A Temporary Bail-In to Stabilize Weak Euro-Zone Banks

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Summary

Policymakers face a difficult choice in the face of a solvent but under-capitalized bank: a bail-out with taxpayer money, an immediate resolution that converts bank debt holders to shareholders or allow a weak institution to struggle creating uncertainty and instability in financial markets.

The ECB has proposed another option. Taxpayers will "temporarily" bail out solvent but under-capitalized banks. Under a "precautionary recapitalization", the government will provide the needed capital temporarily until private sector investors can step in and replace the public funds. The ECB does not want to frighten investors by imposing losses on bank debt holders. Temporary bail-outs create perverse incentives for regulators and investors and, too easily, become permanent. The Euro-zone's bail-in rules should be applied uniformly to solvent and insolvent banks.

There is a market-based alternative to a bail-out or an immediate resolution. If the capital shortfall is really temporary, there is no need for taxpayer funds. The bank's junior and even senior debt holders can provide the interim capital. The bank's debt holders will be temporarily bailed in and their claims temporarily converted to equity. The bank is immediately recapitalized but is given time to develop a viable business plan and raise the needed capital from private sector sources.

Once new capital is raised from private sector sources, the former debt holders will have the option of retaining their shares or reconverting their shares back to their original debt claims. If the funds are truly only needed temporarily, the bank's debt holders will be only temporarily bailed in. If the bank cannot raise new capital from private sector sources, the debt holders will be permanently bailed in.

Though the bail-in may be temporary, the increase in Common Equity Tier 1 (CET1) capital is permanent. The temporary bail-in is a logical extension of the concept of Contingent Capital and will not have a significant effect on the bank's cost of funds. It will not be difficult to implement and will be based upon standard practices of the capital markets.

A temporary bail-in of creditors will create stabilizing incentives and will pressure banks to raise needed capital quickly. The temporary bail-in structure fully complies with European State-aid rules because no public funds are utilized. The Single Supervisory Mechanism/Single Resolution Mechanism or the ESM Treaty provide vehicles for implementation across the Euro-zone.

Small investors can be fully protected under a temporary bail-in while providing equal treatment for all investors of equal rank. EUR 200,000 of every investor's debt holding would remain in its original debt form. Only the excess of each investor's debt holding above EUR 200,000 would be temporarily converted to shares. For banks with large numbers of retail investors, 95% of retail bondholders will be completely protected from the temporary bail-in and keep their entire original debt claim.

I. Temporary Bail-Out: Incentive to Treat Insolvency as Illiquidity

Policymakers face a difficult choice in the face of a solvent but under-capitalized bank: a bail-out with taxpayer money, an immediate resolution of the bank with the permanent conversion of bank debt

holders to shareholders or allow a weak institution to struggle creating uncertainty and instability in financial markets.

The ECB has proposed another option. Under Article 32 of the EU Bank Recovery and Resolution Directive, taxpayers will “temporarily” bail out solvent but under-capitalized banks. In a “precautionary recapitalization”, the government will provide the needed capital temporarily until private sector investors step in and replace the public funds. The ECB does not want to frighten investors by imposing losses on bank debt holders.

“Temporary bail-outs” create an incentive for supervisors to treat an insolvent bank as one that is simply "undercapitalized". Undercapitalization becomes a form of illiquidity. The bank simply needs capital on a short term basis until it is able to raise equity from private sector sources in the near term.

This perverse incentive is the source of many of the problems in sovereign debt.

All emergency loans to governments are "temporary bail-outs". In theory, the IMF, EU and ESM never lend to insolvent governments, only to illiquid governments. But these sovereign "supervisors" always fear that interest rates for other borrowers will rise if they do not temporarily bail out the crisis country. To justify the “illiquidity”, they base their reviews on overly optimistic assumptions to justify the solvency of the borrower.

However, while the taxpayer "temporarily" steps in, the private sector withdraws. Government bonds mature and are repaid with official funds or are bought by official institutions under secondary market support programs. Soon, there are no longer sufficient private sector claims that can be restructured to restore the government's solvency. Losses migrate from private sector creditors to taxpayers.

Greece is the perfect example. What began as a EUR 50 billion 3 year official sector liquidity loan is now a EUR 280 billion 30 year taxpayer claim that will never be repaid in full.

If bank supervisors have a temporary bail-out option, they will have an incentive to be "soft" in their reviews and to treat very weak banks as simply "undercapitalized". As temporary bail-out funds flow into the bank, private sector funds flow out as bonds mature and are repaid. When the need for a permanent conversion of debt to equity is finally recognized, many of the claims originally available to be bailed in will have disappeared. The “temporary” bail-out will then be permanent. The Euro-zone’s bail-in rules should be applied uniformly to solvent and insolvent banks.

II. Temporary Bail-In of Bank Debt Holders: Market-Based Alternative to Bail-Out or Resolution

There is a market-based alternative to a bail-out or an immediate resolution of a solvent but undercapitalized bank. If the problem is simply a question of timing and the capital shortfall is really temporary, there is no need for taxpayer funds. The bank's junior and even senior debt holders can provide the interim equity capital.

To attain necessary capital levels, the bank’s debt holders will be temporarily bailed in and their claims temporarily converted to equity. Debt holders will be converted to shareholders starting at the lowest rank and continuing up the capital structure until the necessary Common Equity Tier 1 (CET1) capital is reached. (See Section A of Technical Appendix below.)

Once the required new capital is raised from other private sector sources, the former debt holders will have the option of retaining their shares or reconverting their shares back to their original debt claims for a 60-day period. At the end of the reconversion period, any non-reconverted temporary shares become ordinary shares.

If the bank cannot raise the required capital from private sector sources within a 12-month period, the debt holder claims will be permanently converted to ordinary shares.

If the funds are truly only needed temporarily, then the bank's debt holders will be only temporarily bailed in. Reconversion of temporary shares back to original debt claims marks the completion of the temporary bail-in. After reconversion, all investors (debt holders, old shareholders and new shareholders) will be in the exact same position as if the bail-in had never taken place.

The investor reconversion option follows the priority rank of the original debt claim. If the bank is only partially successful in raising the required capital from other private sector sources, holders of the most senior original debt claims will have the first right of reconversion back into their original debt. The reconversion right will then follow the priority of original debt claims down the debt hierarchy until the total amount that can be reconverted is reached (minimum CET1 capital requirement). (See Section B of Technical Appendix below.)

The temporary bail-in prevents private sector investors from withdrawing funds that may be needed to recapitalize the bank and leaving taxpayers to pay the bill. If any capital shortfall is filled by a temporary bail-in of the bank's private sector creditors, the supervisor's incentive to be "soft" with weak banks is eliminated.

A temporary bail-in immediately recapitalizes the bank but allows the bank one year to develop a viable business plan and raise the needed capital from private sector sources. If at the end of the year, the bank is unsuccessful in attracting private sector capital, the conversion of debt to equity was necessary and becomes permanent as intended under Euro-zone bail-in provisions. Stability is increased because the viability of the bank is ensured at all times and markets have time to evaluate the bank's business plan and adjust their expectations.

III. Increase in Common Equity Tier 1 Capital is Permanent

Though the bail-in of the bank's debt holders may be temporary, the increase in CET1 capital is absolutely permanent. Any reconversion of shares back to the original debt claim is subject to the condition that the bank raise the necessary CET1 capital from other private sector sources. This condition ensures that the CET1 capital of the bank will meet required levels under all circumstances, i.e. whether reconversion of temporary shares back to original debt claims takes place or not.

If the bank raises additional capital from other private sector sources, the CET1 requirement is met even after the reconversion of shares back to original debt claims. If the bank does not raise the additional capital from other private sector sources, the debt necessary to meet the CET1 requirement is permanently converted to equity. If the bank is only partially successful in raising capital from other private sector sources, reconversion will be partial to ensure that the CET1 requirement is met.

Under a temporary bail-in, the supervisor, the bank, the market and the bank's investors and depositors all know that the bank will meet its capital requirements with certainty. This eliminates any uncertainty over the bank's future viability.

IV. Temporary Bail-In is Logical Not Revolutionary

The temporary bail-in is a logical extension of the concept of Contingent Capital. The concept of bail-in for "going concern" and "recovery" was introduced very successfully with Contingent Convertible (CoCo) bonds and similar instruments. Markets have priced and embraced this concept. One way to view the temporary bail-in reconversion feature is as the mirror image of a CoCo bond.

Under a CoCo bond, if the CET1 capital of a bank falls below a specified trigger level, the bond is automatically converted from debt to equity.

Under a temporary bail-in, if the CET1 level rises above a specified target, because the bank has raised equity from other private sector sources, temporary shares can be reconverted back to their original debt claim.

Markets have no difficulty valuing CoCo bonds and determining their impact on share prices. CoCo bonds have a higher yield/lower value than debt without the conversion feature and a lower yield/higher value than ordinary shares. Similarly, the temporary shares with a reconversion feature under the temporary bail-in will have a higher yield/lower value than non-converted debt and a lower yield/higher value than ordinary shares.

However, the temporary bail-in has less uncertainty and less risk for the investor than a CoCo bond. Under a CoCo bond, the conversion from debt to equity is permanent. The temporary bail-in will be temporary if the bank is solvent and has a viable business model.

If a bank is truly "viable and solvent and facing merely temporary issues", a temporary bail-in will have negligible effects on the price of its shares and even on the prices of its bonds. If the problems are temporary, then the share holding period of any converted debt holder will also be temporary. The debt holder will suffer no loss and may receive an additional profit if its converted shares become worth more than its original debt claim.

If a bank cannot raise the necessary capital from other private sector sources, the problems were not temporary. In this case, the bail-in should not be temporary either and the conversion from debt to equity will, and should be, permanent.

V. Increased Incentives for Recapitalization

A temporary bail-out reduces the pressure on a bank to raise the required equity. Banks have great power to convince supervisors to extend temporary bail-outs.

Under a temporary bail-in, investors will pressure banks to raise the necessary capital quickly to allow the reconversion of their temporary shares back to their original debt claims. If a bank quickly raises the necessary capital that allows reconversion, investors will reward it with lower financing costs.

VI. Compliance with EU State-Aid Rules and Implementation of the Temporary Bail-In Tool

The temporary bail-in structure fully complies with European State-aid rules because no public funds are utilized.

The Single Supervisory Mechanism/Single Resolution Mechanism can provide the vehicle for implementation of the temporary bail-in tool across the Euro-zone. The ESM Treaty could provide another mechanism. The necessary provisions could be included in any modification of the Treaty that addresses direct bank recapitalization with ESM funds.

VII. Protection of Small Investors while Ensuring Equal Treatment of All Investors

The protection of small investors may be necessary to ensure financial stability if a large portion of the bank's debt is held by retail investors as in the case of Italian banks such as Monte dei Paschi.

A structure that replicates the treatment of depositors in a bank liquidation/restructuring will fully protect small investors while ensuring that all creditors of equal rank are treated equally.

Each investor's debt holdings in each priority rank will be divided into two baskets:

1. A EUR 200,000 fully protected amount ("Protected Holdings"); and
2. The investor's holdings above the EUR 200,000 fully protected amount ("Non-Protected Holdings").

Protected Holdings will remain in their original debt form. Non-Protected holdings will be temporarily bailed in and converted into temporary shares according to the priorities of the debts to the extent necessary to achieve the required equity capital.

The excess of Non-Protected Holdings over the amount necessary to recapitalize the bank will remain in their original debt form. All allocations across debt issues of the same priority and among investor Non-Protected Holdings will be pro rata.

For banks with large numbers of retail investors, the EUR 200,000 protection will ensure that 95% of retail bondholders will be completely protected from the temporary bail-in and keep their entire original debt claim.

All creditors of equal rank, whether the investor is an institution or a small retail investor, whether it is domestic or foreign, receive the same treatment:

1. Total protection up to EUR 200,000 debt holdings; and
2. Identical temporary conversion to equity of the investor's debt holdings above EUR 200,000.

The standard operations of the clearing systems will handle all necessary processing of each investor's bonds into Protected and Non-Protected Holdings. The standard chain from bondholder to custodian bank to clearing system to the Bank-issuer will be followed. The operational mechanics used by Argentina to allocate Par Bonds between investor holdings above/below US$ 50,000 in its 2005 bond exchange would be utilized.

An appendix discussing technical aspects of the temporary bail-in tool is attached.

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Technical Appendix

A. Priority and Pro Rata Conversion of Debt Claims

It is important to maintain the priority of debt claims.

To meet the necessary capital shortfall, one should start at the lowest level of debt claims and move up the hierarchy until the necessary CET1 capital level is achieved. Each level of claim will be fully converted until only a portion of the highest level of claim needed to meet the capital shortfall is reached. This last level will be partially converted to equity on a pro rata basis. All debt holders of the same priority ranking will be treated equally.

Example:
Capital shortfall: EUR 5 billion
Subordinated debt: EUR 4 billion
Senior unsecured debt: EUR 20 billion
Uninsured deposits: EUR 50 billion

Temporary bail-in:
Subordinated debt: 100% of claim converted to temporary shares (EUR 4 billion total)
Senior unsecured debt: 5% of claim converted to temporary shares (EUR 1 billion total)
Uninsured deposits: 0% of claim converted to temporary shares
Total capital raised: EUR 5 billion

The subordinated debt holder will be fully converted to temporary shares under the temporary bail-in.

Each senior unsecured debt holder will exchange 5% of its claim for temporary shares under the temporary bail-in and retain 95% of its claim in its original senior debt form.

Uninsured depositors will retain their full original deposit claim.

Pro rata treatment of claims is a standard practice in the capital markets. This pro rata method was used in the Bank of Cyprus bail-in of uninsured depositors.

B. Reconversion Option Structure

The reconversion option of the investor follows the priority rank of the original debt claim.

If the bank is successful in raising all the required new equity capital from other private sector sources, all temporary shares may be reconverted back to their original debt claims.

If the bank is only partially successful in raising the required equity capital from other private sector sources, holders of the most senior original debt claims will have the first right of reconversion back into their original debt claim. The reconversion right will then follow the priority of original debt claims down the debt hierarchy until the total amount that can be reconverted is reached (the minimum CET1 capital requirement).

There will be a different class of temporary shares issued for each rank of original debt converted to equity under the temporary bail-in. Each class of temporary shares will have a different priority of reconversion.

Example:
Capital shortfall: EUR 5 billion
Subordinated debt: EUR 4 billion
Senior unsecured debt: EUR 20 billion
Uninsured deposits: EUR 50 billion

Temporary bail-in:
Subordinated debt: 100% of claim converted to temporary shares (EUR 4 billion total)
Senior unsecured debt: 5% of claim converted to temporary shares (EUR 1 billion total)
Uninsured deposits: 0% of claim converted to temporary shares
Total capital raised: EUR 5 billion

Reconversion of temporary shares to original debt claims:
Capital raised from other private sector sources: EUR 3 billion (60% of new capital required)
Senior unsecured debt reconverted: EUR 1 billion (100% of temporary shares)
Subordinated debt reconverted: EUR 2 billion (50% of temporary shares)
Final position of uninsured deposit holder: 100% of original debt claim
Final position of senior unsecured debt holder: 100% of original debt claim
Final position of subordinated debt holder: 50% of original debt claim + 50% of original debt claim converted to ordinary shares
Total capital raised: EUR 5 billion

Under an alternative reconversion option structure, all temporary shares would have the same right of reconversion regardless of the original debt claim rank in the hierarchy of creditors. From a fairness and legal standpoint, retaining the priority of the original debt claim in any reconversion is the better choice. However, the market liquidity of the temporary shares during the temporary bail-in period will be greater if all temporary shares are identical.

C. No Uncertainty Created by Reconversion for Pricing of New Shares

The reconversion feature will not create uncertainty for potential investors in new ordinary shares.

If the reconversion option is to be activated (the necessary CET1 capital is raised from other private sector sources), all the necessary information for the potential investor's decision will be predetermined and known at the time of the new share purchase. Markets will know:

1. The price of the new shares;

2. The amount of temporary shares that have a reconversion feature;

3. The reconversion price (temporary share/original debt exchange rate); and

4. The market valuation of the equity of the bank.

Markets will compare the reconversion price to the price of the new shares and quickly determine

whether the temporary shares will be reconverted or not.

If the bank raises the necessary capital from other private sector sources, arbitrage will ensure that either virtually all of the temporary shares will be reconverted to debt (market value of old debt higher than price of ordinary shares) or virtually none of the temporary shares will be reconverted to debt (price of ordinary shares higher than market value of old debt).

If no uncertainty is created by the reconversion feature, no additional risk premium will be created.

In the unlikely event that the price of the ordinary shares is very close to the market value of the old debt, the amount of temporary shares that will be reconverted to debt will be uncertain.

However, this uncertain reconverted amount of temporary shares has no impact on the decision of the new investor. The temporary shareholder will be buying (no reconversion) or selling (reconversion) its shares at the same price as the new investor's purchase. There is no dilution for the new shareholder.

D. No Loss for Shareholders from Reconversion

Reconversion will not create a loss for the ordinary shareholders (old or new) compared to the situation where the bank had raised the necessary new equity directly from private sector sources.

The objective of the temporary bail-in is to be temporary. Reconversion marks the completion of the temporary bail-in. After reconversion, all investors (debt holders, old shareholders and new shareholders) will be in the exact same position as if the bail-in had never taken place. There is no dilution of new shareholders.

After reconversion, the bank's capital structure is exactly as it would have been if the bank had raised the new equity directly from private sector sources without a temporary bail-in. The bail-in was exactly what it claimed to be: temporary.

Debt holders should have the potential gain if the value of their shares exceeds the value of their original debt claim because they took the risk of a permanent conversion to equity.

E. Reconversion Option of Investor Reduces Debt Holder Risk

The option of the investor to reconvert back to debt or to retain its shares, once the reconversion condition is met, reduces risk for debt holders.

Once the bank has raised the necessary equity capital from other private sector sources and the reconversion condition is met, the investor is given a choice to:

1. Reconvert its shares back into its original debt claim including accrued interest. This would return the investor to its original position as if no temporary bail-in had occurred; or

2. Retain its shares and continue as an equity holder.

The original conversion price (temporary bail-in exchange rate of debt for temporary shares) and the price of ordinary shares after the equity capital has been raised from other private sector sources will determine the investor's choice. The logical original conversion price would be based upon the balance

sheet value of the debt claim and the market price of the bank's ordinary shares at the time of conversion. The market price of the debt at the time of conversion is an alternative pricing benchmark.

The investor is always in an equal or better position under the temporary bail-in than under a permanent bail-in. The reconversion option reduces the debt holder's risk.

F. Equity Capital in Excess of Requirements

If former debt holders decide to retain their shares after the bank has raised the necessary capital from other private sector sources, the bank's CET1 capital will exceed requirements. The bank and its supervisor will then be in the happy position of deciding whether to retain the extra equity capital or to initiate a share buy-back program.