Bank Restructuring Proceedings and Bail-in in Switzerland

20.03.2023

Key takeaways

- **FINMA has a rather wide discretion in the issuance of restructuring measures on Swiss banks.**
- **Restructuring measures may have substantial effects on creditor's and contractual parties' rights, in particular in case of systemically important banks.**
- **The impact of Swiss restructuring and protective measures on contractual relationships is very much dependent on the particular measures that have been ordered and must be analyzed in each individual case.**

Introduction

Swiss banks are subject to special rules regarding stabilization, restructuring or liquidation. In the event of a crisis, the measures provided by Swiss law are primarily aimed at stabilization of the bank and the continuation of banking operations. In particular, a potential failure of systemically important banks would not only affect the interests of depositors and bank shareholders, but also overarching interests such as financial stability. Hence, systematically important functions will primarily be preserved by means of restructuring tools. However, such restructuring tool may affect rights and duties of the bank's contractual parties.

In the present legal update, we offer an overview of both the restructuring procedure and restructuring tools available in Switzerland regarding banks including a closer look at the bail-in tool. Where appropriate, certain linkages are made to the respective European resolution legislation.

Protective Measures

The Swiss resolution regime consists of several stages of intervention by the Swiss Financial Market Supervisory Authority ("FINMA"). If there are reasonable grounds for concern that a bank is over-indebted or has serious liquidity problems, FINMA may set a grace period in which the bank should ensure compliance with the capital adequacy requirements. In case such grace period expires unsuccessfully, the restructuring proceedings can start with the protective measures, which are the least intense.

While certain protective measures solely affect internal activities and decision-making processes (e.g. the issuance of instructions to the governing bodies or appointment of an investigating officer), others may directly affect creditor's or contractual parties' rights.

Potential protective measures, which may affect contractual rights and duties of banks, are the following:

- Restriction of the business activities of the bank (e.g. transactions affecting the liquidity of the bank);
- Prohibition of the bank from making disbursements, accepting payments or effecting transactions;
- Closure of the bank (prevention of a bank run);
- Order of deferment and deferral of maturity.

Depending on the specific measures taken by FINMA, certain measures may trigger contractual consequences, such as early termination due to events of default. However, due to the wide discretion of FINMA and the wide range of potential combination of various measures, the actual impact on particular contractual relationships is subject to a detailed analysis of the contractual framework in view of the measures imposed.

General Restructuring Tools

In case protective measures do not achieve the envisaged effect, but there is still reasonable prospect that the bank can be restructured or that individual banking services can be continued, FINMA may initiate restructuring proceedings. Restructuring proceedings are subject to a restructuring plan, which may include the following tools or measures:

- Continuation of individual banking services;
- Transfer of the Bank's assets or parts thereof to other legal entities or to a transitional bank;
- Merger/takeover with another company;
- change of the legal form of the Bank;
- Deferral of the termination of contracts and the exercise of rights to terminate them for a maximum of two days;

- Deferral of the exercise of rights of set-off, exploitation and transfer for a maxi-mum of two days;
- Reduction of existing equity and the creation of new equity, Conversion of debt in-to equity and reduction of receivables (bail in).

It is in the discretion of FINMA whether in a particular case it is reasonable to order only one or several measures together to achieve the intended effect. However, 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 may reject the plan; if so deciding, FINMA may order the opening of bankruptcy proceedings.

An exception from the rejection right of creditors is made for banks with systemic relevance. FINMA may also approve the recovery plan of systemically important banks if, in derogation from the "no creditor worse of" principle, it places creditors in a worse economic position, provided that they are adequately compensated.

In this context, it is worth noting that the European Union's Bank Recovery and Resolution Directive ("BRRD") provides for similar instruments. In particular, the asset separation, the sale of business, and the bridge institution tool are also foreseen in the BRRD and correspond to the measures described above.

The Bail-in Tool

As of 1 January 2023, the provisions regarding bail-in have been transferred into the Swiss Banking Act. Under Swiss law, the reduction of existing equity and the creation of new equity, the conversion of debt into equity and the reduction of receivables are collectively understood as bail-in. In the following, we provide a more detailed overview of the bail-in tool.

Prior to the conversion of debt into equity, the company's capital must be reduced in full, which means previous shareholders will no longer be owners of the bank. Thereafter, creditors' claims are converted into equity, which creates new shares. For the purposes of a bail-in, debt capital must be converted into equity capital to an extent that the bank is expected to undoubtedly meet the equity capital requirements necessary for the continuation of business operations after the restructuring has been completed, whereby 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 to the amount of debt that must be converted.

In principle, all debt capital is subject to a bail-in, except for certain privileged claims as described in the private bankruptcy laws (e.g. employees salaries) and certain claims specifically excluded in the Swiss Banking Act. In particular, the following claims are excluded from the conversion as well as the reduction within the bail-in tool:

- secured claims: to the extent of their security; and
- offsettable claims: to the extent of their offsettability.

Those exceptions are of particular interest in the context of finance contracts. In particular, derivatives contracts regularly include netting arrangements. Claims arising from derivatives (or other contracts containing offsettable claims) are exempt from the scope of bail-in measures to the extent of their offsettability, if the creditor can plausibly demonstrate the existence and amount of the claim or this is evident from the bank's books. However, in case the (close-out)-netting results in an excess claim, or parts of the claim remain unsecured, such amounts can be subject to a bail-in.

In addition to the above, FINMA may also exclude receivables from deliveries of goods and services to the extent necessary for the bank to continue as a going concern. Such necessity is assumed in case a service is necessary for the continuation of the bank and could not be substituted within a reasonable period of time and at the same time the respective service provider would discontinue future services as a result of bail-in.

Compared to the European legislation, the Swiss law exceptions from bail-in are rather restricted. 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 bail-in 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.

Cross-Border Enforceability of Resolution Measures

Swiss law requires Swiss banks to 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, 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.

However, the Swiss obligations also refer to postponed termination rights and do not capture all potential restructuring measures. The Financial Stability Board (FSB) promotes a contractual recognition approach to facilitate crossborder enforceability of resolution actions. Accordingly, financial instruments should 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 in the BRRD.

The Swiss regulation of a bail-in, however, does not foresee a provision equivalent the BRRD. Hence, banks have no legal requirement to include a clause 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 clauses 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.

Next steps

Contractual relationships with banks that may go through critical times in terms of liquidity should be monitored and reviewed in order to identify potentially exposed claims in a first step. The extent of applicability and possible impact of potential restructuring measures on contractual relationships and potential consequences should be determined with respect to each particular contract (e.g. early termination of contracts, netting arrangements with derivative transactions and securities lending contracts or need to give timely notice to the defaulting party). Subsequently, the loss risks should be assessed and potential mitigation action, including exercise of (early) termination rights should be determined and adopted in due course if indicated.

Pestalozzi has many years of experience in advisory and assistance in pre-insolvency situations as well as assistance in insolvency proceedings. Do not hesitate to contact us to arrange an initial, non-binding discussion of your situation and needs.

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Contributor: Niku Gholamalizadeh (Associate)

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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

Sébastien Roy

Partner
Attorney at law

Pestalozzi Attorneys at Law Ltd
Cours de Rive 13
1204 Geneva
Switzerland
T +41 22 999 96 40
sebastien.roy@pestalozzilaw.com
