The Czech National Bank's position on the European Commission's "Discussion paper on the debt write-down tool – bail-in"[1]

Generally

The Czech National Bank is aware of the need to find as many tools as possible to help the competent national authorities maintain financial market stability and confidence in the financial system while not placing excessive demands on public financial support. The Czech National Bank declared the same opinion in the European Commission's public consultation on the technical details of a possible European crisis management framework in 2011.

However, the Czech National Bank regards the aforementioned tools as very difficult to find. It considers that prioritising the speed of completion of regulation in this area at the expense of an adequate analysis of the related risks could be counterproductive and hinder or completely halt the restoration of trust in the financial system.

Given that application of the bail-in tool represents significant interference in ownership rights, it can be expected that the decisions of resolution authorities will be the subject of lawsuits. We therefore regard it as vital to minimise any ambiguity in the tool and its details. We oppose and warn against incorporating bail-in "generally" into the regulations and only subsequently elaborating it in more detail. The exact definition of bail-inable liabilities, the relationship to the jurisdictions of third countries, the avoidance of conflict with existing regulations (for example in the conversion of liabilities to equity instruments) and other problem areas need to be sufficiently analysed in advance and regulated in appropriate detail.

Bail-in, which the Commission so far presents in only general terms in the discussion paper, appears to be a tool associated with a high degree of legal and reputational risk for the authorities responsible for implementing it. It is a very complex tool, one which has yet to be tested in the resolution of systemically important institutions and which could also have significant impacts on the financial system.

We therefore regard it as essential, before incorporating bail-in into the regulations, to analyse in detail the potential impacts of such regulation on the financial market and on financial market participants, especially banks, and also on insolvency law, which is not harmonised in the EU. Without such analyses, we fundamentally disagree with the introduction of bail-in into the regulations. We view the Commission's discussion paper as a first step towards conducting the necessary analyses and refining the description of the tool.

We are fundamentally against bail-in being designed for application on a consolidated basis, as such an approach could ultimately mean that sound institutions in an unsound group would face debt write-down. We regard the application of debt write-down on an institution by institution basis as a crucial principle.

Given the absence of legal and technical (accounting) analyses, which must accompany proposals of this type to enable an informed assessment of the issue, all the CNB's answers to the Commission's questions should be regarded as preliminary. They are meant primarily to offer the Commission a guide to conducting the necessary analyses. The entire bail-in concept will also

[1] The EC discussion paper is available here (English only):
http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bail_in_en.pdf

need to be reviewed in the context of the other parts of the directive on the recovery and resolution of credit institutions and investment firms after its proposal is published.

Opinions on individual questions

1. Do you consider that the point of entry into resolution should be the same as the one for the rest of the resolution tools? Do you consider that it should be a point close to insolvency?

Opinion of the Czech National Bank: We agree that the point when it is admissible to use the bail-in tool should be the same as the point when it is admissible to use other resolution tools affecting the rights of shareholders and creditors. However, the Commission has not yet published the full European bank recovery and resolution framework proposal. Consequently, we do not know all the tools that will fall under the term "the rest of the resolution tools".

As for the criteria for entry into resolution themselves, the Czech National Bank would prefer them to be formulated more flexibly. It will often be difficult to prove that an institution has met the conditions proposed by the Commission, especially in the short period of time that the resolution authority has available to assess the situation. In this assessment it will not be possible to rely on the institution's accounting records, as they may not provide sufficiently objective information on its financial condition (especially in the case of an institution in difficulties).

We would also like to point out (without any specific link to the aforementioned question) that the discussion paper fails to address some important issues:

- According to previous consultation documents, the bridge bank should be state-owned. How can such a situation be achieved if, as a result of the conversion of liabilities into capital, its original creditors become its shareholders? Does this mean that before the bank's business is transferred to the bridge bank it will be possible only to write down the liabilities and not to convert them into equity? It is not clear what method would be used to capitalise the bridge bank using the bail-in tool (the discussion paper clearly counts on such a method).

- How would one handle a situation where entities that would otherwise not obtain permission to acquire a qualifying holding in a bank, e.g. due to non-transparent origin of funds, become shareholders of the bank as a result of the conversion? Entities that are not authorised to acquire shares or whose interests conflict with the proper management of the institution being resolved could probably also become shareholders after bail-in.

In addition, no detailed analyses of the bail-in tool and its practical implementation under various different legal systems, including non-European ones, have been conducted yet – the financial instruments that institutions have in their liabilities can be governed practically by any law.

In particular, however, it is essential throughout the proposal to fully reflect the fact that responsibility for crisis management and financial institution resolution lies with the individual Member States within whose territory the institution operates. The consequences of any unsuccessful resolution will impact primarily on the economies of those countries. Countries must therefore retain the option of determining the parameters of the tools they use for such activities, including bail-in. This is necessary also because insolvency regimes in the EU are not subject to harmonisation (especially with regard to substantive law) and therefore differ from country to country.

2. Do you consider that a credible framework for the resolution of banks should include both the open bank and the closed bank bail-in?

Opinion of the Czech National Bank: The Czech National Bank considers that the option of applying the debt write-down tool should not be limited to just two models. Other resolution models, for example acquisition by another institution, are possible. Debt write-down should be possible in this case as well; there is clearly no reason why a bridge bank must be used in such cases. The Czech National Bank suggests conducting a detailed analysis of the situations in which bail-in would come into consideration.

3a. Do you agree with the suggested list of excluded liabilities?

Opinion of the Czech National Bank: We feel that the Member States should define the list of bail-inable liabilities in generally binding regulations in their systems of law. This means that they will also be able to take their national insolvency laws into account.

In the opinion of the Czech National Bank, short-term liabilities with an original maturity of less than one month should be included in the list of bail-inable liabilities. In insolvency proceedings they would be treated in the same way as any other liability. Even if these liabilities are excluded from bail-in, rational and prudent creditors can be expected to withdraw their claims from institutions in difficulties or to require collateral. Moreover, such a preference could motivate creditors even more to offer funds with a short maturity only.

By contrast, we believe that the claims of central banks and (other) resolution authorities should be excluded. Such authorities are often the last creditors willing to provide emergency liquidity assistance to an institution in difficulties, thereby reducing its risk of failure and protecting the claims of other creditors. In such cases, resolution authorities – unlike other creditors – are not motivated by profit maximisation. They should not be penalised through the write-down of the liabilities they incur as a result of such loans. In addition, claims arising from credit financing provided to institutions in general insolvency proceedings have preference over standard claims under Czech insolvency law.

3b. Do you consider that liabilities with an original maturity shorter than a certain period should be excluded from bail-in? Should this period be 1 month, 3 months, or another period?

Opinion of the Czech National Bank: The Czech National Bank believes that short-term liabilities should not be excluded from bail-in, for the reasons given above. It would constitute a significant deviation from standard insolvency rules.

3c. Do you consider that derivatives should be included in the scope of bail-in? If not, what would be the reason that would justify granting them a preferential treatment?

Opinion of the Czech National Bank: The Czech National Bank agrees that liabilities arising from derivatives should also be bail-inable. We see no reason to exclude derivatives from the scope of bail-in. However, the point made in the answer to question 1 applies here too. The Commission must – at the latest at the same time as the legislative proposal – prepare analyses and case studies to explain the potential risks of such an approach in practice.

3d. Do you consider that DGS should be included in the scope of bail-in (i.e. DGS suffers losses instead of covered depositors pari passu with unsecured liabilities)?

Opinion of the Czech National Bank: The Czech National Bank considers that DGS assets should be safely deposited with central banks or placed in safe investments. If DGS are unable to safely manage credit risk and place deposits in banks that subsequently are to be resolved by means of resolution tools, DGS claims will have no special status and will be included in bail-inable liabilities, as in the case of bankruptcy.

3e. Do you consider that secured liabilities should be included in the scope of bail-in when the value of the security is lower than that of the liability? Under what conditions do you consider they could be totally excluded without granting them an unjustified preferential treatment?

Opinion of the Czech National Bank: We agree that liabilities should be subject to bail-in to the extent in which they are unsecured, in the same way as completely unsecured liabilities. However, the various different security instruments and techniques need to be analysed in more detail. It is not entirely clear from the Commission's proposal whether liabilities secured by guarantees (be they private, corporate or state ones) are subject to bail-in, and if so, why.

In addition, it can be difficult to determine the value of a security at the time of bail-in (for example, the value of non-publicly traded securities used as collateral by a bank). Partially secured liabilities should probably not be fully excluded unless they are liabilities that would be excluded from the scope of bail-in even if they were totally unsecured.

3f. How would it be possible to avoid that financial instruments are designed with the purpose of being excluded from the scope of bail in able liabilities (i.e. bonds with embedded options?

Opinion of the Czech National Bank: If all liabilities were bail-inable, it would be impossible to design instruments with the purpose of being excluded. However, given that it is assumed that some liabilities will not be bail-inable, the only way is to try to minimise the scope of exceptions from the set of bail-inable liabilities.

4a. Which of the two options do you consider more appropriate in order to mitigate any systemic impact of the use of the tool and minimise the impact in funding costs?

Opinion of the Czech National Bank: The Czech National Bank prefers Option 1 because it deviates less from the established insolvency procedures than Option 2 while ensuring preferential application of bail-in to the debt instruments included in capital. We agree that the very first step should be to use all the institution's equity, hybrid instruments and subordinated debt to cover the losses. This reflects the standard insolvency practice whereby shareholders receive only the portion of the insolvency assets that remains after full satisfaction of all liabilities (i.e. they are right at the bottom of the hierarchy). If the Commission considers that Option 1 could lead to tension on financial markets and increase funding costs, especially in the case of short-term liabilities, it should provide more detailed argumentation and analyses on the basis of which it would be possible to re-assess this issue.

The CNB does not support Option 2, because dividing up liabilities according to their maturity does not correspond to the procedures used in insolvency proceedings.

The CNB would also like to raise for discussion and further analysis the question of how to proceed on certain intra-group liabilities. For example, if a parent company provides a loan to its subsidiary, should this loan be used for bail-in in the same order as all other loans, or should it be used preferentially? It could be argued that shareholders or other group members have better

information on the institution's financial condition than other creditors do. Moreover, the following situation which might arise with regard to the said loan seems rather strange: equity, hybrid instruments and subordinated debt will be fully written off to cover the loss. The institution no longer has any losses, but it does not have any equity either. Its remaining liabilities will therefore be converted into equity. As a result of the conversion of its loan into equity of the institution, the original parent company will again become a shareholder (albeit now probably not one with a 100% stake).
This problem is a more general one, because bail-in may lead to mutual or cyclical ownership structures in which financial institutions would (partially) own each other. Such structures would be even more difficult to supervise and – in case of need – to resolve.

4b. If you do consider the sequential model to be suitable Do you consider that derivatives that are cleared through a CCP should be treated differently from other derivatives in a bail-in?

Opinion of the Czech National Bank: The CNB does not support the sequential model and considers that derivatives should be treated uniformly or in line with national insolvency regulations. It is necessary to stress that insolvency legislation has been developed for many years in every jurisdiction and there is a great amount of court rulings (judicature) which cannot be used in bail-in if bail-in rules deviate from insolvency rules.

5a. Which do you consider is the best way to fix a minimum amount of bail-inable liabilities – option 1 or 2a), 2b)? If you consider option 1 preferable how could possible fragmentation of the internal market and unlevel competitive conditions within the Internal Market be avoided? How would clarity and predictability be ensured under option 1?

Opinion of the Czech National Bank: The Czech National Bank prefers Option 1 because it allows for the most accurate calibration of the requirements placed on individual institutions from among the options on offer. The required amount of bail-inable liabilities should reflect a number of criteria, including the systemic significance of individual institutions. Option 2, by contrast, would impose – to all entities - the obligation to the maximum extent, which corresponds to large, complex and systemically significant institutions. This would lead to an unjustified increase in costs for institutions which, despite being systemically significant, are not complex and can be resolved using other tools.

Another argument in favour of Option 1 is that responsibility for crisis management and institution resolution lies with the individual Member States within whose territory the institution operates. The consequences of any unsuccessful resolution will impact primarily on the economies of those countries. Countries must therefore retain the option of determining the parameters of the tools they use for resolution activities, including bail-in.

The Czech National Bank is aware that Option 1 may lead to market fragmentation and increase the unlevel competitive conditions between EU Member States. In the CNB's opinion, however, it is better to have unlevel regulation than regulation that is unfair for a significant proportion of institutions.

5b. What do you think is the optimal minimum level of bail-inable liabilities + capital (e.g. 10% of total liabilities excluding own funds) to prepare for future potential crisis?

Opinion of the Czech National Bank: The Czech National Bank prefers an option combining Option 1 and Option 2a whereby the necessary amount of bail-inable liabilities would be defined by national legislation. This national legislation would also define the criteria according to which

the national supervisory authority (possibly by agreement with the resolution authority) may increase/decrease the legally defined minimum amount of bail-inable liabilities for a particular institution. We are unable to determine the specific necessary minimum amount of bail-inable liabilities at present. This amount should inter alia be set on the basis of analyses reflecting previous resolution experiences.

5c. Would a minimum amount of bail-inable liabilities + regulatory capital have an excessive negative effect on certain types of banking businesses present in Europe (retail vs. investment banking)? Would it be necessary to establish an exclusion from the minimum rule for certain banks or no rule at all (e.g. small banks, overwhelmingly deposit financed, mortgage banks)?

Opinion of the Czech National Bank: The Czech National Bank agrees that setting a uniform minimum amount of bail-inable liabilities could have undesirable consequences (see the argumentation above). It is not easy to determine which specific types of institutions would be harmed more by this than others; detailed analyses and studies would be needed. We wish to point out that this discussion paper does not address certain important questions (see our answer to question 1) and that analyses of the practical application of bail-in have yet to be provided. Reliable conclusions cannot be drawn in such a situation.

5d. Do you consider that the requirement to hold a minimum amount of bail-inable liabilities should be set both at holding and subsidiary level? Do you consider that resolution authorities should be allowed to apply the requirement exclusively at holding level if that is agreed by all the competent resolution authorities in the context of the resolution plans?

Opinion of the Czech National Bank: The Czech National Bank is of the opinion that institutions should meet the minimum requirements for bail-inable liabilities on an individual basis only. The actual application of bail-in is also admissible only on the individual basis. When it is necessary to apply this tool it will be important how many bail-inable liabilities the institution under resolution has; on the contrary it will be irrelevant how many bail-inable liabilities any other member of the group has. We regard the application of debt write-down on an individual basis as a key principle. Application on a consolidated basis could mean that sound members of an unsound consolidated group would also face debt write-down.

6. Do you agree that there should not be an absolute obligation to cancel existing shares? Would it be enough in certain cases to establish a sufficiently penalising rate of conversion?

Opinion of the Czech National Bank: In a situation where any sort of liability is to be written down without being converted into shares, it is clearly not imaginable that the original shareholders could retain any share in the ownership of the institution. Even in standard liquidations creditors are satisfied first; any remaining assets can be distributed to shareholders only after all the creditors have been satisfied. It is therefore all the more vital to respect this principle in near-insolvency situations.

In a situation where an institution has equity remaining after its losses have been settled but needs a capital injection through bail-in, it can be regarded as fair for the original shareholders to retain some share of the equity. Creditors whose liabilities will be converted into shares for recapitalisation should be compensated through the conversion rate for the decrease in the value of their liabilities.

However, the relevant conversion rates for the specific situation will be very difficult to determine. It can be expected that resolution authorities/Member States will subsequently face

lawsuits for breach of investment protection obligations under various international treaties. It will therefore be vital to complement such a proposal with a very robust legal analysis of the international treaties concerned and the related (arbitration) court rulings.

We would also like to point out that it is not always possible to rely on the accounting records, as institutions may have unrecognised liabilities. The legislation should address the issue of whether or not such liabilities are subject to supplementary bail-in.

As regards the section relating to derivatives, we wish to note that liabilities other than those arising from derivatives may also be subject to netting arrangements.

7. Do you consider that a business reorganisation plan should be presented soon (e.g. 1 month) after the application of the bail-in tool? Should this only apply in the case of an open bank bail-in or also for a closed bank bail-in?

Opinion of the Czech National Bank: To minimise the negative impacts, a business reorganisation plan should be presented to the resolution authority without undue delay. According to the Czech National Bank, however, the setting of specific time limits and requirements for the business reorganisation plan should be within the competence of the resolution authority. For example, a period of one week for assessing and approving an amended plan may be unrealistic in practice. It is necessary to take into account the fact that it will not always be possible to rely on the institution's accounting records, the availability of all information, the continued presence of key employees in the institution, and so on.

We believe that this principle should apply in the case of both the open institution model and the closed institution model, as clearly it will not always be possible to immediately sell a bank's business transferred to a bridge bank. If the bridge bank is going to operate for some period of time, a plan at least to preserve the value of the assets placed in it will clearly also be needed.

8. Do you consider that including a contractual recognition of the debt write down would facilitate the enforcement of the debt write down powers with respect to instruments issued under the law of a third country?

Opinion of the Czech National Bank: The Czech National Bank considers that including a contractual recognition of the debt write-down could help make the bail-in tool more effective, but will not always be a sufficient measure. In cases where such contractual recognition is in contravention of the law governing the contract, it may be absolutely invalid. If a resolution authority is to require an institution to hold a particular amount of bail-inable liabilities, it should also have the ability to specify that those liabilities will be governed by the law that allows the application of bail-in.

9a. According to your views, what would be the likely impact of the debt write down tool? What measures (if necessary) could be envisaged to mitigate such impact?

Opinion of the Czech National Bank: Greater nervousness and heightened tension on the financial market among both institutions and customers can be expected in the initial phase. Increased funding costs cannot be ruled out either.

9b. Do you consider that the bail-in tool provisions should only become applicable after a certain date in the future? What do you think that date should be?

Opinion of the Czech National Bank: The specific date from which resolution authorities will be entitled to use the bail-in tool should be derived from an estimate of the time that institutions will need to obtain the necessary amount of bail-inable liabilities.

9c. Do you consider that it would be desirable to exclude debt issued before a certain date from the scope of bail-in (grandfathering)?

Opinion of the Czech National Bank: The application of bail-in to contracts signed before the law allowing bail-in takes effect would represent interference in the justified expectations of creditors and it is not certain whether such intervention would be regarded as constitutional by the courts. It is also necessary to take into account the fact that not just one, but many constitutions would come into play here, as would some international treaties (e.g. investment protection treaties). A very extensive and detailed legal analysis covering all the aforementioned factors would have to be conducted before one could argue for including liabilities negotiated before the new legislation takes effect.

Furthermore, it will be necessary to analyse to possibility that existing (grandfathered) contracts would be renewed, or the maturity of liabilities would be extended with contractual amendments.

9d. Do you consider that there is a need to foresee a transitional period/progressive phase-in for the building of the minimum requirement of "bail-inable" liabilities? What do you think it should be and over how many years?

Opinion of the Czech National Bank: See our answer to question 9b.