**MEMO# 24920**

January 28, 2011

# Write-Down or Conversion of Debt and European Consultation Regarding Management of Failing Firms

[24920]

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TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 7-11
FIXED-INCOME ADVISORY COMMITTEE No. 12-11
INTERNATIONAL MEMBERS No. 3-11
SEC RULES MEMBERS No. 21-11 RE: WRITE-DOWN OR CONVERSION OF DEBT AND EUROPEAN CONSULTATION REGARDING MANAGEMENT OF FAILING FIRMS

On January 6, 2011, DG Internal Market and Services of the European Commission ("DG Internal Market") issued a consultation regarding a crisis management framework for failing banks. [1] Comments are due March 3, 2011. One of the proposed resolution tools is providing authorities with the power to write-down debt or convert it to equity.

With respect to debt write-down as a resolution tool, DG Internal Market states that such a mechanism would enable resolution authorities to write-down the claims of some or all of the unsecured creditors of a failing institution and, possibly, to convert debt claims to equity. DG Internal Market believes such a mechanism would offer a valuable and additional resolution tool by allowing authorities greater flexibility in their response to the failure of large, complex financial institutions. Nevertheless, DG Internal Market recognizes that there are practical and legal challenges in designing an appropriate mechanism.

DG Internal Market also notes that there are other policymakers considering this resolution mechanism, including work by the Basel Committee on Banking Supervision on capital instruments that absorb losses at the point of non-viability and work by the Financial Stability Board on "bail in" in the context of improving the resolvability of systemically important financial institutions (SIFIs). Accordingly, any policy for the European Union will consider this work. Therefore, given the status of the work by other policymakers, DG Internal Market is seeking to only consult in general terms on the legal and practical questions raised by the concept of debt write-down or conversion as a resolution tool and on possible design options. The key issues and a brief overview of alternatives with questions are set out in Annex I of the consultation (pages 87-92).

# Debt Write-down as an Additional Resolution Tool

Debt write-down is contemplated as an additional tool for situations where standard resolution tools are not an option or are not sufficient (e.g., where a SIFI is “too big to fail”). It is contemplated that any write-down would be accompanied with significant restructuring to return an institution to viability.

For debt write-down, the concept is that authorities would be given statutory authority, exercisable when an institution meets the specified trigger conditions for entry into resolution, to write off all equity, and either write off subordinated debt or convert it into an equity claim. However, in some cases such an action would not be sufficient for maintaining the viability of a firm. As an example, DG Internal Market cites the Royal Bank of Scotland (“RBS”), noting that RBS' balance sheet at the end of 2007 contained £38bn in subordinated liabilities, while losses before tax in 2008 and 2009 amounted to around £43bn. Therefore, DG Internal Market outlines two possible models for additional write-down powers. Building on the minimum powers described above, the first comprehensive approach aims to make a broad range of senior creditors face the real risk associated with bank failure. The second targeted approach aims to create a more focused tool for resolving institutions which have been assessed as likely to prove difficult to resolve with traditional resolution tools at a time of fast moving idiosyncratic or systemic crisis. The options are not mutually exclusive and elements of each could be combined to leverage the relative pros and cons of the approaches. DG Internal Market seeks comments on the approaches.

## First Comprehensive Approach

In addition to the power to write off equity and write-down or convert subordinated debt, resolution authorities could have statutory power to write-down by a discretionary amount, possibly with a fixed upper cap, or convert to an equity claim, all senior debt deemed necessary to ensure the credit institution is returned to solvency. This power would be exercisable in relation to all senior debt, and resolution authorities would have discretion as to which classes of debt would be written down or converted, the extent of the “haircut” and, where relevant, the rate of conversion. The exercise of that discretion might take into account, among other things, the systemic risks of writing down certain creditors.

To support the proper functioning of credit markets, DG Internal Market states that certain exclusions might be necessary. For example, the following may need to be excluded: swap, repo and derivatives counterparties and other trade creditors; short-term debt (defined by a specified maximum maturity); retail and wholesale deposits and secured debt (including covered bonds).

DG Internal Market also believes that the design and exercise of a debt write-down power must seek to preserve as far as possible the ranking of claims under insolvency regimes. For this reason, DG Internal Market proposes that equity should be wiped out before any debt is written down, and subordinated debt should be written down completely before senior debt holders bear any losses. DG Internal Market states, however, that a power to write-down some, but not all senior debt in resolution, with some senior liabilities either excluded entirely from the regime or excluded under the discretion of the resolution authority on a case-by-case basis, would subvert the normal rankings and the principle of pari passu treatment of creditors within the same class.

**Second Targeted Approach**

An alternative to the comprehensive approach would be for resolution authorities to require credit institutions to issue a fixed volume of 'bail-in' debt which, in addition to the power to write off all equity, and either write off existing subordinated debt or convert it into an equity claim, could be written down or converted into equity on a statutory trigger. Such debt would need to include a contractual term which would specify that the relevant resolution authority could use a statutory power to write-down the debt when the institution meets the trigger conditions for entry into resolution. The amount of the write-down or conversion rate could be either specified in the instrument, or it could be left to the discretion of the resolution authorities (subject to the principle that the affected debt holder should be no worse off than in liquidation).  The requirement could include a fixed minimum for all institutions and the power for authorities to increase it further.  Such a tailored requirement could help ensure that debt contracts are not able to evolve in a way that reduces the effectiveness of the regime and would provide certainty for both the institution and creditors about what would happen in a resolution. Additionally, the issuance could be restricted to SIFIs.

## Market Capacity

DG Internal Market recognizes that some have argued that the market appetite for instruments with write-down or conversion features may be limited for several reasons.  For example, such instruments would offer a fixed return but have risk bearing properties similar to equity.  In addition, there are questions concerning the desirability of a conversion feature which would turn a debt holder into an equity holder and there are also questions regarding the lack of predictability about the circumstances in which it would be triggered and the size of the write-down.  DG Internal Market seeks views on how the trigger could be as transparent, objective and predictable as possible.

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If you have any questions or concerns, you can contact me at 202-326-5813 or solson@ici.org.

Susan Olson
Senior Counsel - International Affairs

**endnotes**

[1] The consultation on the Technical Details of Possible European Union Framework for Bank Recovery and Resolution is available at http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.