News Bulletin January 21, 2010



The Minimum "Bail-in" Criteria for Regulatory Capital

Further to the 16 December 20101 publication of the final Basel III rules, as reported in our client alert "Basel III: The (Nearly) Full Picture,"2 on 13 January 2011 the Basel Committee on Banking Supervision ("BCBS") announced the minimum requirements to ensure that all regulatory capital instruments are capable of fully absorbing losses at the point a bank becomes non-viable.³ In its December 2010 papers, BCBS stated that it would be developing more detailed eligibility criteria for contingent capital to address issues of loss absorbency at the point of a bank's non-viability. Therefore, the minimum requirements set out in the 13 January 2011 paper are additional to the criteria for Tier 1 and Tier 2 capital instruments set out in its December 2010 papers.

BCBS incorporates into the new requirements all of the specific proposals (the "gone-concern" proposals) set out in its consultative document on the matter, which we discussed in our client alert dated 25 August 2010.4

We summarise the key requirements below.

Post-trigger Instrument

Any compensation to the instrument holders as a result of the write-off must be (i) paid immediately and (ii) in the form of common stock (or its equivalent in the case of non-joint stock companies). The issuing bank must maintain all prior authorisations necessary under applicable national company laws and its articles of association (e.g., authorised share capital) in readiness for this contingency.

BCBS has not proposed a single method of calculating the number of shares to be issued upon such write-off or conversion. Based on its consultative document, it appears that BCBS intends that each country should be free to impose a suitable method in that country's own national context.

1 Attorney Advertisement

¹ Basel III: A global regulatory framework for more resilient banks and banking systems (16 December 2010), http://www.bis.org/publ/bcbs189.pdf, and Basel III: International framework for liquidity risk measurement, standards and reporting (16 December 2010), http://www.bis.org/publ/bcbs188.pdf.

² See Morrison & Foerster client alert: Basel III: The (nearly) full picture (23 December 2010), http://www.mofo.com/files/Uploads/Images/101223-Basel-III-The-Nearly-Full-Picture.pdf.

BCBS press release: "Basel Committee issues final elements of the reforms to raise quality of regulatory capital" and annex: "Minimum requirements to ensure loss absorbency at the point of non-viability" (13 January 2011), http://www.bis.org/press/p110113.pdf.

⁴ See Morrison & Foerster client alert: Super-Absorbent Bank Regulatory Capital (25 August 2010), http://www.mofo.com/files/Uploads/Images/100825SuperAbsorbent.pdf

Trigger Event

The trigger event ("Trigger Event") is the decision either (i) that a write-off (or conversion) is necessary or (ii) to make a public sector injection of capital (or equivalent support), whichever is earlier. Each of these is subject to a determination by the relevant authority that the bank would otherwise become non-viable.

Any issuance of new shares upon the Trigger Event must be timed to precede any public sector injection of capital, to prevent a dilution of the public sector capital.

Treatment of Banking Groups

The relevant jurisdiction for determining the Trigger Event is that in which the capital is given recognition for regulatory purposes. Where an issuing bank is part of a wider banking group, and wants to include the instrument in both its solo capital and the group's consolidated capital, both the jurisdictions of the issuing bank and the banking group must be capable of triggering write-down or conversion. Therefore, the instrument's contractual terms must specify an additional Trigger Event by reference to the supervisory authority of the consolidated group (i.e., in addition to the relevant authority of the bank's home jurisdiction).

In such case, any common shares issued as compensation to the instrument holders can be those of either the issuing bank or the group parent company (including any successor in resolution).

Transitional Arrangements

Instruments which are issued on or after 1 January 2013 must meet these minimum requirements as a precondition to receiving regulatory capital treatment. To minimise the impact on existing creditors, instruments which are issued prior to 1 January 2013 which do not meet the minimum requirements will be gradually phased out from that date. The Basel III rules published in December 2010 fix the base at the nominal amount of such instruments outstanding on 1 January 2013. Their recognition will be capped at 90% from 1 January 2013, with the cap reducing by 10% in each subsequent year.

Potential Implications

Banks may seek to refinance part or all of their outstanding Additional Tier 1 or Tier 2 capital, in anticipation of the new minimum "bail-in" criteria as well as the more stringent capital requirements under Basel III. Some have already started this process by issuing hybrid capital instruments, but with trigger events which are set by reference to defined capital ratios, rather than left to be decided at the discretion the regulator.

On 6 January 2011, the European Commission suggested in a consultation paper in relation to bank recovery and resolution that regulators could be given the power to write-down senior debt as part of the resolution tools. Given the overall uncertainty as to the factors which the regulators may take into account in determining the Trigger Event, it is unclear what kind of investor appetite there might be for new instruments which develop based on the new requirements.

It will also be interesting to see the effect that the requirements have upon the issuance of hybrid debt instruments, particularly Tier 2 instruments which have previously only been required to absorb losses on a gone-concern basis, when a firm is wound-up or becomes insolvent. The new requirements are therefore likely to blur some of the distinctions between Tier 1 and Tier 2 instruments. It is possible that previous investors in Tier 2 instruments may be unwilling to take the additional risk of the instruments being written-off or converted into common shares upon the occurrence of a trigger event.

2 Attorney Advertisement

⁵ European Commission consultation paper: EU framework for bank recovery and resolution (6 January 2011), http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

MORRISON FOERSTER

Next Steps

BCBS has stated that systemically important banks should have additional "going-concern" loss absorbency (i.e., at a point prior to the Trigger Event referred to above) that could be provided by contingent capital instruments beyond the minimum criteria, and that it is working with the Financial Stability Board to develop an integrated approach which may involve a combination of capital surcharges, contingent capital and bail-in debt.⁶ BCBS is expected to develop this work in the next few months.⁷

Contacts

Peter Green +44 20 7920 4013 pgreen@mofo.com

Helen Kim +44 20 7920 4147 hkim@mofo.com Jeremy Jennings-Mares +44 20 7920 4072 jjenningsmares@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

© 2011 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

3 Attorney Advertisement

⁷ See Remarks of Nout Wellink, BCBS chairman: "Basel III and beyond" (17 January 2011), http://www.bis.org/speeches/sp110118.pdf.