**KEY POINTS**
- Proposals to give European and UK regulators "bail-in" powers to write down failed financial institutions' senior unsecured obligations are moving forward, but the new framework is not contemplated by standard credit default swaps (CDS) and could undermine their use as contractual hedges against default risk.
- Due to ambiguities in the proposals and in standard CDS documentation, it is unclear whether commencement of a "resolution proceeding" in respect of a distressed financial institution would qualify as a "Bankruptcy", or whether the exercise of a bail-in of any obligations would qualify as a "Restructuring" credit event.
- Most ambiguity relating to the definitions of credit events and deliverable obligation characteristics may be resolved by modification to existing documentation as suggested here.

Feature

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# The imperfect hedge: bail-in risk and CDS contracts

Unlike a publically funded governmental "bail-out", current thinking would empower regulators to impose the costs of a financial institution failure upon the institution's bondholders. If a European or UK financial regulator writes down principal amounts owed by a systemically important bank to unsecured creditors using the proposed "bail-in" powers, could the risk of bail-in be effectively hedged under standard credit default swap contracts? The existing bail-in proposals and relevant ISDA CDS definitions do not provide the certainty needed for hedging. This article summarises the problematic language in both, provides a few drafting recommendations and explains why a hedge for the bail-in risk would be imperfect.

Credit default swap contracts (CDS) that provide for payments to credit protection buyers upon the occurrence of predefined credit events have become an essential component of modern credit markets. They enable creditors to hedge against default risks or otherwise recalibrate portfolios, which in turn makes debt origination easier and credit cheaper. For the unwary, however, strict application of technical CDS provisions can sometimes yield surprising results.

Since early 2011, legislators in both the UK and European Union governments have considered proposals to grant regulators the power to "bail in" systemically important financial institutions by unilaterally writing down the outstanding amounts of their long-term unsecured debt or by converting such debt to equity in a resolution process that occurs outside of traditional insolvency or bankruptcy proceedings. The bail-in power may well protect the enterprise value and operations of systemically important institutions, but without careful legislative clarification, the new powers may have an unintended side-effect – namely, CDS contracts between creditors seeking to hedge default risks and third-party protection sellers may be rendered ineffective on technical grounds.

## THE EUROPEAN AND UK PROPOSALS

Two bail-in proposals made headlines in the credit markets last year: the first appeared in a working paper published by DG Internal Markets and Services, as consultants for the European Commission (EC), in January, and the second appeared in a report by the UK's Independent Commission on Banking (ICB) released in final form in September. Though their details varied, both proposed that resolution authorities should have the power to: (i) write off equity and subordinated debt claims; (ii) write down (or convert) a discretionary amount of senior unsecured debt; and (iii) give depositors preference over all other unsecured creditors.

The EC working paper proposed two possible bail-in powers. The first, a "Comprehensive Approach", would allow resolution authorities to write down any senior unsecured debt or convert it to equity. The power would apply to all "senior" unsecured debt (though "senior" durations were not specified), except for grandfathered debt issued prior to the effective date of the bail-in power. Authorities would have discretion as to classes of debt affected and the extent of haircuts imposed. In addition, the paper proposed a second "Targeted Approach" under which affected financial institutions would be required to issue a predetermined amount of debt which is expressly subject to potential bail-in, leaving other debt unencumbered. The paper stated under both approaches that debt contracts should contain provisions describing principal amounts outstanding as subject to the regulatory bail-in regimes. Credit institutions, certain investment companies and bank holding companies potentially would all be affected.

Although the ICB Report also left open the possibility of converting debt into equity, it focused on use of the bail-in power to write down unsecured claims (other than those of depositors). In particular, the report proposed that the UK's existing Special Resolution Regime should have a "primary bail-in power" in which it could impose losses on "all unsecured debt with a term of at least 12 months at the time of issue". If such losses were insufficient to recapitalise a bank, a "secondary bail-in power" could be applied imposing "losses on all unsecured liabilities beyond primary loss-absorbing capacity". The report rejected grandfathering existing obligations, but it specified that bail-ins should apply to deposit-taking institutions only. As in the EC working paper, debt contracts would be expected to include disclosures about outstanding principal being subject to bail-in.

The UK government has pledged that the ICB Report's proposals will be passed in substantive part by the current parliamentary session's close in 2015 with a suggested implementation deadline set for 2019. The future of the EC working paper's proposals is less certain. Draft EC legislation regarding bail-in powers was originally expected in June 2011, but was postponed by the EU's financial services commissioner until the fourth

quarter. At the time of this writing, draft legislation still had not been released.

### CREDIT EVENTS UNDER A CDS

The ICB and EC papers both focus on the capital structures of systemically important financial institutions and their relationships with creditors and contractual counterparties. But they both fail to consider the impact of proposed bail-in regimes on relationships between creditors and *creditors'* counterparties in standard third-party CDS arrangements.

This failure creates contractual uncertainty because a "bail-in" of senior unsecured debt while a company is "in resolution" is a new process for reconstructing an entity's balance sheet, and that process does not fit neatly into the definitional framework of standard CDS contracts. Although parties are free to modify CDS contracts for unique trades, standard CDS contracts referencing European corporate entities include two triggers for payment potentially applicable after a bail-in – namely, "Bankruptcy" and "Restructuring", in each case as defined by ISDA's 2003 Credit Derivatives Definitions (the CDS Definitions). Unfortunately, based on current proposals, it is unclear whether a bail-in would trigger either a "Bankruptcy" or "Restructuring" credit event under the CDS Definitions. These issues are considered in detail below.

### Bankruptcy

"Bankruptcy" is a near-universal credit event built into standard corporate CDS contracts. In general, it provides a bright-line test for whether (among other things) a debtor admits its insolvency or institutes or has instituted against it an insolvency or bankruptcy proceeding that is sustained by the relevant judicial authority. It also includes, under cl (f) of the definition, certain proceedings outside of traditional bankruptcy in which a debtor "seeks or becomes subject to the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all its assets". Although less frequently used, an additional cl (h) of the definition captures any event with respect to the company which has an analogous effect to any of the other enumerated events, including cl (f).

Sometimes non-bankruptcy proceedings fit squarely within the meaning of a "Bankruptcy". For example, when the US Treasury Department placed Fannie Mae and Freddie Mac into conservatorship, the 13 major dealers of ISDA CDS contracts unanimously agreed that a "Bankruptcy" under cl (f) had occurred. In the case of a bail-in while a company is "in resolution", however, it is not clear at what point, or which actions must occur so that, a debtor would be considered subject to the appointment of an official "similar" to an administrator, liquidator, conservator, receiver, trustee or custodian.

In the UK, for example, the Banking Act of 2009 already empowers the Financial Services Authority to put a failing bank into a new Special Resolution Regime (SRR). Under that regime, a bank may become subject to an assortment of receiver-like powers, including temporary nationalisation, sale in whole or part to a private buyer, transfer to a bridge financial institution or temporary administration by regulators. Some of these powers have in the past been viewed as not to have triggered a Bankruptcy credit event. On the other hand, if an official is appointed in the special resolution process of a bank, subjecting it to the collection of those powers – many of which have been used by North American and European receivers, custodians and trustees of failed financial institutions in the past – "Bankruptcy" under cl (f) or (h) of the definition may be triggered.

The ICB Report recommends that bail-in powers should be added to the list of existing SRR powers. The additional power to write down creditors' unsecured debt is unprecedented in any traditional bankruptcy, insolvency, administration, receivership or conservatorship process. As a result, the bail-in power may not change the categorisation of an SRR as a Bankruptcy or not a Bankruptcy credit event, adding no clarity.

The lack of clarity could be compounded as other jurisdictions formalise their own resolution regimes, each with their own set of procedures, powers and nomenclature. In addition to the UK, Denmark, Germany and Ireland have already implemented resolution regimes. Other resolution plans remain under consideration throughout the rest of the European Union, though, to its credit, the EC working paper states that European and UK bail-in regimes should be harmonised to the extent possible.

### Restructuring

Ordinarily, an official order imposing a mandatory haircut on existing unsecured debt, in the context of a deterioration of the issuer's credit-worthiness, would be a relatively straightforward example of a restructuring. However, a precondition in the "Restructuring" definition requires that the terms of the debt obligation do not expressly provide for a given restructuring event. The relevant portion of the definition follows:

> "Section 4.7. Restructuring.
>
> (a) 'Restructuring' means that, with respect to one or more Obligations...any one or more of the following events… is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority in a form that binds all holders of such Obligation, and such event is not expressly provided for under the terms of such Obligation…:
>
> (ii) a reduction in the amount of principal or premium payable at maturity or at scheduled redemption dates;"

A bail-in of an unsecured obligation as proposed by the ICB or EC likely would constitute a decree by a "Governmental Authority" that "binds all holders of such Obligation", and it would effect a reduction in the amount of principal payable under such an "Obligation", as those terms are defined. But because the ICB and EC proposals require that every debt instrument include statements that they are subject to possible bail-in, one could argue that the terms of the debt instrument "expressly provided for" the contingency of restructuring by bail-in.

The analysis may need to be more nuanced than that. A distinction can be made between: (i) disclosure of risks that may affect

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an investor's rate of return which are made in connection with debt issuances without rendering the debt contingent (comparable to disclosures related to currency exchange risk or *force majeure*); and (ii) contractual agreement between the issuer and holder of the debt instrument as to the conditions under which the amounts due would be reduced. The former merely puts a creditor on notice as to known risks. The latter is a result of negotiations between the issuer and the holder as to the contractual rights and obligations in respect of payments. Insofar as bail-in is a statutory power and the debt instrument merely acknowledges it, it could be argued that no agreement to opt into bail-in treatment has taken place – rather, statutory bail-in would occur by operation of *law* irrespective of whether the holder of the debt intended for debt payments to be reducible by bail-in or not.

Unfortunately, it is also possible that this question will turn on the precise statutory language applicable to a resolution regime and the precise language of a debt instrument's description of bail-in matters. The ICB Report advises requiring debt instruments to include a "specific risk disclosure acknowledging" primary bail-in powers and would require the contractual provisions of any foreign law-governed bail-in bonds to "expressly make such debt subject to the primary bail-in power". For obligations of UK entities, then, narrowly tailored risk disclosures and choice of governing law provisions could mean that bail-in is not "expressly provided for" under the terms of such obligations for the purposes of the Restructuring definition. The same analysis would apply in connection with any required contractual "clause recognizing the statutory power" to bail-in, as proposed under the EC's working paper's "Comprehensive Approach".

Under the EC's contemplated "Targeted Approach", however, it seems that the debtor will need to elect – presumably through express contractual terms – to treat certain of its debt as subject to bail-in powers. Likewise, any holder of such debt could more easily be viewed as *opting in* to expressly provided for bail-in treatment since only some, but not all, of a debtor's senior unsecured debt would be eligible for bail-in. Debt contracts executed under a "Targeted Approach" regime, therefore, would seem to face the highest risk that they would be viewed as expressly providing for bail-in contingencies and that their bail-in would not trigger a "Restructuring" credit event. The full extent of that risk (and the risks under the other proposals) is difficult to assess since current proposals contain only preliminary (and terse) descriptions of required debt provisions.

## IS A BAILED-IN BOND A "DELIVERABLE OBLIGATION" UNDER CDS?

Even if a bail-in is viewed as triggering a "Bankruptcy" or "Restructuring" credit event, CDS contracts may not provide all credit protection buyers with protection from full bail-in risks. A protection buyer's payout under a CDS contract is generally based on the recovery value of the obligation (or, if there are more than one, the cheapest obligation) that meets the "Deliverable Obligation" criteria contained in the CDS Definitions. But bailed-in or bail-in-eligible obligations may not qualify as "Deliverable Obligations" under the CDS Definitions. Excluding bailed-in or bail-in-eligible debt being excluded from the definition may mean that a protection buyer seeking to physically settle may be left holding an undeliverable obligation and parties settling in cash may base payouts on inappropriately high quotes or auction prices of obligations that *do* qualify as "Deliverable Obligations" (ie, those that are not subject to bail-in and therefore are more valuable).

As discussed below, three components of the standard "Deliverable Obligation" definition pose technical obstacles when applied to bail-in or bail-in-eligible debt as currently contemplated in the EC working paper or ICB Report.

### Not Contingent

In order to qualify as a "Deliverable Obligation", a debt instrument generally must, at a minimum, be "Not Contingent". Under s 2.20(b)(i) of the CDS Definitions, "Not Contingent" means:

> "…any obligation having as of the Delivery Date and all times thereafter an outstanding principal balance…that pursuant to the terms of such obligation may not be reduced as a result of the occurrence or nonoccurrence of an event or circumstance (other than payment)…"

The requirement that principal balances of "Deliverable Obligations" not be contingent pursuant to its own terms raises the question of whether some or any forms of risk disclosure, election of governing law or other terms or conditions that provide for regulators' exercise of statutory bail-in powers would preclude an obligation from being "Not Contingent". As discussed above, whether a given debt obligation is viewed as contingent "pursuant to" its terms may hinge upon the precise language of the terms and whether a given jurisdiction's bail-in regime requires mere disclosure and acknowledgment of potential bail-in treatment or an affirmative agreement conditioning repayment upon the non-occurrence of bail-in.

### Not Subordinated

In addition to being "Not Contingent", most CDS contracts require any "Deliverable Obligation" to be "Not Subordinated" – ie, not subordinated in priority of payment to any other unsubordinated obligations of a debtor in respect of borrowed money, or in the less common cases, to the most senior reference obligation designated by the parties. "Subordination", in turn, means:

> "a contractual or similar arrangement providing that (i) upon liquidation…or winding up of the Reference Entity claims of the holders of the Senior Obligation will be satisfied prior to the claims of the Subordinated Obligation or (ii) the holders of the Subordinated Obligation will not be entitled to receive or retain payment in respect of their claim against the Reference Entity at any time that the Reference Entity is in...default under the Senior Obligation".

The first interpretative question, therefore, is whether, once bailed in, the holders of the bailed-in debt would: (i) have a claim upon the liquidation of the Reference Entity that would not be satisfied until another senior debt claim is satisfied; or (ii) not be entitled to receive or retain a payment any time the Reference Entity is in default under another senior debt.

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Neither of these criteria is clearly satisfied in the bail-in regime as proposed in the EC working paper or the ICB Report. For example, because resolution authorities would have the right to apply bail-in on a discretionary basis, bail-in-free obligations may not be fully satisfied before bail-in-eligible obligations are entitled to any repayment. This could mean that the bailed-in debt is indeed "Not Subordinated". Of course, the bailed-in debt holders would welcome more clarity in the relevant statute, so that they are not subject to the whim of the resolution authority.

Secondly, the extent to which debtors and creditors can be viewed as making "contractual or other arrangements" is significant. Cases where a debtor is allowed or required to *choose* which of its unsecured obligations are subject to bail-in powers (such as under the EC's "Targeted Approach") may be especially problematic under this "Deliverable Obligation" characteristic. In such cases, it could be argued that debtors and creditors agree by operation of *contract* to treat particular classes of obligations as subject to potential write-down, allowing such obligations to be treated less favourably than other unsecured obligations free of bail-in provisions.

## Outstanding principal balance

Unlike the issues discussed above, which arise because of ambiguity in the CDS Definitions or in the bail-in proposals, the issue discussed in this section is an inherent one under CDS contracts. At settlement, assuming the bailed-in debt obligation is the only "Deliverable Obligation", payment to a protection buyer under a CDS contract reflects the difference between: (i) the recovery value of the bailed-in debt with an outstanding principal balance equal to the notional amount of the CDS; and (ii) that notional amount. Uncharacteristically, the CDS Definitions do not define "outstanding principal balance". Nonetheless, examining the ordinary sense of the phrase, an issue arises for a protection buyer whose bonds have been written down as a result of the bail-in: if a bail-in is viewed as reducing *ex post facto* the outstanding principal balance of an obligation, then protection payment does not reflect the reduction in the outstanding principal balance due to the bail-in.

Standard CDS would not protect a protection buyer holding bailed-in bonds to the full extent of its bail-in loss because the protection buyer holding an obligation with such a diminished principal balance would not receive the protection payment that would make it whole – ie, a payment equivalent to the debtor paying back 100% of the *original, pre-bail-in* principal amount. This result would protect the interest of the protection seller, as the protection seller should be entitled to receive a claim against the reference entity for the notional amount of the CDS after it pays the protection payment based on the notional amount of the CDS. From the protection buyer's perspective, however, this basically means that the principal write-down risk remains unhedged.

## RECOMMENDATIONS

Assuming that policymakers would want to maintain CDS as viable devices for hedging European corporate debt and CDS market participants would agree that a bail-in of unsecured debt is a credit risk that should be capable of being hedged, we suggest four core drafting issues which must be addressed by ISDA and the relevant legislators and regulators:

- ISDA should update the "Bankruptcy" definition to include the resolution regimes that will exist in the UK and throughout Europe since they are new phenomena and not easily categorised.
- ISDA should clarify that a contractual recognition of a statutory power, even with the express intent of the parties to be subject to that power, does not mean that the exercise of the power or the consequences is "expressly provided for" (as used in the definitions of "Restructuring") "pursuant to its [contractual] terms" (as used in "Not Contingent").
- Statutory and regulatory requirements for the inclusion of certain terms in debt contracts subject to potential bail-in should be limited to: (i) disclosures of the risk of a bail-in; (ii) recognitions of the resolution authority's statutory power to bail in debt; or (iii) choice of law provisions acknowledging that the law of the debtor's jurisdiction of formation applies for the purpose of determining the principal amount owed following resolution proceedings and bail-in of principal amounts owed. Holders of a debt instrument should not be required to expressly condition payment of outstanding principal amounts upon the non-occurrence of a bail-in.
- Statutes and regulators should clarify the bail-in power's effect on the priority of claims based on bailed-in obligations *vis-à-vis* other senior unsecured obligations.

## CONCLUSION

Standard CDS contracts have a term of five years and it is not surprising that astute market participants are beginning to focus on the potential impact of a future bail-in regime on standard European corporate CDS. As explained in this article, many ambiguities exist in the bail-in proposals and in the ISDA credit derivatives definitions, and the ultimate outcome in any individual event may also depend on the precise language of the debt obligation itself, and the approach taken by the relevant resolution authority in its exercise of the statutory powers. If the drafting issues above are resolved, the CDS market will have more clarity as to whether a "Bankruptcy" and/or "Restructuring" credit event would likely be triggered upon the commencement of a resolution or bail-in and whether bailed-in debt would likely be "Not Contingent" and "Not Subordinated".

There is, however, another inherent issue that may prevent bail-in risks from being fully hedged under a standard corporate CDS – as mentioned above. The protection payment under a standard corporate CDS does not take into account the reduction of principal amount of the debt obligation due to the bail-in. Instead, the protection payment only reflects the difference between the recovery value of a given principal amount of the bailed-in debt and that (post-bail-in) principal amount. After receiving the protection payment, the protection buyer would not be in an economically equivalent position as if the reference entity had paid back 100% of the original, *pre-bail-in*, principal amount. Therefore, from the perspective of the protection buyer holding the bailed-in debt, the hedge will be imperfect. ■