDA Master Agreement, as well as under any other financial contracts. Absent such avoidance, the institution's derivatives contracts could be closed out, leading to a significant loss of franchise value and expansion of liabilities for the bailed in firm. Acceleration would also create an additional pathway for stress to be propagated to other institutions.
2 This result could be obtained through legislation or regulation, or possibly via a change to ISDA protocols. For example, bail-in legislation could specify that the bail-in is disregarded in determining whether an event of default has occurred under any contracts to which the relevant institution is a party, credit support provider and/or specified entity, as is the case of share and property transfer instruments under the UK Banking Act (and the 24 hour enforcement stay under the Dodd-Frank Act).

e. **Liquidity**

1 Liquidity concerns were a prominent feature of the recent crisis. While bail-in does not address that concern directly, it does address the root cause of illiquidity - the fear that creditors are not adequately protected by equity. Liquidity often has its own dynamics and momentum, however, and will need to be addressed specifically. After bail-in has been used a few times there may be less liquidity pressure because the market will know that funding related to franchise activities (vulnerable to runs) will be protected. Until then, a bail-in will need to be accompanied by a liquidity plan that is sufficiently strong to restore liquidity and confidence.

2 There are private market approaches that could be effective, such as a bank syndicate to provide funding post-bail-in (similar to the consortium that provided support for LTCM in 1998). However, this is an area where central bank procedures have often proved decisive due to their financial capacity and respect in the market.

3 Central bank liquidity support to a strongly recapitalised institution (i.e., one with low true credit risk) should be considered as part of a range of tools. One approach that merits particular consideration is the potential for a super-senior class of funding that could be pledged to the central bank. This could create an indirect supply of liquidity to the new institution through a facility made widely available to consortium banks. Such support would be in line with traditional lender of last resort concepts, without putting taxpayer capital at risk.

f. **Lehman as case study**

1 Consider the case study in the table overleaf which examines how a bail-in might have been applied in the case of Lehman. Old equity capital is written off due to asset write downs. New equity capital is created by converting Lehman’s common, preferred, subordinated and a portion of senior unsecured debt.
This would be sufficient to achieve a tier 1 ratio above 20% (purposely conservative to engender market confidence).

<table>
<thead>
<tr>
<th>Case Study: Bail-in of Lehman</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Write down assets to conservative level (ca $25 billion loss)</strong></td>
</tr>
<tr>
<td><strong>Remove management</strong></td>
</tr>
<tr>
<td><strong>Recapitalise firm through exchanges (not write-offs)</strong></td>
</tr>
<tr>
<td><strong>Old balance sheet</strong></td>
</tr>
<tr>
<td>$25 bn equity</td>
</tr>
<tr>
<td>$25 bn preferred &amp; sub debt</td>
</tr>
<tr>
<td>$120 bn senior unsecured</td>
</tr>
<tr>
<td>Remaining 85% debt is unchanged - but better rated</td>
</tr>
<tr>
<td>Secured debt, insured deposits, customers and counterparties are unaffected</td>
</tr>
</tbody>
</table>

2 Investors in the Lehman case study would have to recognise embedded losses of roughly $25 billion under a bail-in, considerably less than the estimated $150 billion in market losses that occurred. (The market loss estimate is based on post-bankruptcy trading levels for Lehman equity, preferred and subordinated debt - essentially worthless - and unsecured debt securities trading at approximately 20% of face value). Some argue that these losses were especially high due to the disorderly nature of the Lehman filing. While it is difficult to determine the exact components of this loss, most believe that even an orderly transition to gone-concern will destroy substantial value.

3 Although the bail-in would have reduced claims and subordinated investors, investors should still be better off in economic terms than under a liquidation. Bail-in avoids the large, unnecessary additional losses that arise in the transition from “going concern” to “gone-concern.” If Lehman had undergone a bail-in, senior unsecured creditors might have retained value equal to 85% to 95% of their original claim, rather than the 10% to 20% recovery values indicated by post-bankruptcy market trading levels.

4 The reduction in losses has important systemic implications. If the loss to creditors can be reduced from the severe levels implied by liquidation to a more modest (5% to 15%) level, stress on investing institutions will be much reduced. For example, one practical outcome of a lower loss level might have been to avoid the "breaking the buck" event that occurred at The
The Systemic Safety Net

Reserve Fund, which led to significant contagion in that sector after the Lehman bankruptcy.

g. Challenges in cross-border implementation

1. The likely preferred route to conferring bail-in authority would be statutory provisions in the firm's home state conferring on the home state regulator the necessary range of powers as an extension of its resolution regime. These would include powers to cancel, write down or convert existing claims of equity and debt holders (including powers to override pre-emption or other restrictions on issuing new shares or warrants), replace management and override termination/acceleration provisions in debt and other contracts in order to preserve the firm's value as a going concern.3

2. Because the objective is to preserve the firm as a going concern, these powers will need to be capable of operating in relation to the regulated entities within the group and the group holding company (in particular so that creditors whose claims are written down can be given equity in the group holding company) and possibly other group companies.

3. Where the regulator takes action affecting creditors' rights under a firm's obligations whose governing law is not the law of the firm's home state jurisdiction (e.g. where a non-US or non-UK firm has issued debt governed by New York or English law), there will be an issue as to whether foreign courts will recognise the effectiveness of that action. One solution may be for firms to include contractual provisions in the instruments constituting those obligations making clear that the creditors' rights are subject to the powers granted to the home state regulator under the relevant statutory provisions in the home state (so that over time the bulk of a firm's relevant liabilities would be subject to the regime). Alternatively, states may be willing to adopt laws recognising the effectiveness of action taken under bail-in authorities in other jurisdictions (within the EU, a directive could require mutual recognition of action by other EU

---

3 A possible alternative approach is to embed the resolution authority in debt instruments that are potentially subject to conversion/write down. There would be issues for the regulators as to whether they are prepared to rely solely on contractual authorities without a statutory basis, particularly where there are large number of contractual provisions in potentially different forms in a multiplicity of senior debt instruments and where the regulator is required to exercise significant discretion. In addition, the regulator is likely to need statutory powers to cancel existing shares, override pre-emption rights, stay termination rights, change management, etc.
The resolution authority granted to the home state regulator under its law would not extend to subsidiaries in other jurisdictions (absent statutory provisions in those jurisdictions extending the home state regulator's powers, which may conflict with local mandates). Therefore, there is the risk that the success of a bail-in could be undermined by regulatory or creditor action against those subsidiaries (e.g. to ring fence or seize local entities or assets). However, for most groups, the group holding company and the key regulated entities in the home state will be the obligors in respect of the bulk of liabilities necessary to recapitalise the group. The recapitalisation of those entities through the bail-in process should also allow the holding company sufficient flexibility to write off or convert claims on the subsidiaries and/or downstream fresh liquidity to preserve their business and to address concerns of local regulators or creditors. In addition, the subsidiaries’ regulators may also be willing to use their own powers to support the bail in process at the group level (e.g. where there are cross-default clauses). The group's recovery and resolution plans should enable the college of regulators to identify in advance where co-operative action might be necessary to enable a bail in process to be successfully implemented.

h. Impact on capital resources and debt pricing

1 Capitalisation of most large banks typically includes a variety of instruments, including equity, preferred and hybrid capital instruments, and senior and subordinated unsecured debt. In many cases, a bail-in would need to convert only a few junior classes (e.g. subordinated debt) to recapitalise. In severe cases (such as Lehman) a firm might, however, need to allow for the capability of converting a portion of its senior unsecured debt to create sufficient capital.

2 The scale of the unsecured senior class would help provide assurance to supervisors and regulators that a bank possessed sufficient resources to handle even highly adverse scenarios via a bail-in. For example, the 20 largest US banks have approximately $3.3 trillion of non-deposit liabilities. A majority of this is comprised of senior and subordinated debt that, if converted to equity, would create a pool of potential going
concern capital that far exceeds their existing tier 1 capital of approximately $0.8 trillion.

3 The cost of funding in a bail-in regime is an important practical consideration. Some believe that it might be significantly more expensive than the current regime and that it should be analysed like a form of contingent capital. Others believe that the correct analysis is based on an economic framework that considers debt subject to a bail-in regime as normal funding subject to a more economically efficient and appropriate form of resolution.

4 A robust bail-in regime could mean that bank debt would no longer trade on the premise that the government might bail it out upon insolvency. This will also affect bank spreads in some jurisdictions. Credit markets subject to a bail-in regime should trade based on economic fundamentals - namely the risk that a given bank will suffer a major capital shortfall.

5 The economic analysis of bail-in for the cost of bank capital rests primarily on probability of default / intervention and the size of loss given default. Probability of default should be largely unchanged by the possibility of a bail-in, as it is triggered by the same threshold conditions as a regulatory seizure. The loss given default comparison depends on the benchmark. The loss to senior investors from a bail-in should be smaller than a Lehman-like liquidation (roughly 20% recovery) but larger than situations where debt investors are fully protected by government support. A reliable policy of full government support would produce cheaper funding but undermines the key policy objective of ending bailouts. If government support is excluded (or even uncertain in practice), bail-in should provide a better result to investors than liquidation because of the lower loss given default.

6 Uncertainty remains over whether the overall cost impact would be somewhat negative, due to the loss of potential government support as well as market structure and transition concerns, or be flat to negative for well-run institutions, due to the economic effect cited above.

4 Quantifying the cost of losing sovereign support can also be considered a “benchmarking” issue. If policymakers succeed in making bailouts extinct, then this issue will be removed and the only question will be around the efficiency of the methods used to resolve a troubled firm.
i. Potential feedback effects and market discipline

1. It is important to consider how firms and markets would react to a convincing bail-in framework. Some firms may be incentivised to replace unsecured debt (subject to potential bail-in conversion) with protected, lower cost financing such as repo. While this incentive may not be significant in good times, it could grow if a firm faced a crisis and debt investors feared a bail-in.

2. This pressure could be managed via anti-arbitrage rules, but this would bring different challenges. Perhaps the simplest, most direct approach would be to require a minimum level of unsecured debt that could be accessed. The “bail-in capital” ratio could become a key systemic risk indicator.

3. It is possible that a bail-in policy could change market behaviour for certain classes of counterparties. In particular, if certain customer and liability sectors (insured deposits, derivatives, repo) are protected, they should be less prone to flight risk if rumours about a bank’s health begin to surface. This could result in less market discipline from these markets. However, these groups have often been less valuable as a signal due to the short tenor of these instruments and because other financial elements (e.g. collateral support) often overshadow the credit view of the underlying firm.

4. In contrast, a bail-in regime could lead to the unsecured debt market being used to signal the creditworthiness of the bank. This is a good outcome as this market is more comfortable with credit analysis and better suited to provide strong market discipline.

5. Transferring losses to shareholders and creditors addresses moral hazard. Some might argue that imposing greater losses (e.g. from liquidation) might be better still, because larger losses might provide stronger incentives. We believe that the motivations for managers, equity and debt holders to work hard to avoid a bail-in are sufficiently strong. Beyond that we see no benefit from imposing higher losses on the financial system if a firm could be reorganized among private investors without taxpayer capital.

6. Bail-in avoids the need for a cumbersome restructuring of a firm’s internal organisation (for example, subsidiarisation) that other commentators have suggested as a way to deal with the potential failure of a large bank. Similarly, bail-in mitigates the
need for overly conservative capital requirements that could affect economic growth, which are driven by the same objectives as bail-in, namely, avoiding bailouts.

j. Summary

1 A bail-in could increase going concern bank capital by a large multiple and would give regulators an important new tool in a future crisis.

2 Bail-in protects depositors, transaction payments and key customer activities, which should materially lower the risk of runs and reduce a source of systemic risk.

3 While bail-in does haircut certain investors, they are likely to end up with a better economic outcome.

4 Bail-in reduces systemic risk by avoiding a potentially costly and damaging liquidation outcome. By reducing the cost of big bank failure and improving certainty, it reduces the risk and impact of contagion.

5 Bail-in could be used to help address the challenging issue of cross-border resolution. It creates new capital that could be used to recapitalise subsidiaries and create mutual incentives for a globally constructive solution.
## ANNEX 1

### Summary Terms of Lloyds and Rabobank Contingent Capital Notes

<table>
<thead>
<tr>
<th></th>
<th>LBG ECNs</th>
<th>Rabobank SCNs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Subordination:</strong></td>
<td>In a winding-up will rank junior to Senior Creditors and senior to UT2 and Tier 1 capital and all share capital <em>Pari passu</em> with LT2 capital</td>
<td>In a winding-up will rank senior to Tier 2 and Tier 1 capital and all share capital <em>Pari passu</em> with other senior unsecured obligations</td>
</tr>
<tr>
<td><strong>Maturity:</strong></td>
<td>Dated, bullet, minimum 10 years</td>
<td>Dated, bullet, 10 years</td>
</tr>
<tr>
<td><strong>Early redemption options:</strong></td>
<td>Tax and capital disqualification calls</td>
<td>Tax call</td>
</tr>
<tr>
<td><strong>Coupon deferral:</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Issuer conversion option:</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Mandatory conversion / write-down:</strong></td>
<td>Mandatory conversion into fixed number of ordinary shares of LBG upon breach of Trigger Event Conversion ratio is based on the share price at issue</td>
<td>Mandatory write-down of original principal amount to 25% of par if Trigger Event occurs Automatic redemption at 25% of original principal after mandatory write-down</td>
</tr>
<tr>
<td><strong>Investor conversion option:</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Trigger event:</strong></td>
<td>Latest published consolidated Core Tier 1 ratio falls below 5% Consolidated Core Tier 1 ratio means Core Tier 1ⁱ / RWA of LBG</td>
<td>Equity Capital Ratio is less than 7% as certified by two Executive Board members on any two successive observation dates approximately 23 business days apart Equity Capital Ratio means Equity Capital² / RWA of Rabobank on a consolidated basis</td>
</tr>
<tr>
<td><strong>Regulatory treatment:</strong></td>
<td>LT2 for Pillar 1 and Pillar 2, and upon conversion as Core Tier 1 Core Tier 1 under FSA’s stress test</td>
<td>None stated</td>
</tr>
<tr>
<td><strong>Ratings:</strong></td>
<td>Ba2 / BB / BB (Note: Moody’s have subsequently stated that they will not rate subsequent instruments given regulatory uncertainty re trigger linked to regulatory capital)</td>
<td>Unrated</td>
</tr>
</tbody>
</table>

1: Core Tier 1 means core tier one capital as defined by the FSA as in effect and applied (as supplemented by any published statement or guidance given by the FSA) as at 1 May 2009

2: Equity Capital means the aggregate Euro amount of Member Certificates (and such successor or other instruments representing capital paid up or contributed to the Rabobank Group by members) and retained earnings of the Rabobank Group at such time calculated by the Issuer on a consolidated basis in accordance with the accounting standards applicable to the Rabobank Group at such time

*Source: Offering Circulars*
## ANNEX 2

### Triggers for Use of Resolution Powers under the UK Banking Act, US Dodd-Frank Act and UK Insolvency Act

<table>
<thead>
<tr>
<th>Resolution Powers</th>
<th>Triggers</th>
</tr>
</thead>
</table>
| **UK** Use of stabilisation powers under the UK Banking Act 2009 (the “UK Banking Act”) | Under Section 7 of the Banking Act, a stabilisation power (i.e. including a transfer to a private sector purchaser, bridge bank or to temporary public sector ownership) may be exercised in respect of a bank only if the UK Financial Services Authority (“FSA”) is satisfied that the following two conditions are met:  
  - **Condition 1** is that the bank is failing, or is likely to fail, to satisfy the threshold conditions (within the meaning of section 41(1) of the Financial Services and Markets Act 2000 (“FSMA”) (permission to carry on regulated activities)).  
  - **Condition 2** is that, having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.  
  
  Section 7(4) specifies that the FSA shall treat Conditions 1 and 2 as met if satisfied that they would be met but for financial assistance provided by the Treasury or the Bank of England (disregarding ordinary market assistance offered by the Bank on its usual terms). |
| **US** Systemic risk determination under Section 203 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) | Under Section 203(a)(4) of the Dodd-Frank Act, a financial company shall be considered to be "in default or in danger of default" (and therefore subject to the orderly liquidation provisions of the Act) if, as determined by the Treasury Secretary in accordance with the Act:  
  (a) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code;  
  (b) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;  
  (c) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or  
  (d) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business. |
| **Switzerland** Condition to taking action on a failing bank by Swiss authorities | FNMA can decree the following "preventative measures", restructuring, or liquidation if "a justified concern exist that a bank is over-indebted or has serious liquidity concerns or that the bank no longer fulfils the capital-adequacy provisions after expiry of a deadline set by FNMA". Preventative measures may be decreed in isolation or in conjunction with a restructuring or liquidation.  
  A bank is "deemed to be overindebted as soon as the valuation of its assets is such as to raise doubts about its ability to meet the claims of its creditors."  
  **Timing**  
  "Early intervention": FNMA "steps in as soon as a bank is unable to comply with the capital-adequacy requirements for an extended period or..." |
experiences liquidity problems, or if there is other indications of impending insololvency. No formal evidence of overindebtedness or inability to meet payment obligations is required before restructuring or liquidation proceedings are initiated.

<table>
<thead>
<tr>
<th>UK Insolvency Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration order under the UK Insolvency Act 1986 (as amended by the Enterprise Act 2002) (the &quot;Insolvency Act&quot;)</td>
</tr>
<tr>
<td>Under paragraph 11 of Schedule B1 of the Insolvency Act, a court may make an administration order in relation to a company only if satisfied -</td>
</tr>
<tr>
<td>(a) that the company is or is likely to become unable to pay its debts, and</td>
</tr>
<tr>
<td>(b) that the administration order is reasonably likely to achieve the purpose of administration.</td>
</tr>
<tr>
<td>Where the company in question is a regulated entity, the FSA’s consent to the appointment of the administrator is required under Section 362A of FSMA.</td>
</tr>
</tbody>
</table>