Bank Restructuring Procedure and Bail-in in Switzerland

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1. Introduction

Even though it is not bound by the European Union's Bank Recovery and Resolution Directive (BRRD), Switzerland has also adopted legislation addressing issues dealt with in the BRRD. Two other provisions, both in effect since 1 January 2016, add to and partly amend the already existing provisions in the Swiss Banking Act (BA) and the Swiss Banking Ordinance (BO). In the following, we offer an overview of both the restructuring procedure and restructuring tools available in Switzerland regarding banks, followed by a closer look at the bail-in tool. Throughout, we will emphasize the novelties and the differences with the EU regime.

2. Bank Restructuring in Switzerland

2.1. Restructuring Procedures

If there is substantiated concern that a bank is overindebted or has serious liquidity problems, or if it does not fulfill the relevant capital adequacy requirements after the Swiss Financial Market Supervisory Authority's (FINMA) deadline, the latter can begin restructuring procedures after considering either imposing safeguard measures or initiating bankruptcy proceedings.

According to the BA, if there is a substantiated prospect of a bank's recovery or its ability to continue its individual banking services, FINMA may initiate restructuring procedures. With this, FINMA designates a person responsible for drawing up a restructuring plan. Then FINMA must approve and publicly announce this restructuring plan. The plan must ensure that the Bank will fulfill the licensing requirements for banking institutions and other legal provisions after completion of the restructuring. If the restructuring plan provides measures interfering with creditor rights, FINMA will, upon the plan's approval, set the creditors a deadline for the rejection of the plan. Creditors jointly representing more than half of the third class claims, according to Art. 219 para. 4 of the Swiss Debt Collection and Bankruptcy Act (DCBA), may reject the plan; if so deciding, FINMA may order the opening of bankruptcy proceedings. An exception is made for banks with systemic relevance, where creditors have no right to reject the restructuring plan.

2.2. Restructuring Tools

Possible restructuring tools include the partial or complete transfer of assets and liabilities as well as contractual relationships of the concerned bank to another legal entity or to a transitional bank. These instruments roughly correspond to the asset separation tool, the sale of business tool, and the bridge institution tool laid out by the BRRD.

The Financial Market Infrastructure Act (FinfraG) recently introduced to the BA a provision enabling FINMA to forcibly postpone agreements being terminated. The purpose of this provision is to allow FINMA to take safeguard or restructuring measures, without triggering any contractual rights of termination or rights according to Art. 27 BA. This provision ensures the continuation of contractual relationships during stress situations such as a restructuring. The provision implements a concern of the Key Attributes of Effective Resolution Regimes for Financial Institutions of the Financial Stability Board of October 2011. This tool can also be found in Art. 70 and 71 BRRD (power both to restrict the enforcement of security interests and to temporarily suspend termination rights). As under European law, the Swiss regime requires the contractual acknowledgment that the counterparties to a bank's agreements may suspend the aforementioned rights. More specifically, banks must ensure that any new contracts or amendments to existing contracts, which are governed by foreign law or providing for foreign jurisdiction, are agreed upon only if the counterparty recognizes the possibility to postpone the termination of agreements as FINMA may order. This requirement must be born in mind when concluding new agreements or amending any existing ones. The requirement aims to avoid any hindrance caused by postponing a FINMA-directed termination of agreements especially where a foreign legal order could deny any postponement's validity by incorporating the acknowledgment of the measure in the contracts directly. This could, for example, be done by adhering to the ISDA 2015 Universal Resolution Stay Protocol of 4 November 2015 (ISDA-Protocol), which allows amending the terms of agreements covered by the protocol; this would be accomplished by opting-in to the protocol's provisions to ensure the enforceability of suspensions of contractual termination rights that were ordered by a national authority on an international level. The requirement here is to be fulfilled by banks, both on the level of the individual institution as well as on a group level. Therefore, foreign group companies of a Swiss bank must also amend their agreements accordingly.

Further, FINMA measures in connection with a restructuring procedure include capital measures, i.e., the reduction or creation of new equity, the conversion of debt into equity (debt to equity swap), or the writedown of liabilities. The latter two measures are jointly defined as bail-in. As opposed to a bail-out, where, in case of failure of a financial institution, liabilities are ultimately carried by third parties – in particular the State. Conversely, a bail-in requires both the owners and creditors to carry the costs of recapitalization. The debt to equity swap, a novelty introduced with the BRRD in the EU, was already known to the Swiss regime since 2011, while the possibility to write down debt, although previously mentioned as a measure in Art. 50 of the FINMA Banking Insolvency Ordinance (BIO-FINMA), was only introduced on a federal act level with the entry into force of the FinfraG on 1 January 2016.

3. The Bail-in Tool

The BA itself does not further specify the functioning of the bail-in. The bail-in is regulated in more detail in the BIO-FINMA. The same provisions apply to both the debt to equity swap as well as the write-down of liabilities.

Two general principles govern the bail-in procedure: the principle of subsidiarity and the no creditor worse off principle. The former entails that a capital measure is only possible where the insolvency of the concerned bank cannot be otherwise resolved. The latter requires that the creditors can anticipate being better off following the restructuring rather than following bankruptcy proceedings.

3.1. Timing

As mentioned, a restructuring procedure is initiated if there is substantiated concern that a bank is overindebted or has serious liquidity problems, or if it does not fulfill the capital adequacy requirements after the FINMA deadline. This initiation moment is called "Point of Non-Viability" (PoNV). In its position paper regarding the restructuring and winding up of banks with globally systemic relevance, FINMA explains this point to be the moment of either of two scenarios: first, when the total capital of the financial group on a consolidated basis or at individual institution level of the parent company falls to or under 8 percent of the risk-weighted assets or second if the common equity falls to or under 5 percent of the risk weighted assets. In this regard, FINMA has a certain leeway in deciding whether the triggering point is reached.

Following the principle of subsidiarity, a bail-in is the last resort (ultima ratio) of all the available restructuring tools. Only if the other measures are insufficient to achieve the necessary prospect of success for a restructuring procedure, can a bail-in be ordered.

In accordance with the principle that creditors' interests take precedence over those of the owners, a bail-in is only possible once the share capital has been completely written down. In exceptional cases, this can happen nearly simultaneously. Furthermore, any debt instruments issued by the bank, which are part of additional core capital or supplementary capital (namely CoCos), must have already been converted into equity capital.

3.2. Scope

Sufficient debt capital must be converted into equity capital to ensure that the bank holds the required capital necessary to continue its business activities after the restructuring. In this regard, FINMA takes the position that it could be required to decide on a deliberately cautious recapitalization ("over bail-in"), i.e., to add a security margin (which could subsequently be corrected) to the amount of debt that must be converted to achieve the necessary goal, since a bail-in is only possible once.

According to Art. 49 BIO-FINMA, all debt capital may be converted into equity capital. Excluded are privileged claims, namely employees' salaries and other claims arising from the employment as well as various claims concerning social securities. Covered deposits as well as secured claims, to the extent that they are secured and offsettable, are excluded from convertibility. Even though not explicitly mentioned, neither assets owned by a client (and not by the bank) nor liabilities arising out of a fiduciary relationship are convertible.

This list of exceptions to the convertibility of claims is more limited than the one foreseen by the BRRD, which also excludes short term liabilities (with a maturity of less than seven days) as well as liabilities to commercial or trade creditors arising from the provision of goods or services critical to the daily functioning of the institution's operations from the bail-in.

Furthermore, the BRRD grants the competent resolution authority the discretionary power to exclude or partially exclude further liabilities from the bail-in where: a.) it is not possible to bail-in that liability within a reasonable time; b.) the exclusion is necessary to ensure the continuity of critical functions; c.) the bailin could lead to a widespread contagion that would threaten the functioning of financial markets and cause serious disturbance to the economy of a EU Member State; or d.) the bail-in would lead to a destruction in value. FINMA is not granted such discretionary power by statute (although FINMA considers that exceptions to equal treatment of creditors of the same category may be necessary and are possible).

3.3. Hierarchy of Creditors and Equal Treatment of Creditors

Creditors' hierarchy must be respected. Accordingly, as mentioned earlier, before converting any debt into equity, the share capital must be completely written down and the bank must issue debt instruments, which are part of additional core capital or supplementary capital and must have already been converted into equity capital, in particular CoCos.

In addition, this conversion must respect the following order of rank: subordinated claims without capital adequacy eligibility; other claims not excluded from the conversion, with the exception of deposits; and deposits, in so far as they are not privileged. Claims of the next rank can only be converted if the conversion of claims of the previous rank is insufficient to meet the capital adequacy requirements necessary for the bank to continue its business.

These provisions correspond to the provisions of the BRRD. Even though it is not explicitly mentioned, as in the BRRD, the principle that creditors of the same class are to be treated equally also applies to the Swiss regulation because it is a fundamental principle of Swiss insolvency law.

3.4. Acknowledgment by Creditors

The Financial Stability Board (FSB) promotes a contractual recognition approach to facilitate crossborder enforceability of resolution actions. Accordingly, financial instruments must include legally enforceable contractual provisions that recognize the application of resolution tools by the relevant resolution authority. With regard to the bail-in tool, the EU implemented this approach by way of Art. 55 BRRD.

The Swiss regulation of a bail-in, however, does not foresee a provision equivalent to Art. 55 BRRD. Hence, banks have no legal requirement to include a clause April 2016 (v01) Page 4 Swiss Financial Market Regulation www.pestalozzilaw.com/regulatory in their contracts by which the creditor party not only recognizes that liabilities may be subject to a conversion or write-down but also agrees to be bound by any such measure if the relevant resolution authority so orders. Without such a term in contracts concluded by Swiss banks and in absence of any international agreement ensuring the cross-border recognition of resolution acts, there is no guarantee that a bail-in ordered by FINMA will be effective with regard to contracts subject to foreign law or foreign jurisdiction. Rather, it would depend on the conditions for recognition of any resolution act in the third State.

As for EU Member States, the BRRD fundamentally recognizes resolution acts of third States; however, the recognition is subject to a rather long list of exceptions.

Thus, agreements between a Swiss financial institution and any counterparty (Swiss or non-Swiss), even if subject to foreign law or jurisdiction, do not require a contractual term being incorporated for the recognition and acceptance of the bail-in. However, agreements, for instance, concluded by a Swiss party with an EU financial institution, even if subject to Swiss law, may require the incorporation of such a contractual term based on EU law.

The concerned EU institutions include the three following: first, financial holding companies, mixed financial holding companies, and mixed-activity holdings established in the EU; second, parent financial holding companies or parent mixed financial holding companies of an EU Member State or Union companies of the sort; and third, financial institutions established in the EU, which are subsidiaries of any of the above or of a credit institution or investment firm and which are covered by the supervision of the parent undertaking on a consolidated basis in accordance with Regulation (EU) No 575/2013. An exception to the requirement is granted if the competent European resolution authority determines that the concerned liabilities can be subject to a bail-in ordered by a European resolution authority, according to the law of a third country or pursuant to a binding agreement with that country. In other words, if the European resolution authority determines that Switzerland will recognize a bail-in, according to its law or to an agreement with the EU, then the incorporation of a contractual term is not necessary from an EU law perspective.

4. Conclusions

The recent legislative developments have not brought major changes to the regulation of the bank resolution procedure. Mainly, the provisions regarding the suspension of contractual termination rights and regarding the write-down of debt, both previously merely on ordinance level, were moved to federal act level because of their importance and were intended to enhance their legitimacy.

The bail-in tool, newly introduced on EU level through the BRRD, has already been applicable in Switzerland since 2011. FINMA can order a bail-in as a restructuring measure if all other measures are insufficient to ensure that the bank holds the required capital to continue its business activities after the restructuring.

In principle, all liabilities may be subject to a bail-in, except for certain specific claims. This list of exceptions differs only slightly from the one BRRD provides in that it is more limited.

The major difference between the Swiss and the European regulation to bear in mind is that the BRRD requires a contractual acknowledgement of the possibility of a bail-in by counterparties to agreements with financial institutions, while the Swiss regulation does not include such a requirement.

On the other hand, the Swiss regulation requires a contractual acknowledgement regarding the possibility of suspending agreement termination rights, while the BRRD does not.

Robert Furter

Senior Counsel
Attorney at law

Pestalozzi Attorneys at Law Ltd
Feldeggstrasse 4
8008 Zurich
Switzerland
T +41 44 217 91 55
robert.furter@pestalozzilaw.com

Oliver Widmer

Partner
Attorney at law
Head Financial Services

Pestalozzi Attorneys at Law Ltd
Feldeggstrasse 4
8008 Zurich
Switzerland
T +41 44 217 92 42
oliver.widmer@pestalozzilaw.com