Information on bank resolution procedures and creditor participations (bail-ins)

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Based on lessons learned from the financial crisis of 2008, many countries have adopted rules for how banks at risk of default can be resolved in an orderly manner without involving taxpayers. Under these procedures, shareholders and creditors of a bank in distress may be required to bear a portion of the losses. The objective is to ensure that the bank can be resolved without the use of public funds.

The European Union has passed the following legislation to this effect:

- the Bank Recovery and Resolution Directive (BRRD) and
- the Regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (SRM regulation).

One of the requirements under the BRRD is that every EU member state must establish a national resolution authority with certain powers to effect recovery and resolution of credit institutions. The measures taken by this authority can have negative consequences for creditors and shareholders of banks.

The precise nature of the measures that the resolution authority is authorized to take at a national level can vary between member states. The following outlines the different resolution measures available in Germany. The resolution procedures of other countries, and especially non-European countries, can differ and may be even more far-reaching.

How could I be affected?

You could be affected if you are a shareholder or creditor holding financial instruments issued by the bank in distress (e.g. shares, bonds or certificates) or if you have a contractual claim against the bank (e.g. certain deposits or individual transactions under a master agreement for financial derivatives transactions).

Securities held in your securities account as a custodial client of the bank that are not issued by the bank would not be affected by resolution measures taken against the custodian bank. Your ownership rights to these financial instruments in your account remain unaffected if the custodian bank is in resolution or liquidation.

Who is the resolution authority?

Resolution authorities were set up in order to ensure that resolutions can be carried out in an orderly manner in the event of a crisis. Under certain conditions, the resolution authority responsible for a bank in distress has the power to implement certain resolution measures.

The resolution authorities responsible for German financial institutions are the Single Resolution Board (SRB) and Germany‘s Federal Financial Supervisory Authority (BaFin). For ease of reading, no distinction will be made between the SRB and BaFin in the following.

When would a bank resolution/bail-in occur?

The resolution authority can impose certain resolution measures if all of the following conditions are met:

- The bank as a going concern is at risk. This condition is assessed based on statutory provisions. It is deemed to be fulfilled, for example, if the bank is no longer able to meet the statutory requirements for the retention of its license as a credit institution as a result of losses.
- There is no prospect of averting the bank’s failure by alternative private sector measures or other measures of the supervisory authorities.
- The measure needs to be taken in the public interest,i.e. it is necessary and proportionate, and using a regular liquidation process to wind up the bank is not an equivalent alternative.

What measures can the resolution authority take?

If all of the above resolution conditions are met, the resolution authority can take extensive resolution measures, even before the bank is officially insolvent. These measures can have negative implications for shareholders and creditors of the bank.

- The bail-in tool (also referred to as creditor participation): The resolution authority may write down some or all of the financial instruments issued by the bank and claims against the bank or convert them into equity (shares or other company interests) in order to stabilize the bank.

- The sale of business tool: Some or all of the shares, as- sets, rights and/ or liabilities of the bank being wound up are sold to a specific buyer. To the extent shareholders and creditors are affected by the sale of business tool, they will face a different, already existing institution.
- The bridge institution tool: The resolution authority may transfer shares in the bank or some or all of the bank's assets, including its liabilities, to a so-called 'bridge institution'. This action may adversely affect the bank's ability to meet its payment and delivery obligations to its creditors and may reduce the value of the bank's shares.
- The asset separation tool: The assets, rights or liabilities of the bank are transferred to a separate asset management vehicle. The aim of this measure is to manage the assets in a way that maximises their value until their eventual disposal or the liquidation of the bank. As in the case of business sales, creditors have to assert their claims against a new debtor once the transfer has taken place.

The resolution authority may amend the terms and conditions of financial instruments issued by the bank and of creditors' claims against the bank through an administrative order. It may, for example, change the due date and interest rate to the detriment of the creditor. Payment and delivery obligations can also be modified. This may include a temporary suspension of these obligations. Creditors' termination rights and other contractual rights of creditors in connection with their financial instruments or claims against the bank may also be temporarily suspended.

Under what circumstances would a bail-in affect me as a creditor?

Whether or not creditors are affected by a bail-in measure depends on the scope of the measure that has been imposed and on how the financial instruments they hold or their claim against the bank would be classified. As part of a bail-in, financial instruments and claims are al- located to different categories. The order in which these categories of instruments and claims can be drawn on for the purposes of the resolution measure is defined by law (the so-called 'liability cascade').

To determine the exposure of shareholders and creditors, the following principles will be applied: Any higher category of the bank's liabilities in the cascade must be used first for any attempt to offset losses and stabilise the bank. Any lower category of liabilities can only be accessed for write-downs or conversion into equity if the liabilities in all higher-ranking categories in the cascade have been exhausted and the bank is still not sufficiently stabilised.

Certain types of financial instruments and claims are excluded by law from the bail-in-tool. This applies, for example, to any deposits up to an amount of €100,000 that are protected by the statutory deposit guarantee scheme, and to asset-backed liabilities (e.g. covered bonds).

The liability cascade for banks based in Germany categorizes liabilities as follows:

(1) First, resolution measures are applied to the common equity Tier 1 capital, which affects the bank's shareholders (i.e. owners of shares of common stock in the bank).
(2) Next, creditors of additional Tier 1 capital are affected (i.e. owners of unsecured perpetual subordinated bonds and silent participations with a conversion or write-down clause, which are subordinated to Tier 2 capital).
(3) The next category is Tier 2 capital, which is held by creditors of subordinated liabilities (e.g. holders of subordinated bonds or subordinated loans).
(4) Following next in the liability cascade are unsecured subordinated liabilities that do not comply with the requirements for additional core capital and supplementary capital.

(5) Next are certain unsecured non-subordinated, not structured debt instruments[1]. Any debt instrument will fall into this category only if it

   - was issued prior to 21 July 2018 and is neither a structured product nor a money market instrument.
   - has been issued since 21 July 2018, has by its terms a maturity of at least one year, is not a structured product, and the terms and conditions (and the prospectus, if required to be published) expressly indicate that the liabilities rank lower than category (6) below.

Liabilities in this category are sometimes referred to as 'senior non-preferred.'

(6) The next category includes other unsecured, non-subordinated liabilities, such as:

- Debt instruments that do not fall into category (5), for example debt instruments that have been issued since 21 July 2018 and that do not include an expressly refer to ranking lower than this category (6).
- Structured financial instruments and liabilities (e.g. equity index certificates) or liabilities from derivatives. In these cases, the amount of interest or principal de- pends on an uncertain future event or the transaction is settled on a basis other than cash.

In addition, deposits by corporates exceeding €100,000 are in included in this category, unless they fall in category (7).

Liabilities in this category are sometimes referred to as 'senior preferred'.

(7) Finally, deposits by individuals, micro-businesses and small and medium-sized enterprises can be affected to the extent to which they exceed the general statutory deposit protection limit of €100,000 ('other deposits').

This means that the simplified liabilities cascade presented on the last page applies in the order of the arrow, starting with the common equity Tier 1 capital. Any lower-ranking category cannot be used to cover losses unless all prior categories have been fully exhausted. The resolution authority may deviate from this principle in individual cases.

How can resolution measures affect me as a creditor?

In the event a resolution measure is taken or imposed by the resolution authority under these rules, may not terminate their financial instruments or liabilities or exercise other contractual rights solely in response to that measure, as long as the bank continues to fulfil its primary contractual obligations per the terms and conditions of the relevant financial instruments and liabilities. This includes payment and service performance obligations.

If resolution measures are implemented by the resolution authority, a total loss of the capital invested by shareholders and creditors may result. Shareholders and creditors of financial instruments and liabilities may therefore lose the entire purchase price and other costs associated with the purchase.

The mere possibility of resolution measures could make it more difficult to sell a financial instrument or liability in the secondary market. As a result, the shareholder or

creditor may have to sell the financial instrument or liability at a substantial discount. Even if financial instruments feature a repurchase obligation of the issuing bank, shareholders or creditors may have to accept a significantly mark-down of the purchase price.

Bank resolution may not lead to shareholders having a less favorable position than under normal insolvency proceedings. If the resolution measure does nevertheless result in a shareholder or creditor being worse off than they would have than been under normal insolvency proceedings, the shareholder or creditor is entitled to receive compensation from the fund established for resolution purposes (restructuring fund or Single Resolution Fund (SRF)). If an entitlement to compensation from the SRF arises, there is the risk that the corresponding payments may be made significantly later than they would be made if the bank was fully complying with its contractual obligations.

Disclosure pursuant to Article 41 (4) of the Commission Delegated Regulation (EU) 2017 / 565 of 25 April 2016

Certain financial instruments issued by credit institutions and investment firms are used to ensure compliance with regulatory capital requirements pursuant to Regu- lation (EU) 575/2013, Directive 2013/36/EU and Directive 2014/59/EU. These include, in particular, common equity Tier 1 capital, additional Tier 1 capital and Tier 2 capital per categories (1) – (3), the subordinated liabilities de- scribed in category (4) and the senior non-preferred debt instruments described in category (5).

These instruments typically yield a higher return than bank deposits, but they are subject to greater default risk in the event of insolvency proceedings or the implementation of resolution measures, as they rank lower in the liability cascade and typically are not covered by deposit protection. Unlike bank deposits, these instruments are generally tradable in the secondary market but it may not be possible to find a buyer or seller in the secondary market (liquidity risk) and the market price may change to the detriment of the investor (market price risk).

Please refer to the product documentation for your financial instruments for details on opportunities and risks.

Where can I find more information?

The German Federal Financial Supervisory Authority (BaFin) publishes information on the resolution of banks and the potential loss participation of clients:

https://www.bafin.de/EN/Aufsicht/BankenFinanzdienstleister/Massnahmen/SanierungAbwicklung/sani- erung_abwicklung_node_en.html;jsessionid=D9318B-7738F2FFA135BF67518499530A.1_cid390

Liability cascade
(simplified)



(1) Common Equity Tier 1 capital (CET1)

e.g. stocks, shares in a limited liability company (GmbH) or limited partnership (KG)

(2) Additional Tier 1 capital (AT1)

e.g. unsecured perpetual subordinated bonds and silent partnerships with write down or conversion provision

(3) Tier 2 capital (T2)

e.g. subordinated loans, subordinated bearer bonds

(4) Unsecured subordinated liabilities

e.g. subordinated loans, subordinated bearer bonds that do not meet the AT1 or T2 capital requirements

(5) Unsecured, non-subordinated and non-structured debt instruments ('senior non-preferred')

— If issued since 21 July 2018, that expressly indicate that the debt instruments rank lower than category (6)
— Maturity ≥ 1 year

(6) Other unsecured, non-subordinated liabilities ('senior preferred')

— Debt instruments not included in category (5)
— Structured financial instruments
— Derivatives
— Deposits of corporates that exeed €100,000 and do not fall in category (7)

(7) Other deposits

generally deposits above EUR 100,000 held by natural persons, micro-enterprises or SMEs

Exemptions from bail-in
(not final)

Deposits in accordance with the statutory deposit protection scheme up to generally €100,000

Secured liabilities

e.g. covered bonds