FMA

Finanzmarktaufsicht
Liechtenstein

Principles & Operation of bail-in execution

Disclosure by the FMA Liechtenstein according to the *EBA Guidelines to resolution authorities on the publication of the write-down and conversion and bail-in exchange mechanic* (EBA/GL/2023/01)

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Executive Summary

The “Bail-in-tool” is a key resolution instrument in order to recapitalize a failing bank of public interest. In contrast to a bail-out, bail-in procedures place the burden of loss absorption and recapitalization on owners and certain creditors of the bank, not on the taxpayer. When applying the tool, the FMA (in its role as resolution authority) may write down liabilities of the institution or convert them into ordinary shares. Both measures are aimed to stabilize the bank and prepare it for resolution, e.g. selling the entity to a new investor.

The operation of the bail-in tool will take the following steps:

Step 1: Bail-in decision
The process starts with a bank being declared failing or likely to fail (FOLTF) by the FMA (in its role as supervisory authority). An independent valuer establishes a resolution valuation. Based on the results of this valuation, the FMA decides to apply the bail-in tool to stabilize and recapitalize the bank.
Step 2: Take-over of control / suspension of trading:
The FMA will take control of the bank. Trading of the bank’s shares on the stock exchange will be suspended (if applicable).
Step 3: Loss absorption: Bail-in
In a next step, the bank’s losses will be absorbed, using the bail-in instrument: The burden of loss absorption is placed on the owners and certain creditors of the bank: to the extent of the loss, the FMA instructs that the bank’s retained earnings and the par value of the shares are written down and the principal amount of certain liabilities (“eligible liabilitites”) is wholly or partly written down.
Step 4: Recapitalization: Issuance of new shares:
In a next step, the bank will be recapitalized so that it once again meets its licence requirements. Eligible liabilities are converted into newly issued shares to the extent needed.
Step 5: Liquidation valuation: After the bail-in has been implemented, the liquidation valuation will be carried out to verify whether the no-creditor-worse-off-principle (NCWO) has been respected.

Zusammenfassung

Der «bail-in» ist ein zentrales Abwicklungsinstrument zur Rekapitalisierung einer ausfallenden Bank, bei welcher die Abwicklung im öffentlichen Interesse ist. Im Gegensatz zu einem «bail-out» werden die Kosten der Verlustabsorption und Rekapitalisierung von den Eigentümern und bestimmten Gläubigern der Bank getragen, nicht vom Steuerzahler. Bei der Anwendung des Instruments kann die FMA (in ihrer Rolle als Abwicklungsbehörde) bestimmte Verbindlichkeiten des Instituts herabschreiben oder in Stammaktien der Bank umwandeln. Beide Massnahmen zielen darauf ab, die Bank zu stabilisieren und auf eine Abwicklung vorzubereiten, z.B. auf den Verkauf des Instituts an einen neuen Investor.

Der Bail-in Prozess erfolgt in folgenden Schritten:

Schritt 1: Bail-in Entscheidung

Der Prozess beginnt damit, dass eine Bank von der FMA (in ihrer Rolle als Aufsichtsbehörde) für ausfallend oder wahrscheinlich ausfallend (FOLTF) erklärt wird. Ein unabhängiger Bewerter erstellt eine Abwicklungsbewertung. Basierend auf den Ergebnissen dieser Bewertung entscheidet die FMA, das Bail-in Instrument zur Stabilisierung und Rekapitalisierung der Bank einzusetzen.

Schritt 2: Übernahme der Kontrolle / Aussetzung des Handels

Die FMA (in ihrer Rolle als Abwicklungsbehörde) wird die Kontrolle über die Bank übernehmen. Der Börsenhandel mit Aktien der Bank wird (falls zutreffend) ausgesetzt

Schritt 3: Verlustabsorption: Bail-in

In einem nächsten Schritt erfolgt die Verlustabsorption durch das Bail-in Instrument. Die Verluste werden von den Eigentümern und bestimmten Gläubigern der Bank getragen: Die FMA weist an, dass die einbehaltenen Gewinne sowie der Nennwert der Aktien und der Nennbetrag bestimmter Verinbindlichkeiten («berücksichtigungsfähige Verbindlichkeiten») im Umfang des erlittenen Verlusts ganz oder teilweise herabgeschrieben werden.

Schritt 4: Rekapitalisierung / Ausgabe neuer Aktien

In einem nächsten Schritt wird die Bank rekapitalisiert, sodass sie die Zulassungsvoraussetzungen wieder erfüllt. Berücksichtigungsfähige Verbindlichkeiten werden im erforderlichen Umfang in neu auszugebende Aktien umgewandelt.

Schritt 5: Liquidationsbewertung

Nach Durchführung des Bail-in wird die Liquidationsbewertung durchgeführt, um zu überprüfen, ob das no-creditor-worse-off Prinzip (NCWO) eingehalten wurde.

Legal framework

- Liechtenstein Act of 4 November 2016 on the Recovery and Resolution of Banks and Investment Firms (Sanierungs- und Abwicklungsgesetz, SAG; hereinafter referred to as the “RRA”), as amended.
- Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, as amended; hereinafter referred to as “BRRD”.
- EBA Guidelines on the rate of conversion of debt to equity in bail-in (EBA/GL/2017/03)
- EBA Handbook of Valuation for purposes of resolution (2019)
- EBA Guidelines to resolution authorities on the publication of the write-down and conversion and bail-in exchange mechanic (EBA/GL/2023/01

Abbreviations

AT1	Additional Tier 1 Capital (according to Art. 51 CRR[1])
BRRD	Bank Recovery and Resolution Directive
CET1	Common Equity Tier 1 (according to Art. 26 and 27 CRR)
EAS Liechtenstein	Deposit Guarantee and Investor Compensation Foundation PCC
FOLTF	failing or likely to fail (according to Art. 39 (1) RRA)
NCWO	no-creditor-worse-off principle (according to Art. 42 (1) g RRA)
RRA	Liechtenstein Act on Recovery and Resolution of Banks and Investment Firms
T2	Tier 2 Capital (according to Art. 62 CRR)
WDCCI	Write down and conversion of relevant capital instruments
WDC	Write down and conversion

[1] Regulation (EU) no 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

1. Introduction

Transparency and predictability are both key to the credibility of the resolution framework and to safeguard depositor and investor protection.

The ***EBA Guidelines to resolution authorities on the publication of the write-down and conversion and bail-in exchange mechanic*** (EBA/GL/2023/01) require that resolution authorities disclose the operational steps necessary to execute the write-down and conversion of relevant capital instruments (WDCCI) and the bail-in tool ("*exchange mechanic*").

Using a simplified and hypothetical case study, this publication outlines the FMAs currently proposed approach to implementing the bail-in tool for banks if necessary for resolution action. In this publication, the FMA first outlines the legal background and the characteristics of the bail-in instrument, followed by the corresponding bail-in cascades. In a next step, the role and different types of valuations are presented, before the individual steps of the bail-in process are outlined.

"Bail-in" is a key resolution tool the resolution authority has at its disposal to (timely) intervene in a bank (credit institution) that is failing or likely to fail[2]. In contrast to a bail-out, a bail-in is intended to stabilize a failing bank by making its creditors and shareholeders bear the cost of recapitalizing the bank through conversion of some or all of the bank's bail-inble debt into common shares. When applying the tool, the FMA (in its role as resolution authority) may instruct that reserves and shares are written down and certain non-excluded liabilities of the institution are written down or are converted into shares of the institution.

The bail-in instrument shall be applied under consideration of the five resolution objectives (according to Art. 37 RRA). The resolution objectives are:

1. ensuring the continuity of critical functions
2. avoiding a significant adverse effect on financial stability
3. protecting public funds by minimising reliance on extraordinary public financial support
4. protecting covered deposits and investors as well as
5. client funds and client assets.

Bail-in ensures, inter alia, the continuity of critical functions such as lending and deposit taking, while minimising the impact on the economy and financial system.

If the resolution objectives or the circumstances of the specific case require, the FMA may choose to apply the bail-in tool differently than set out here. The provisions contained in Art. 55 RRA do not prescribe a specific procedure for the application of the bail-in tool. This description applies to institutions and other affected entities falling under Art. 2 (1) (a) to (d) RRA (for example EEA parent financial holdings) and for which the FMA has taken a decision to apply and execute the bail-in tool.

[2] According to Art. 39 of the Resolution and Recovery Act (RRA): National transposition of the Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173, 12.6.2014, p. 190–348 ("BRRD").

2. General remarks

The resolution authority has several instruments at its disposal in order to stabilize a failing bank in the public interest and to prepare it for resolution. For purposes of loss absorption and recapitalization, it can specifically apply the write down and conversion of capital instruments (WDCCI-) tool or the bail-in tool.

The power to write down or convert relevant capital instruments and eligible liabilities (WDCCI) may be applied either independently from resolution actions or in combination with several resolution instruments. The tool may be used outside of resolution for example if it is sufficient to avoid insolvency (and no other resolution tool is necessary). Basically, the WDC-process is applied in the reverse order of the priority of claims in the Liechtenstein insolvency proceedings ("cascade"). Once shares (and relevant capital instruments) have been wholly or partly written down, certain (non-excluded, eligible) liabilities are written down or converted into rights to newly issued shares of the bank in resolution.

Bail-in, on the other hand, will be applied if the conditions for resolution have been met (see below) and if WDCCI is not sufficient to stabilize a failing bank. In such a case and if public interest is given, the FMA will place the bank in resolution and apply the bail-in tool for loss absorption and recapitalization.

Due to similar technical procedures involved in implementing the WDCCI tool and the bail-in tool, for the purposes of this disclosure, both tools are referred to under the term "bail-in".

3. Principles of the bail-in instrument

Bail-in is one of the four resolution tools that the FMA may apply in respect of institutions and other affected entities that meet all of the following conditions for resolution (according to Art. 38 (1) RRA):

- The FMA (in its role as competent authority in banking supervision) has determined that the institution is failing or likely to fail;
- Having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures or supervisory action, would prevent the failure of the institution within a reasonable timeframe; and
- resolution action is necessary in the public interest.

According to the principle of proportionality, the FMA shall further assess whether the respective intervention is necessary and proportionate as well as whether the resolution objectives could not be achieved equally well through ordinary insolvency proceedings.

According to Art. 55 (2) RRA, the bail-in tool may be applied for two purposes:

- to recapitalize an institution that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation and to sustain market confidence in the institution or entity
- to convert to equity or reduce the principal amount of claims or debt instruments that are transferred either to a bridge institution (providing capital for that bridge institution) or under the sale of business tool or the asset separation tool.

For purposes of recapitalization, there must be a reasonable prospect that the bail-in tool together with other relevant measures will restore the institution's financial soundness and long-term viability.

The bail-in tool may be combined with other resolution tools, namely the use of a "bridge bank", "asset separation" and the "sale of business" tool. For example, if the sale of business tool is used, it can be applied to the bank in resolution before transferring shares to a new owner.

Certain liabilities are excluded from bail-in by law. Items that are excluded from bail-in include covered deposits, secured liabilities, liabilities with an original maturity less than seven days, employee liablitiites or claims owned by a Deposit Guarantee Scheme (EAS Liechtenstein[3]). In addition to these liabilities explicitly excluded by law, the FMA in its role as resolution authority may wholly or partly exclude certain liabilities from bail-in if specific conditions are fulfilled - for example if the exclusion is strictly necessary to avoid adverse contagion in financial markets.

When the bail-in tool is applied, the FMA will take the write-down and conversion steps in the following order ("cascade" respecting the insolvency hierarchy of creditors):

1. CET1 items
2. principal amount of AT1 instruments
3. principal amount of T2 instruments
4. the principal amount of subordinated debt that is not AT1 or T2 capital
5. principal amount of, or outstanding amount payable in respect of, the rest of bail-inable liabilities, including debt instruments referred to in Article 108(3) BRRD.

[3] for more details: https://eas-liechtenstein.li/en/start

4. Valuation

Valuation of the entities' assets and liabilities is critical to bail-in execution. Independent valuations are carried out at various points in time during the resolution process and ensure that the power to intervene in the rights of a bank's shareholders and creditors is executed so that both the resolution objectives and the rights of shareholders/creditors are respected. There are three different kinds of valuations:

Valuation 1 (Resolution conditions): Valuation to assess whether the conditions for resolution or WDCCI in the recovery phase or in resolution are met (Art. 46 lit a RRA): This is an accounting valuation of the bank's assets and liabilities based on fair and realistic assumptions and results in an updated balance sheet. This valuation is initiated by the FMA and is carried out by an independent party before WDCCI or resolution is applied.

Valuation 2 (Resolution valuation; Art. 46 lit b - g RRA): This valuation assesses which resolution measures may be taken and the extent to which reserves, shares, and non-excluded liabilities are written down or converted and the conversion rate as well as any other decisions on the implementation of resolution tools. An independent economic valuation of the bank's assets and liabilities is initiated by the FMA. Ideally, this valuation should be completed before the resolution decision is taken, but in urgent cases it may be finalized later. However, the valuation should be completed before the final conversion rate can be determined. This valuation also includes a (provisional) valuation concerning the "no creditor worse off" (NCWO) principle. The principle stipulates that creditors may not be in a worse position as a result of resolution than they would have been if the bank had been put in liquidation.

Valuation 3 (Liquidation valuation; Art. 93 RRA): The aim of this kind of valuation is to determine whether an entitiy's shareholders and/or creditors would have received better treatment if the entity had entered into normal insolvency proceedings rather than into resolution (NCWO). This valuation is initiated by the FMA and carried out by an independent party. The liquidation valuation must take place as soon as possible after resolution.

5. Execution of the bail-in tool

This chapter illustrates the execution of the bail-in tool in a simplified example, depicting the different steps taken by the FMA:

Assets (x Units)		**Liablities (x Units)**	
Liquid assets	**100**	Capital:	**100**
Secured loans	**600**	*-retained earnings*	*90*
Unsecured loans	**300**	*-Shares (nominal value)*	*10*
		Subordinated debt (other)	***100***
		Senior unsecured debt	***250***
		Secured funding	***200***
		Covered deposits	***350***
Total	**1000**	**Total**	**1000**

Bank LI is located in Liechtenstein. The bank “stands alone” and is not part of a group.

In our scenario, Bank LI’s portfolio of unsecured loans comes under particular stress and as a result the bank has to write down the assets in the portfolio by “150” (=loss amout). Furthermore, the uncertainty about the value of the assets increases the probability of a bank run.

According to the FMA, the conditions for resolution have been met (“FOLTF”) and there is no reason to exclude certain eligible liabilities from bail-in.

Step 1: Bail-in decision

The FMA instructs an independent valuer to prepare the valuation in order to assess whether the bank is FOLTF.

The FMA obtains a FOLTF valuation (Valuation 1). If an independent resolution valuation that meets all the requirements is not possible, a provisional valuation would initially be sufficient. However, a definitive resolution valuation should then be prepared at a later stage (see step 5).

Please note that at this point of time (resolution valuation) the net asset value of Bank LI is negative:

Assets (x Units)			**Liablities (x Units)**	
Liquid assets	**100**		Capital:	**100-150 = -50**
Secured loans	**600**		*-retained earnings*	
Unsecured loans	**300-150= 150**		*-Shares (nominal value)*	
			Subordinated debt (other)	***100***
			Senior unsecured debt	***250***
			Secured funding	***200***
			Covered deposits	***350***
Total	**1000-150 = 850**		**Total**	**1000-150 = 850**

The FMA declares the Bank is "FOLTF".

Assuming that public interest for resolution is given, the FMA (in its role as resolution authority) places Bank LI into resolution (not liquidation nor insolvency). The FMA instructs an independent valuer and obtains a resolution valuation (Valuation 2).

To recapitalize the bank, the FMA decides to apply WDCCI and the bail-in tool.

Step 2: Take-over of control / suspension of trading

At the start of the resolution process, the FMA will take control of Bank LI. The FMA may do this either directly or through the appointment of a special manager. The FMA will have the rights and powers previously exercised by the bodies of Bank LI and its shareholders.

At the FMA's request, the shares issued by Bank LI are suspended from trading on the stock exchange.

Step 3: Loss absorption: WDCCI and bail-in

The reserves and the par value of the shares are written down to zero and the principal amount of other eligible liabilities is wholly or partly written down.

WDCCI: As Bank LI's net asset value is negative, the FMA's decision involves reducing its reserves and the the par value of its shares (owners of the bank are "out of the money") to zero.

Bail-in: The next creditors in line to bear the losses are the holders of other subordinated debt (partially "out of the money"). The resolution decision provides for reduction of the principal amount of the other subordinated debt by 50.

Assets (x Units)			**Liablities (x Units)**	
Liquid assets	**100**		Capital:	**0**
Secured loans	**600**		*-retained earnings*	*90-90=0*
Unsecured loans	**150**		*-Shares (nominal value)*	*10-10=0*
			Subordinated debt (other)	***100-50= 50***
			Senior unsecured debt	***250***
			Secured funding	***200***
			Covered deposits	***350***
Total	**850**		**Total**	**850**

Step 4: Recapitalisation: Conversion and issuance of new shares

The next step is to recapitalise Bank LI with the bail-in tool.[4] The recapitalisation can be achieved by conversion:

- full conversion of its remaining subordinated debt and
- partial conversion of its senior unsecured creditors

In order to recapitalise Bank LI, the FMA decides that the shares that have been written down are cancelled (i.e. the shareholders whose shares have been written down no longer have any claims arising from their shares) and that the above mentioned debts are converted into newly to be issued shares in the amount of 100.

Upon finalization of the resolution valuation, the FMA determines the conversion rate and therefore the number of new shares the former holders of converted subordinated bonds and senior creditors (which fall within the scope of the bail-in tool) will receive in exchange for their (former) exposures.

The FMA arranges the resolution valuation as quickly as possible after effecting the resolution actions. Subject to the general principles (e.g. NCWO principle), different conversion rates may be applied to take into account the difference in ranking between the subordinated bondholders and the senior creditors.

Assets (x Units)		**Liablities (x Units**	
Liquid assets	**100**	Capital:	**100**
Secured loans	**600**	*-newly to be issued shares*	*100*
Unsecured loans	**150**		
		Subordinated debt (other)	***50-50=0***
		Senior unsecured debt	***250-50 = 200***
		Secured funding	***200***
		Covered deposits	***350***
Total	**850**	**Total**	**850**

Step 5: Liquidation valuation: no creditor worse off?

After resolution action has been implemented, the FMA arranges a liquidation valuation (Valuation 3) to verify whether the NCWO principle has been respected during the bail-in process. In order to assess the losses shareholders and creditors have incurred, the resolution should have been largely completed at this stage.

[4] see Art. 55 Abs. (2) (a) and (3) RRA. We assume in this example that there is a reasonable prospect that the application of the bail-in tool will, in addition to achieving relevant resolution objectives, restore the bank's financial soundness and long-term viability.

Liquidation valuation - Balance sheet Bank LI:

Assets (x Units)			**Liablities (x Units)**	
Liquid assets	**100**		Capital:	**0**
Secured loans (assumption – haircut 15%)	**510**		*-retained earnings*	*0*
Unsecured loans (assumption – no additional haircut)	**150**		*-Shares (nominal value)*	*0*
			Subordinated debt (other)	***100-100= 0***
			Senior unsecured debt	***250-40=210***
			Secured funding	***200***
			Covered deposits	***350***
Total	**760**		**Total**	**760**

Post bail-in Balance Sheet Bank LI (*Memo, see above*):

Assets (x Units)			**Liablities (x Units)**	
Liquid assets	**100**		Capital:	**100**
Secured loans	**600**		*-newly to be issued shares*	*100*
Unsecured loans	**150**			
			Subordinated debt (other)	***50-50=0***
			Senior unsecured debt	***250-50 = 200***
			Secured funding	***200***
			Covered deposits	***350***
Total	**850**		**Total**	**850**

According to these valuations **subordinated creditors** are better off in resolution than in insolvency. They have received shares, whereas in ordinary insolvency proceedings, they would have received no payment at all (default: 100% out of the money).

However, according to our scenario, **senior unsecured creditors** could be worse off in the case of a bail-in compared to the liquidation/insolvency scenario. Whether this is the case depends on the final valuation of the shares they have received and the applicable conversion rate, considering the NCWO principle and the bail-in cascade.

If and to the extent there is a violation of the NCWO principle, senior creditors may be compensated by the national resolution fund.[5]

[5] for more details see: https://www.fma-li.li/en/financial-centre/resolution-authority/resolution-financing-mechanism.html

6. Conclusion

Bail-in is a key resolution instrument to protect tax payers and depositors. The tool ensures that the financial burden generated by a failing bank is taken by the shareholders and certain creditors (in contrast to a “bail-out”).

The FMAs disclosure of the operation of bail-in-execution aims to generate higher legal certainy for share- and stakeholders in the case of a “bail-in”.