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Loss Absorption and Bail-in for Swiss Banks

In the event that a bank is failing or where its capitalization is no longer adequate, the Swiss Financial Market Supervisory Authority ("**FINMA**") may take measures to improve such bank's financial viability rather than liquidating it. "Loss absorption" and "bail-in" are important instruments to support any such measures. This is now possible as a result of a revision of the Banking Act of 8 November 1934 (the "**Banking Act**") in 2011 and the taking effect of a revised Bank Insolvency Ordinance on 1 November 2012 (the "**Bank Insolvency Ordinance**") and of a revised Capital Adequacy Ordinance on 1 January 2013 (the "**Capital Adequacy Ordinance**").

1 INTRODUCTION

Swiss banks may issue capital instruments that absorb losses in the event that the bank no longer meets certain capital requirements or if the regulator decides that a financial restructuring is required in order to prevent the bank from failing. The statutory provisions allowing the issuance of such capital instruments were enacted as part of the legislation applicable to banks of systemic importance (as a result of the "too big to fail" debate), but such instruments are available to any Swiss bank.

In this newsletter we discuss how loss absorption under such instruments relates to bank reorganization and bankruptcy proceedings applicable to Swiss banks, in particular to any "bail-in" measures (statutory conversion of bank debt into equity) that may be ordered in the context of a bank reorganization.

2 RELEVANT PROCEEDINGS

Under the Banking Act, if there are concerns that a bank is over-indebted or if a bank does not meet liquidity or regulatory capital requirements, the FINMA may as appropriate: (i) take protective measures; (ii) initiate bank reorganization proceedings; or (iii) order the liquidation of the bank (bankruptcy). The Banking Act grants significant discretion to FINMA in this context. This includes, inter alia, ordering a bank moratorium, a maturity postponement or "bail-in" measures.

Under bank reorganization proceedings in force as of 1 September 2011 and as further regulated by the secondary legislation enacted by FINMA as of 1 November 2012, FINMA may initiate bank reorganization proceedings if it believes that the failing bank can be successfully reorganized or if at least part of the business of the bank can be continued. For such purposes, FINMA may approve a reorganization plan that may, among other things, provide for

(i) the transfer of all or part of the business (including assets, liabilities and pre-existing contracts) of the failing bank to another existing bank or to a "bridge bank", (ii) the conversion of the failing bank's debt or other obligations into equity, and/or (iii) reductions of obligations owed by the failing bank. In this context, the question arises how such proceedings interrelate with capital instruments including loss absorption mechanics.

If FINMA were to resolve that the bank must be liquidated (bankruptcy), all the assets of the bank would be sold to enable a distribution of the net proceeds to the creditors of the bank.

3 CAPITAL WITH LOSS ABSORPTION

3.1 SCOPE

Under the revised regulatory capital regime implementing the rules of Basel III that entered into effect on 1 January 2013 with the revised Capital Adequacy Ordinance, the concept of "loss absorption" applies mandatorily to Additional Tier 1 ("**AT1**") and Tier 2 ("**T2**") capital. As a result, not only the Common Equity Tier 1 ("**CET1**") capital of the bank – which includes actually paid-in share capital, disclosed reserves, provisions for general banking risks, earnings carried forward and current earnings after deduction of the expected proportion – will bear losses, but also the capital instruments qualifying as AT1 and T2 capital as needed.

AT1 capital may be issued in the form of an equity or debt instrument, while T2 capital is issued in the form of a debt instrument. For a description of the requirements that capital instruments must meet to qualify as AT1 or T2 capital, please refer to our newsletter of July 2012.

The capital instruments mentioned above are available for both banks of systemic importance and for other banks. However, if such instruments are used by banks of systemic importance as part of the buffer capital or the progressive component, such capital instruments must have at least the quality of T2 capital and meet certain additional capital ratio trigger requirements in order to qualify for such purposes (as mentioned under 3.3 below).

"The concept of loss absorption affects CET1 as well as hybrid capital in the form of AT1 and T2 instruments."

3.2 ORDER OF LOSS ABSORPTION

In the context of an insolvency, the principles of loss absorption applicable under the revised Capital Adequacy Ordinance provide for a loss absorption in the following order: (i) the CET1 capital bears losses before AT1 and T2 capital, and (ii) AT1 capital bears losses before T2 capital. Where several capital instruments qualify as AT1 or T2 capital, the terms of the issuance determine the order of loss absorption of each such capital instrument.

Loss absorption may also occur prior to a bankruptcy, i.e. in a bank reorganization. As regards capital instruments in the form of debt, this is determined in the terms and conditions. The statutory rules of the revised Capital Adequacy Ordinance determine that such loss absorption must occur, (i) in respect of AT1 capital and capital instruments issued by banks of systemic importance that are to form part of the buffer capital or the progressive component, when certain capital ratio thresholds are no longer maintained, even if the insolvency is not yet imminent, and, (ii) in respect of any capital instrument (including T2 capital), at the latest when insolvency is imminent ("**loss absorption at the point of non-viability**" or "**PONV**"). Regarding the capital ratio loss absorption triggers, the question whether such triggers are reached does not depend on what procedural measures (described under 2 above), if any, FINMA has taken in respect of a bank. However, the question whether a PONV has occurred is a FINMA determination and, as such, must be looked at in the context of the procedural measures (described under 2 above).

3.3 CAPITAL RATIO LOSS ABSORPTION TRIGGERS

AT1 capital in the form of debt must take its share in losses upon the occurrence of a pre-determined trigger event, at the latest, however, when the level of the CET1 capital has fallen below a threshold of 5.125%. Such loss absorption must take place either through a write-off or a conversion into CET1.

AT1 capital in the form of equity is not subject to such capital ratio loss absorption triggers.

Capital instruments issued by banks of systemic importance (even if they only have the quality of T2 capital and not AT1 capital) must include capital ratio loss absorption triggers, in order to be eligible to form part of the buffer capital or the progressive component. To form part of the buffer capital, such instruments must have a capital ratio trigger of 7% and to form part of the progressive component they must have a trigger of 5% (each calculated in respect of the CET1 capital in relation to risk-weighted assets). Such loss absorption must take place either through a write-off or a conversion into CET1.

3.4 POINT OF NON-VIABILITY LOSS ABSORPTION TRIGGER

All capital instruments forming part of the AT1 and T2 capital and, for banks of systemic importance, the capital instruments forming part of the buffer capital and the progressive component, must include a loss absorption trigger when insolvency is imminent (PONV trigger).

The revised Capital Adequacy Ordinance specifies what event constitutes such a PONV. Imminent insolvency means that the bank will likely be able to survive if all the capital instruments including a PONV trigger are either converted into equity or written off. Such loss absorption is triggered at the latest prior to accepting government aid, or if FINMA considers it necessary to avoid insolvency. However, it is not a requirement that the bank be subject to protective measures or becomes subject to restructuring proceedings. If a PONV has occurred, a loss absorption must take place either through a write-of or a conversion into CET1.

"All capital instruments forming part of the AT1 and T2 capital must include a PONV trigger."

4 BAIL-IN MEASURES

4.1 SCOPE

The loss absorption measures described above relate to capital instruments issued by the bank. In addition, the revised procedural rules as specified in the secondary legislation to the Banking Act applicable in a bank reorganization context (i.e. if FINMA believes that the bank may be successfully reorganized or if at least part of the business of the failing bank may be continued), as enacted by FINMA, provide for the competence of FINMA to convert or write-off other debt (even in the absence of any contractual provision to that effect in the arrangement governing such debt) if and to the extent necessary to allow the bank to meet its regulatory capital requirements after completion of the reorganization ("**bail-in**"). Such bail-in is designed to be available as a measure of "last resort" to be taken in the event that the loss absorption under the capital instruments issued by the bank is not sufficient to restore the required capitalization of the failing bank and if the creditors are likely to be better off than in an immediate insolvency of the bank.

The bail-in must be specified in the reorganization plan, which must be approved by FINMA and – except for banks of systemic importance – also by a majority of non-privileged creditors (calculated on the basis of the claim amounts). If such approval cannot be obtained, the bank would be liquidated in bankruptcy proceedings.

In the event that FINMA only applies protective measures, but does not consider any reorganization measures as necessary or adequate, a bail-in could not occur as one of such protective measures.

4.2 EXCLUSIONS

The following bank debts may not be converted into equity or written off: (i) deposits that benefit from the protection of the Swiss depositor protection scheme (such protection currently is granted up to the amount of CHF 100,000 per depositor), (ii) all bank debts that are privileged claims of creditors according to the general insolvency rules (such privileged claims include, for instance, certain claims of employees), (iii) collateralized claims in the amount of the value of the collateral and (iv) all claims in respect of which any set-off or netting (e.g. claims in respect of OTC derivatives entered into under a Master Agreement) could potentially be exercised (provided that this results from the books of the bank or that the creditor could immediately provide satisfactory evidence of the existence of any such rights of set-off).

4.3 ORDER OF CONVERSION

When agreeing to a bail-in a reorganization plan, FINMA must ensure that the interests of creditors are granted preference over the interests of shareholders of the bank. Moreover, FINMA must take into account the order of preference between different groups of creditors, e.g. by ensuring that the interests of creditors of non-subordinated debt are taken into account with preference over the interests of creditors of subordinated debt.

As a result, FINMA has specified in the secondary legislation to the Banking Act that, before converting any debt (without a loss absorption feature) into equity or writing-off any debt as such bail-in measure, (i) the share capital must have been completely reduced and (ii) any capital instruments that may be converted into equity (e.g. the respective capital instruments forming part of the AT1 or T2 capital or, in respect of banks of systemic importance, the capital instruments forming part of the buffer capital or the progressive component, as discussed under 3 above), must have been converted into equity.

Regarding the relation between the treatment of any debt capital instruments with a write-off mechanism (as opposed to a conversion into equity) and the bail-in measures in reorganization proceedings, the secondary legislation to the Banking Act does not explicitly specify that such write-off must occur before any other bank debt is converted into equity or written off in the context of reorganization proceedings. In practice, this question is not likely to arise, because FINMA would probably decide that a PONV trigger occurred prior to the approval of a reorganization plan. However, since debt capital instruments with a conversion feature and a write-off mechanism are treated as equivalent loss absorption instruments, debt capital instruments with a write-off loss absorption mechanism should also be written-off prior to a bail-in of other bank debt.

In the event that a conversion of debt (without a loss absorption feature) into equity were to occur, FINMA specified that the following order applies: (i) subordinated debt must be converted (in full) before the conversion of non-subordinated debt and (ii) non-subordinated debt must be converted (in full) before the conversion of any deposits (that are not excluded from any conversion, i.e. as a result of not benefitting from the protection of the depositor protection scheme). Regarding the order of different types of subordinated debt instruments, the terms of the relevant debt instruments determine the ranking among themselves. The interests of creditors of debt of the same kind must be taken into account with preference over the interests of creditors ranking lower in the waterfall. In the event that FINMA decides to write-off debt as one of the bail-in measures, according to the wording of the Bank Insolvency Ordinance, the order mentioned in this paragraph for the conversion into equity does not apply.

> "The bail-in feature of other bank debt is a measure of last resort to be taken if the loss absorption is not sufficient."

5 CONCLUSIONS

The new bank reorganization regime with the loss absorption features and bail-in possibility gives FINMA the possibility to put banks back on a viable financial basis if it believes that the failing bank can be successfully reorganized (or at least if part of the business of the bank can be continued) and if FINMA is of the view that the creditors are likely to be better off than in an immediate insolvency of the bank.

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