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BRRD and Bail-in

April 28, 2015

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Background to EU Bail-In Powers

- During Financial Crisis many failing banks bailed out by public sector funds – considered “too big to fail” e.g. Citigroup, RBS, Lloyds
- Some failing banks allowed to fail e.g. Lehmans, Icelandic banks
- Became apparent that existing insolvency regimes not suited to bank/financial institution failures
- Some jurisdictions, including UK, drew up legislation to implement “resolution” regimes for banks and certain financial institutions

Bank Resolution

- Restructuring of a failing institution by a regulator through use of resolution “tools” and ancillary powers, to:
  - ensure continuity of critical functions
  - preserve financial stability
  - restore viability of all or part of the institution
  - any remaining non-viable parts to be placed into normal insolvency proceedings
- Aim is to be able to effect all resolution actions over a “resolution weekend” to minimise uncertainty and loss of market confidence/financial contagion

International Response

- G-20 summit in Seoul, November 2010 agreed that no firm should be too big/complicated to fail and tax payers should not bear costs of bank resolution
- Summit endorsed Financial Stability Board’s policy framework designed to reduce moral hazard risks posed by systemically important financial institutions (SIFIs)
- Reaffirmed its commitment to national implementation of Basel Committee’s cross-border resolution recommendations and asked FSB to develop key attributes of effective resolution regimes
- November 2011, FSB published its Key Attributes for Effective Resolution Regimes for Financial Institutions

UK and EU Responses

- UK Banking Act 2009 introduced Special Resolution Regime for banks and some other financial institutions
- Applies to banks, building societies, certain investment firms, recognised CCPs and bank holding companies
- 5 pre-insolvency stabilisation options for banks:
  - transfer to private sector purchaser
  - transfer to bridge bank
  - transfer of assets to an asset management vehicle
  - transfer to temporary public sector ownership
  - bail-in of liabilities
- Bank Insolvency Procedure – the default option unless in public interest to use a stabilisation option. This facilitates the Financial Services Compensation Scheme paying out promptly to depositors, or transforming their accounts to another institution

UK and EU Responses (cont.)

- Bank Administration Procedure – for use in a partial transfer in conjunction with private sector purchase or bridge-bank tool
- Stabilisation powers only exercisable if:
  - PRA satisfied, in consultation with Bank of England, that bank is failing, or likely to fail, to satisfy PRA's threshold conditions; and
  - Bank of England satisfied that:
    - it is not reasonably likely (having regard to timing and other circumstances) that action will be taken by or for the bank that will enable it to satisfy threshold conditions;
    - the action is necessary in the public interest; and
    - the SRR objectives would not be met to the same extent by winding-up the firm
- European Commission Proposal for a Bank Recovery and Resolution Directive published in June 2012
- BRRD finally entered into force on 2 July 2014
- Most complex and controversial provisions for legislators to agree on were bail-in provisions

UK and EU Responses (cont.)

- Member States should have implemented the BRRD into national laws by 1 January 2015, except for bail-in provisions which must be implemented by 1 January 2016
- UK has implemented bail-in powers as of 1 January 2015, though some related provisions are yet to be implemented

BRRD – Key Features

- Appointment of national resolution authority for each EU member state
- Single Resolution Board replaces national resolution authorities for banks subject to supervision by ECB under Single Supervision Mechanism – broadly banks in member states that are participating in Eurozone and some others
- Bank of England is resolution authority for UK
- Main objectives of bank resolution (Article 31):
  - continuity of critical functions
  - avoid significant adverse effect on financial system by preventing contagion and maintaining market discipline
  - protect public funds by minimising reliance on extraordinary public support
  - protect depositors and investors covered by a guarantee scheme
  - protect client funds and client assets

BRRD – Key Features (cont.)

- Recovery plan to be prepared by each institution and submitted to national competent authority for review. Plan must detail measures to be taken by institution to restore its financial position following significant deterioration of its financial situation
- Resolution authority must draw up resolution plan for each institution in consultation with national competent authority and resolution authorities in all jurisdictions where any significant branches are located. Resolution plan must provide for resolution actions to be taken where institution meets conditions for resolution

BRRD – Key Features (cont.)

- Resolution plan must assess resolvability of institution without extraordinary public support (other than permitted resolution financing) or central bank liquidity assistance on emergency or non-standard terms
- Institution must provide all required information and assistance needed to prepare resolution plan
- Resolution authority must also identify material impediments to resolvability, including actions to address the impediments

BRRD – Key Features (cont.)

- Intra-group financial support
  - parent institutions must be permitted to enter into financial support agreements with their subsidiaries in other member states or third countries where those entities are part of the same consolidated supervision
- Where the conditions for early intervention are satisfied, any party to that agreement may provide financial assistance (loans, guarantees, use of assets as collateral, or any combination) to another party
- Member states must remove any national legal impediments to such financial support arrangements

BRRD – Key Features (cont.)

- Early intervention measures to be available to national competent authorities in cases of rapidly deteriorating financial condition, including where one of the following measures:
  - deteriorating liquidity
  - increasing leverage levels
  - increasing non-performing loans
  - increasing concentration of exposures

  is likely to infringe prudential requirements, including CRD4/CRR

BRRD – Key Features (cont.)

- Measures include:
  - requiring management to implement measures contained in the recovery plan
  - requirement for management and/or shareholder meeting to approve/implement an action plan for recovery
  - removing management if found unfit to perform duties
  - requiring management to draw up debt restructuring plan to negotiate with creditors
  - requiring changes to business strategy and/or to legal or operational structures
- Where above measures insufficient to reverse deterioration, competent authorities may require removal of senior management, in whole or in part and, where this is considered insufficient to remedy the situation, competent authorities may appoint a temporary administrator

BRRD - Resolution

- Where the above recovery plan and other early intervention measures are insufficient to stop the financial deterioration, resolution authorities must consider whether conditions to resolution actions have been met
- Resolution authority must consider that all of following conditions are met, before taking resolution action:
  - competent authority or resolution authority has determined, after consulting the other authority, that the institution is failing or likely to fail
  - having regard to timing and other relevant circumstances, there is no reasonable prospect that alternative private sector measures or supervisory action (including early intervention measures and/or write down or conversion of capital instruments) would prevent failure
  - resolution action is necessary in public interest

BRRD – Resolution (cont.)

- Institution shall be deemed to be failing or likely to fail in any of the following circumstances:
  - the institution infringes or will, in the near future, infringe the requirements for continuing authorisation, so as to justify a competent authority from withdrawing authorisation – including but not limited to the incurral of losses that will deplete all or a significant amount of its own funds
  - the institution's assets are or will in the near future be less than its liabilities
  - the institution is or will in the near future be unable to pay its debts or other liabilities as they fall due
  - extraordinary public financial support is required (except that the following extraordinary public financial support is discounted):
    - a state guarantee to back central bank liquidity facilities in accordance with the central bank's conditions
    - a state guarantee of newly issued liabilities
    - an injection of own funds or purchase of capital instruments on terms that do not confer an advantage upon the institution

BRRD – Resolution (cont.)

- The European Banking Authority shall, by 3 July 2015, issue guidelines regarding the interpretation of the different circumstances when an institution shall be considered to be failing or likely to fail – draft guidelines published in September 2014
- These resolution powers apply not only to credit institutions and MiFID investment firms, but also to other EU financial institutions that are subsidiaries of the foregoing and are subject to the same consolidated supervision, or subsidiaries of financial/mixed activity holding companies established in the EU

BRRD – Resolution (cont.)

- When applying resolution tools and powers, resolution authorities must have regard to following resolution objectives and choose tools/powers that best achieve the objectives relevant to the particular circumstances:
  - to ensure continuance of critical functions
  - to maintain financial system stability
  - to protect public funds by minimising reliance on public sector support, e.g. bailouts
  - to protect guaranteed deposits
  - to protect client funds/ assets

BRRD – Resolution general principles

- Resolution authorities must ensure resolution action taken in accordance with following principles:
  - the shareholders of the institution must bear first losses
  - creditors of the institution bear losses after the shareholders in accordance with the priority of their claims under normal insolvency proceedings, except as expressly provided otherwise
  - the management body and senior management of the institution are replaced except where their retention is considered necessary to achieve the resolution objectives
  - except where otherwise provided, creditors of the same class are treated in an equitable manner
  - no creditor shall incur greater losses than they would have incurred under normal insolvency proceedings
  - covered deposits are fully protected

BRRD - Valuation

- Before any resolution action (or writing down/converting capital instruments) can be taken, assets and liabilities of the institution must be valued by a valuer independent from the institution, as well as from the resolution authority and any other public authority
- Among other things, this valuation is used to determine the extent to which capital instruments need to be written down/converted and the extent of any write-down or conversion where liabilities are bailed in, using the bail-in tool
- Valuation based on prudent assumptions, including as to rates of default and severity of losses, but must assume no future provision of extraordinary public support or central bank assistance on emergency/non-standard terms

BRRD – Valuation (cont.)

- Must indicate sub-division of different creditors, based on priority levels under applicable insolvency law, and an estimate of recovery for each class under a standard winding-up action
- EBA may draft regulatory technical standards to specify methodology for assessing value of assets and liabilities – draft RTS published in November 2014

BRRD – Resolution tools

- Sale of business tool – power to transfer to a purchaser (on commercial terms) shares, or all or any assets, rights or liabilities of institution, without consent of shareholders or third parties and without complying with any procedural requirements under company or securities law
- Bridge institution tool – similar power to transfer to a bridge institution shares, or all or any assets, rights or liabilities of institution. Bridge institution is a publicly-owned entity, created for purpose of receiving shares/assets/liabilities in a resolution with a view to maintaining access to critical functions and selling the institution

BRRD – Resolution tools (cont.)

- Asset separation tool – power to transfer assets, rights or liabilities of an institution under resolution or of a bridge institution to one or more publicly-owned asset management vehicles, who will manage the transferred assets with a view to maximising their value by sale or eventual write-down
- Bail-in tool
- Tools can be applied individually or in combination

BRRD – Bail-in

- What is bail-in?
- The imposition of losses on liabilities owed by a financial institution where such liabilities would not, by their terms, be required to absorb such losses
- Loss absorption by:
  - conversion of the liability into a common equity instrument – the most loss-absorbent instrument
  - writing down/off the principal amount of the liability
- Bail-in tool can be used either to:
  - recapitalise the institution under resolution to the extent necessary to restore its ability to comply with the conditions for its authorisation and so continue performing its authorised activities, and to sustain market confidence in the institution; or
  - convert to equity, or reduce the principal amount of, claims or debt instruments that are transferred to a bridge institution (in order to provide capital for that bridge institution) or under the sale of business tool or asset separation tool

BRRD – Scope of Bail-In Tool

- What is bail-inable?
- All liabilities that are not expressly excluded from the scope of bail-in

Express Exclusions

- covered deposits – deposits up to the amount covered by a deposit guarantee scheme
- liabilities in respect of holding client assets or client money, where the client is protected under applicable insolvency law
- liabilities resulting from a fiduciary relationship, where the beneficiary is protected under applicable law
- liabilities to other financial institutions (outside its group) with an original maturity of less than seven days
- liabilities with a remaining maturity of less than seven days, owed to payment or securities settlement systems or their participants
- employee remuneration or benefits (other than variable remuneration)
- liabilities to commercial/trade creditors relating to provision of critical goods/services

BRRD – Scope of Bail-In Tool (cont.)

- liabilities to tax and social security authorities that are preferred by law
- liabilities for contributions owed to deposit guarantee schemes
- liabilities to the extent they are secured – expressly including covered bonds and hedging instrument liabilities of the covered bond issuer

Additional exclusions

- Resolution authority can wholly or partially exclude liabilities from the scope of bail-in in the following circumstances:
  - where it is not possible to bail-in the liability in a reasonable timeframe
  - where the exclusion is necessary and proportionate to achieve continuity of critical functions/core business lines
  - where the exclusion is necessary and proportionate to avoid widespread contagion that would disrupt functioning of financial markets – particularly as regards deposits of individuals and SMEs
  - where bailing-in the liability would cause higher losses to other creditors than not bailing it in

BRRD – Scope of Bail-In Tool (cont.)

- European Commission to adopt delegated acts as to when such an exclusion is necessary. The EBA published technical advice to the European Commission in March 2015
- Where such an exclusion is made by a resolution authority, it may proportionately increase the level of write down or conversion to be imposed on other eligible liabilities
- European Commission can block a proposed exclusion where this would result in a contribution from the resolution financing arrangement
- Where an eligible liability is excluded and the losses that would have been absorbed by that liability are not passed on fully to other creditors, contribution can be made by the resolution financing arrangement to:
  - cover any unabsorbed losses and restore net asset value of institution to zero; or
  - purchase shares or capital instruments in the institution to recapitalise the institution so as to restore its Common Equity Tier 1 capital ratio

BRRD – Scope of Bail-In Tool (cont.)

- Resolution financing arrangement to be established by each Member State, to be funded by:
  - ex ante contributions from institutions authorised in that Member State, including EU branches of non-EU banks (to reach at least 1% of the amount of covered deposits of all institutions authorised in that Member State, by 31 December 2024)
  - ex post extraordinary contributions (where ex ante contributions insufficient) limited to 300% of the annual ex ante contributions
  - contract borrowings and other forms of financial support where the ex ante and ex post contributions are insufficient
- Resolution financing arrangement may only contribute to loss absorption for an institution under resolution where:
  - own funds, capital instruments and eligible liabilities have already absorbed losses of at least 8% of institution's total liabilities (including own funds) measured pursuant to the resolution valuation; and
  - the contribution from the resolution financing arrangement does not exceed 5% of total liabilities (including own funds) measured pursuant to the resolution valuation

BRRD – Scope of Bail-In Tool (cont.)

- Such contribution can be funded from ex ante contributions, amounts that can be raised from ex post contributions within 3 years, and from alternative financing arrangements
- In extraordinary circumstances, resolution authority can seek additional funding from alternative sources where 5% contribution has been used up and all unsecured non-preferred liabilities (other than eligible deposits) have been fully bailed-in
- The resolution financing arrangement can contribute even where the 8% loss absorption has not been effected if the institution has consolidated assets below EUR 900bn and:
  - loss absorption equal to at least 20% on institution's risk weighted assets has been effected; and
  - resolution financing arrangement has at its disposal ex ante contributions (excluding deposit guarantee scheme contributions) of at least 3% of covered deposits of institutions authorised in that Member State

Bail-in sequence under BRRD

Regulatory Capital	Common Equity Tier 1	Fully loss absorbent
	Additional Tier 1	Going concern loss absorbent and gone concern loss absorbent
	Tier 2	Gone concern loss absorbent (possibly also going concern loss absorbent)
Non-regulatory capital	Other Subordinated Debt Instruments	Gone concern loss absorbent
Liabilities	Senior Unsecured Liabilities (incl. non-privileged deposits)	Gone concern loss absorbent (subject to exclusion powers of resolution authority)
	Privileged/Secured/Insured/Excluded Liabilities	Excluded/non-loss absorbent

BRRD – Minimum Bail-inable Liabilities

- Each Member State must set a minimum required level of loss-absorbing liabilities ("MREL") (consisting of own funds (regulatory capital) and bail-inable liabilities) expressed as percentage of the aggregate of an institution's own funds and total liabilities – N.B. not risk-weighted assets
- Minimum own funds are already established by Capital Requirements Regulation by reference to risk-weighted assets
- Where liability governed by law of a non-EU country, it will only count towards minimum bail-inable liabilities where resolution authority is satisfied that the non-EU country would give effect to a decision to bail-in that liability, whether by virtue of the terms of the contract creating the liability, or by international agreements on the recognition of resolution actions/proceedings

BRRD – Minimum Bail-inable Liabilities (cont.)

- In context of financial groups, group level resolution authorities and institution-level resolution authorities must reach joint decision on the levels to be applied, and can require that all or part of the minimum eligible liabilities be in the form of contractual bail-in instruments
- Contractual bail-in instruments are those which:
  - contain a contractual term providing that where a resolution authority decides to apply the bail-in tool the instrument shall be written down/converted before other eligible liabilities are written down or converted; and
  - are subject to a binding subordination agreement, undertaking or other provision under which, in the event of normal insolvency proceedings, it ranks below other eligible liabilities and cannot be repaid until other outstanding eligible liabilities have been settled
- In November 2014, the EBA consulted on draft regulatory standards specifying the assessment criteria for resolution authorities to apply in determining the levels of MREL for individual firms. In the original legislative proposal for the BRRD by the European Commission, a level of 10% was suggested as appropriate, but no percentage features in the final form of the BRRD
- EBA expects the final RTS to be compatible with the FSB's proposed termsheet for Total Loss Absorbing Capacity ("TLAC") for Global Systemically Important Banks ("GSIBs")

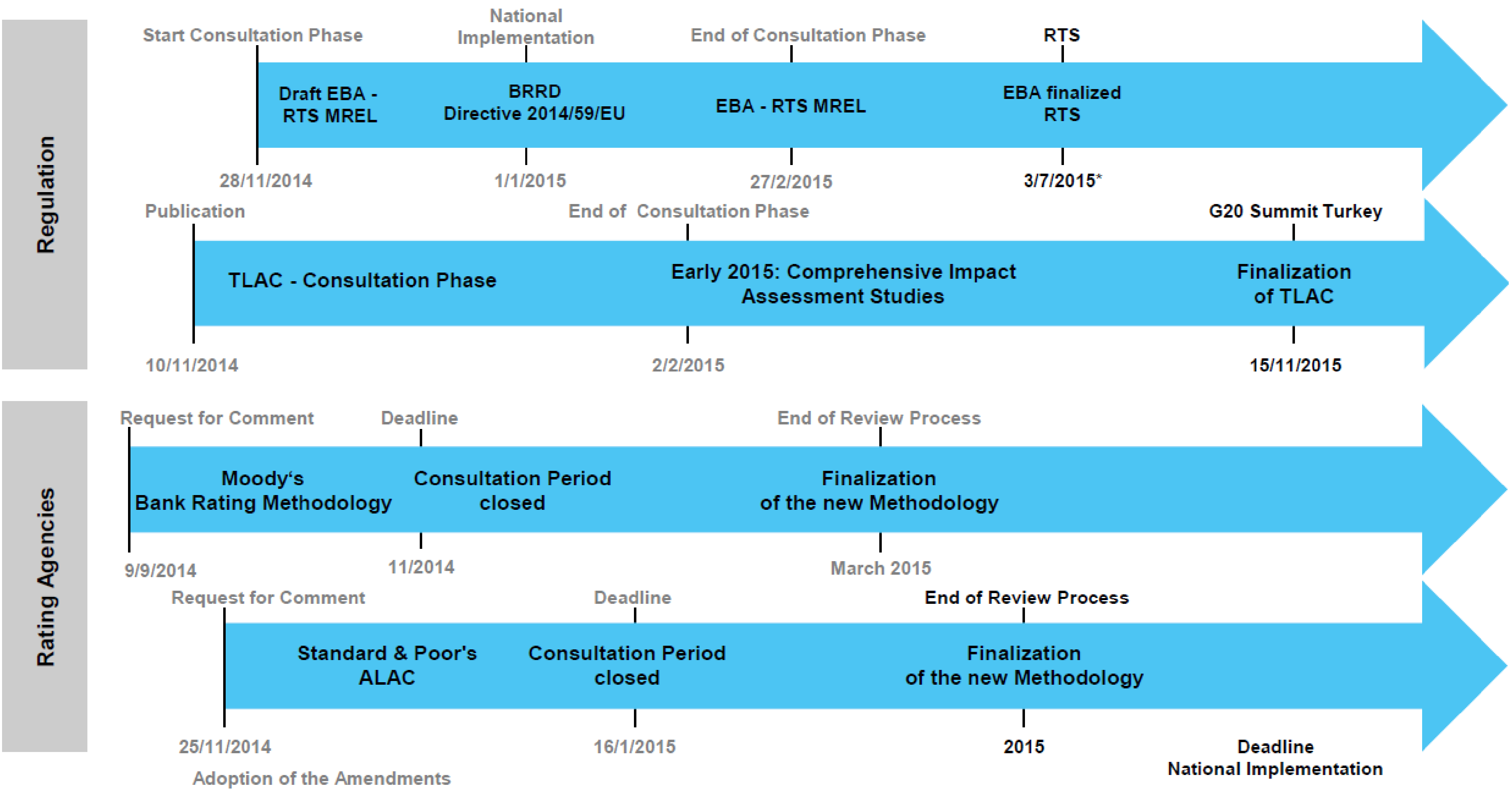
FSB's November 2014 TLAC Proposals for GSIBs

- Pillar I TLAC requirement of 16-20% of **risk-weighted assets** on top of any applicable capital buffer requirements
- Authorities able to set additional institution-specific TLAC requirements on top of these
- Pillar I requirement also must be at least twice the Basel III leverage ratio requirement (which looks at total (non-weighted) assets), implying a level of at least 6% of the GSIB's non-risk-weighted exposures plus off-balance sheet exposures, and possible higher than this
- Controversially, derivatives and securitised derivatives are ineligible for TLAC. This is presumably due to the difficulties in valuing derivatives liabilities, though the EBA has so far not been prescriptive in excluding liabilities for MREL
- EBA does acknowledge though that the likelihood of certain liabilities being excluded from bail-in on an ad hoc basis in a resolution (such as uninsured deposits of individuals and micro, small and medium-sized enterprises) may prompt the consequent adjustment of MREL levels by competent authorities to compensate for such potential exclusion

MREL vs. TLAC

Key Topics in the Financial Sector

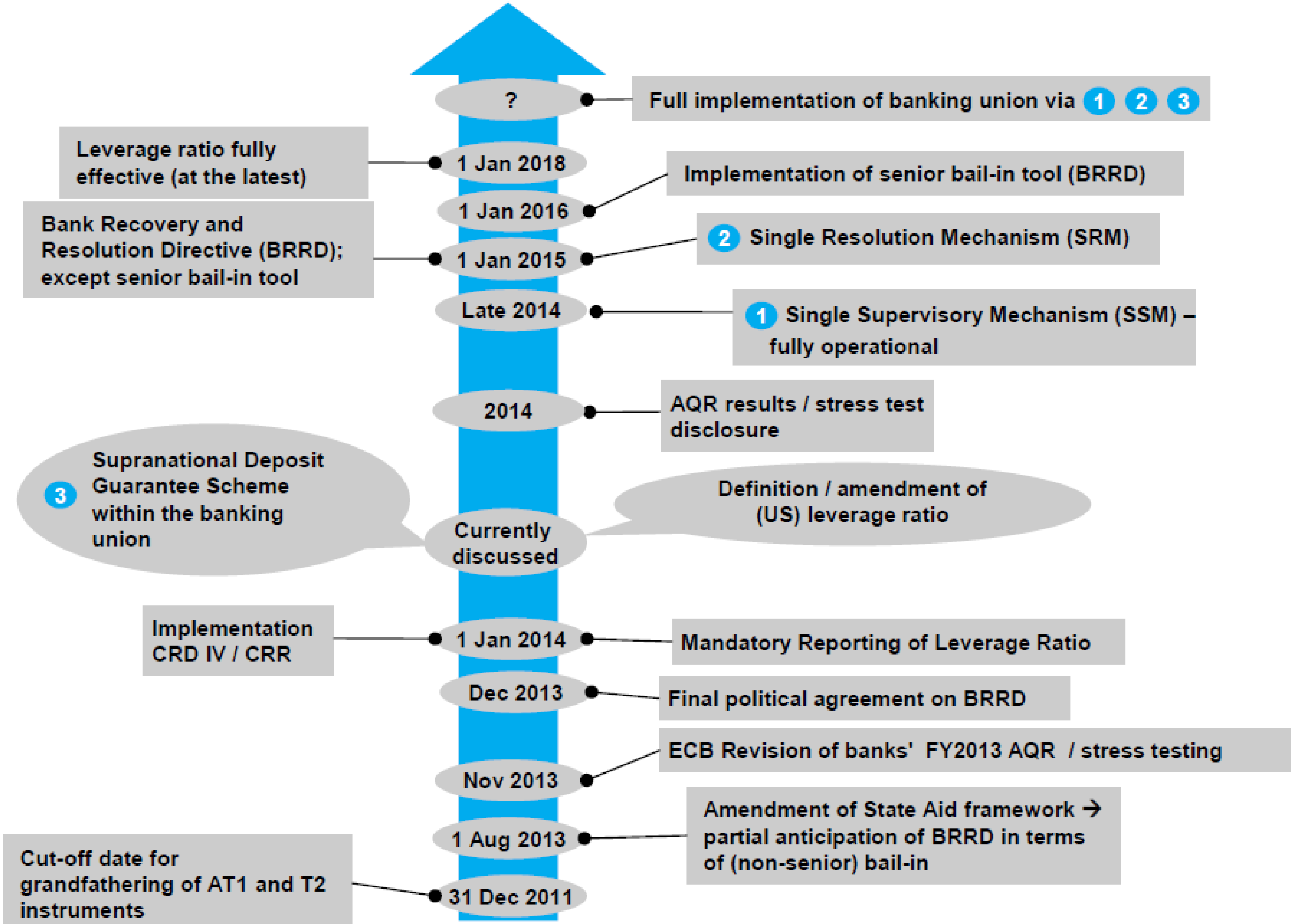
Timeline on ongoing Regulatory and Rating Methodology Developments



Note: * Directive 2014/59/EU BRRD

Timeline of Upcoming Regulatory Milestones

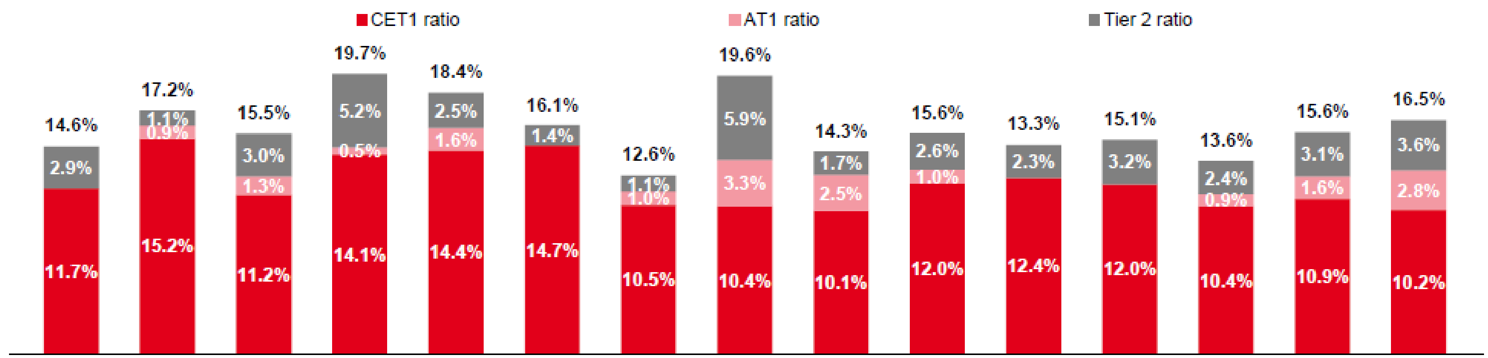
Key capital topics currently discussed within the EU



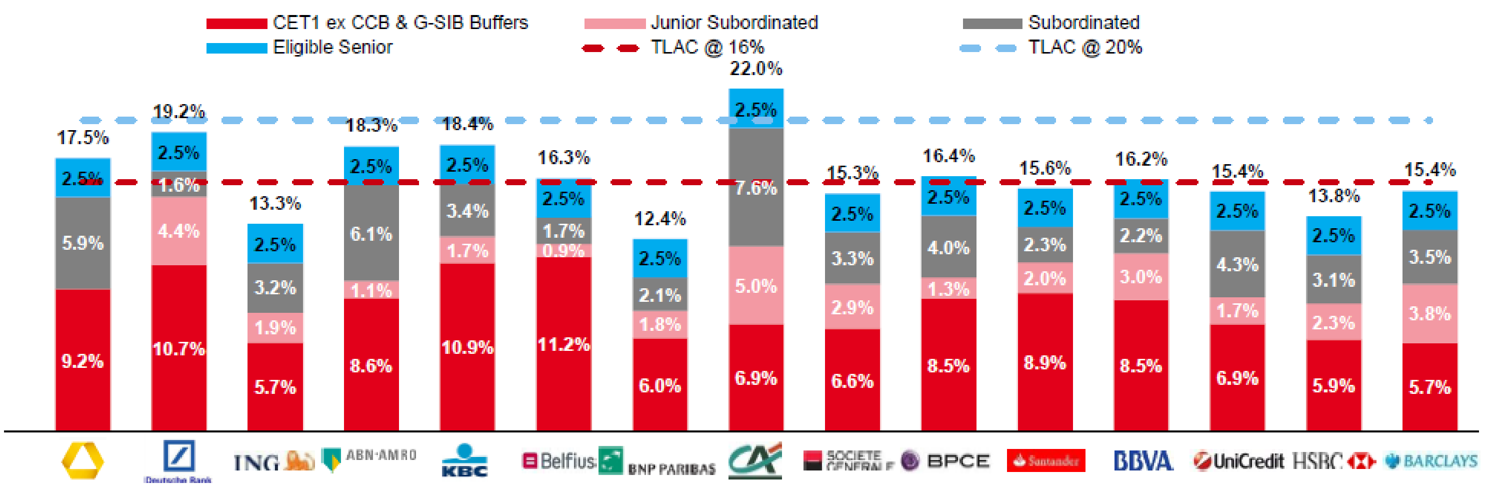
Source: European Central Bank, European Commission, European Banking Authority, UniCredit analysis . Future dates may be subject to change.

Capitalisation of European Banks

Regulatory capital ratios (Basel III phase-in) as of FY 2014*



TLAC ratio (Basel III phase-in) as of FY 2014**



Source: Company 4Q financial reports, Data on the outstanding amounts of Junior Subordinated, Subordinated and Senior from Bloomberg Note: (*) SocGen and BPCE on a fully loaded basis (**) – Ratio based on the regulatory eligible CET1 ratio (after deductions of Capital Conservation Buffer and Systemic Buffer) and the nominal amount of loss-absorbing outstanding debt in the banking group (without regulatory deductions); Junior Subordinated debt includes both old style and new style AT1 and preference securities; Subordinated debt includes both Tier 2 eligible and regulatory non-eligible subordinated debt.

International Bail-in Measures

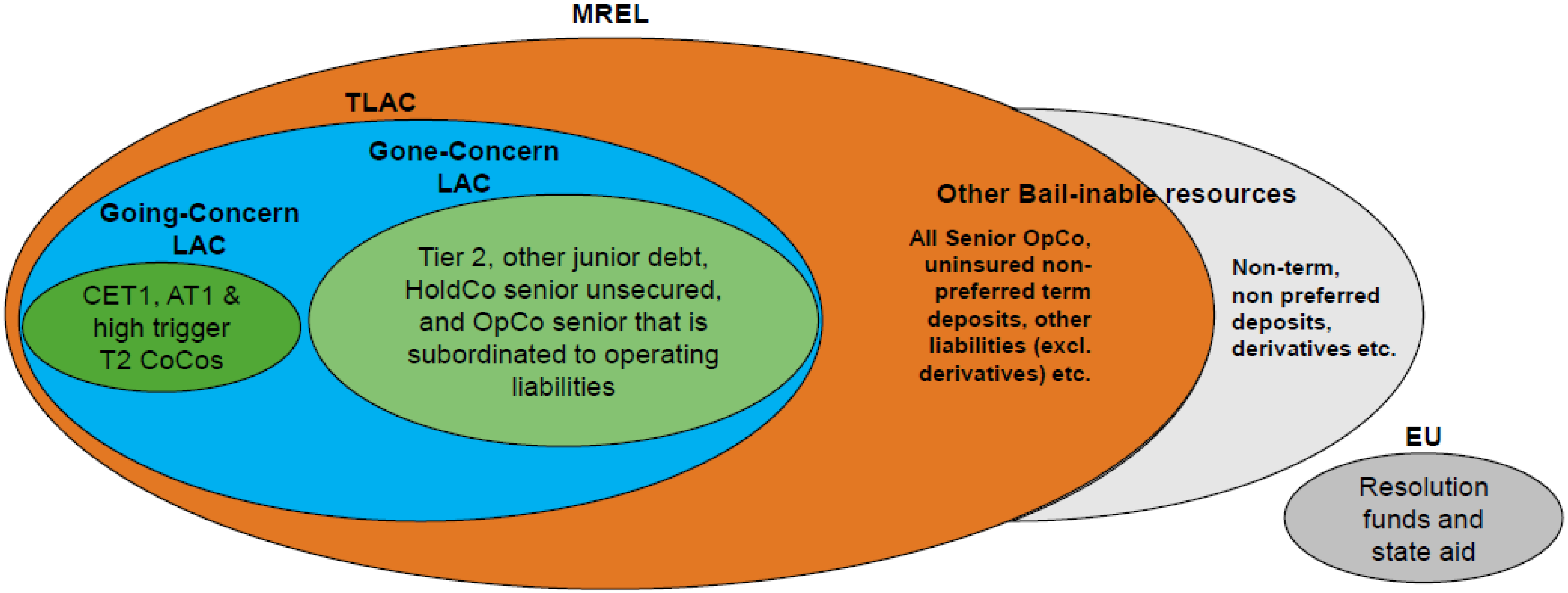
MREL vs TLAC vs PLAC vs Swiss Finish

	MREL Minimum Requirement for Own Funds and Eligible Liabilities	GLAC → TLAC Gone Concern / Total Loss Absorbing Capacity	PLAC Primary Loss-Absorbing Capacity	Swiss Finish	Assessment
Standard setter / Driver:	EU Parliament / EU Council / EU Commission	**The FSB was mandated by the G20 to identify a global standard for gone concern loss absorbing capacity (GLAC) for GSIFs**	FSA, UK	Finma, Switzerland	Is a harmonised measure desirable?
Conceptual Purpose:	Measure of total loss absorbing capital	Recapitalisation / Resolution facility, only — **Measure of total loss absorbing capital**	Measure of total loss absorbing capital	Measure of total loss absorbing capital	GLAC to establish a particular capital class for Resolution Financing only?
■ **Application**	All EU Credit Institutions and Investment Firms	**29 G-SIBs**	UK ringfenced banks and UK-headquartered global banks	Switzerland	At least, two different approaches
Structural details:					
■ **Quantum**	Institution Specific	**Minimum Requirement is the higher of 16 – 20% of RWAs*; or 6% LR****	Harmonised 17%	Institution Specific	Disclosure?
■ **Quality**	Own Funds and eligible Liabilities***	Excluding Own Funds**** (GLAC) ↔ **Including Own Funds (TLAC)**	Equity and potentially loss-absorbing liabilities	CET1, High (7% CET1) and Low (5%) Trigger CoCos	Depends partly on the resolution strategy
■ **Denominator / Basis of the calculation**	Total liabilities and Own Funds	Total Liabilities and Own Funds ↔ **RWAs / Total Balance Sheet**	RWAs	RWAs	
■ **Subordination*****	Not required	Under discussion	Not required	Statutory	
■ **Consequence in case of breach**	Early Intervention Phase?	**Authorities must ensure prompt action in case of a TLAC breach. Buffers on top of min TLAC.**	Regulatory pressure / intervention	Regulatory pressure / intervention	

* Excluding CET1 earmarked for Combined Buffer Requirements (CBRs). ** Pillar I, plus Pillar II add-on for individual risks . *** Derivative liabilities shall be included in the total liabilities on the basis that full recognition is given to counterparty netting rights. **** Excluding Tier 1 and Tier 2 or excluding Tier 1, only? ***** Structural, contractual or statutory subordination possible

BRRD vs. TLAC

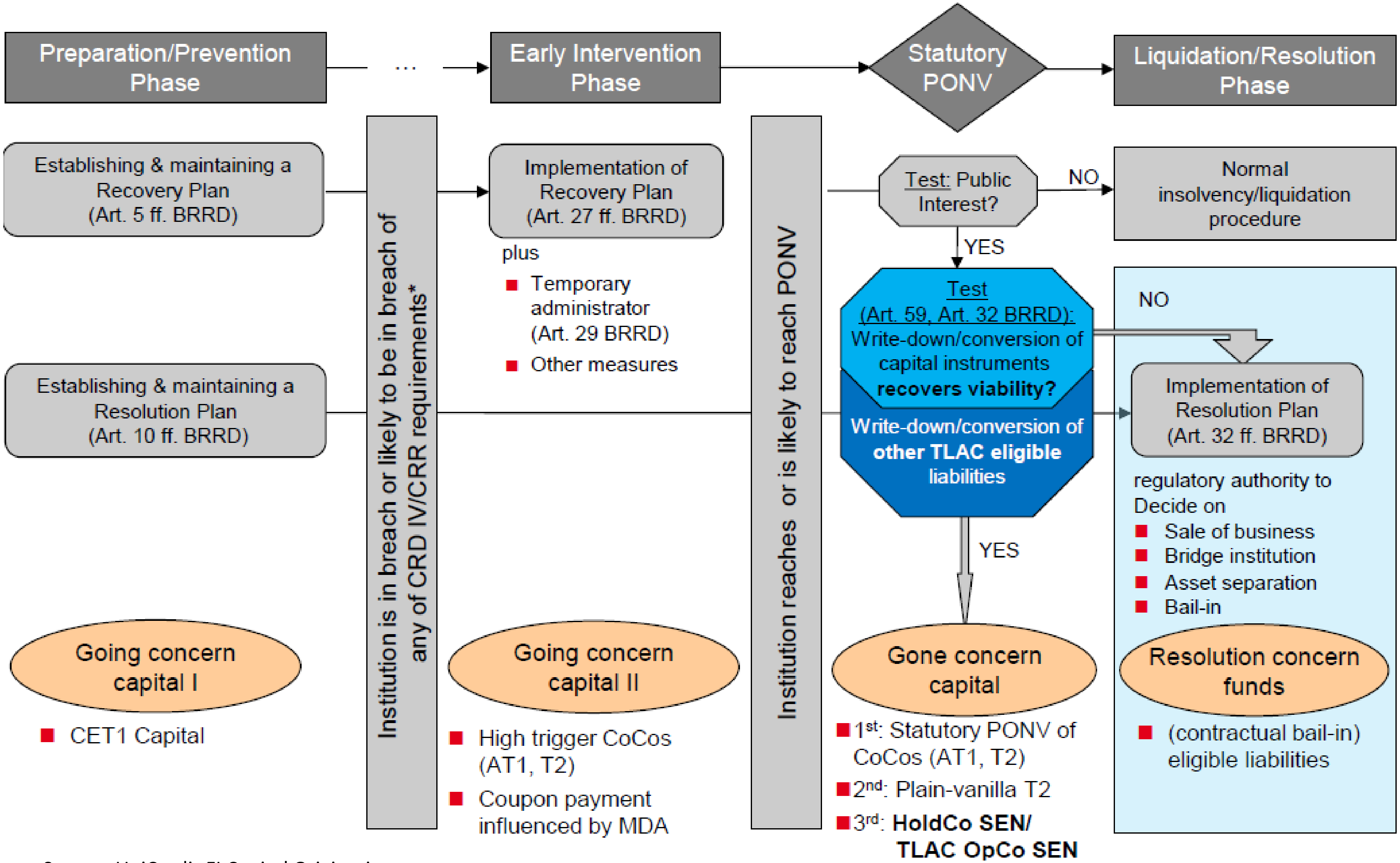
Contradictory Concepts?



- **EU** is implementing its Bank Resolution & Recovery Directive ("BRRD") by enactment in all Member States on 1 January 2015
- BRRD provides for bail-in of senior unsecured liabilities, with limited discretion for the resolving authority to differentiate among creditors of the same class other than for systemic concerns. **Senior debt bail-in effective from 1 January 2016 at the latest, earlier at Member State's discretion**
- **Minimum requirement for bail-inable capital:** Member States shall ensure that institutions meet, at all times, a minimum requirement for own funds and eligible liabilities (MREL). The minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution. (It will likely be above 8% as that is the minimum amount of loss absorbency before any debt can be excluded from bail in and resolution funds/state aid.) Member States may provide for additional criteria on the basis of which the minimum requirement for own funds and eligible liabilities shall be determined. The EBA shall submit those draft regulatory technical standards to the EC [within twelve months from the entry into force of this Directive]. The EC shall, if appropriate, submit by 31 December 2016 to the European Parliament and the Council a legislative proposal on the harmonised application of the minimum requirement for own funds and eligible liabilities
- **FSB's TLAC requirements differ in terms of quantum and eligible instruments:** (i) MREL includes all Senior OpCo debt (incl. structured notes) and other senior liabilities such as non-preferred deposits whereas standard EU Senior Op co debt will not be strictly eligible under current FSB proposal (ii) Calibration of MREL requirements are not yet defined

Bank Recovery and Resolution Directive – BRRD plus FSB Proposal

Steps of main elements of the framework



Source: UniCredit FI Capital Origination

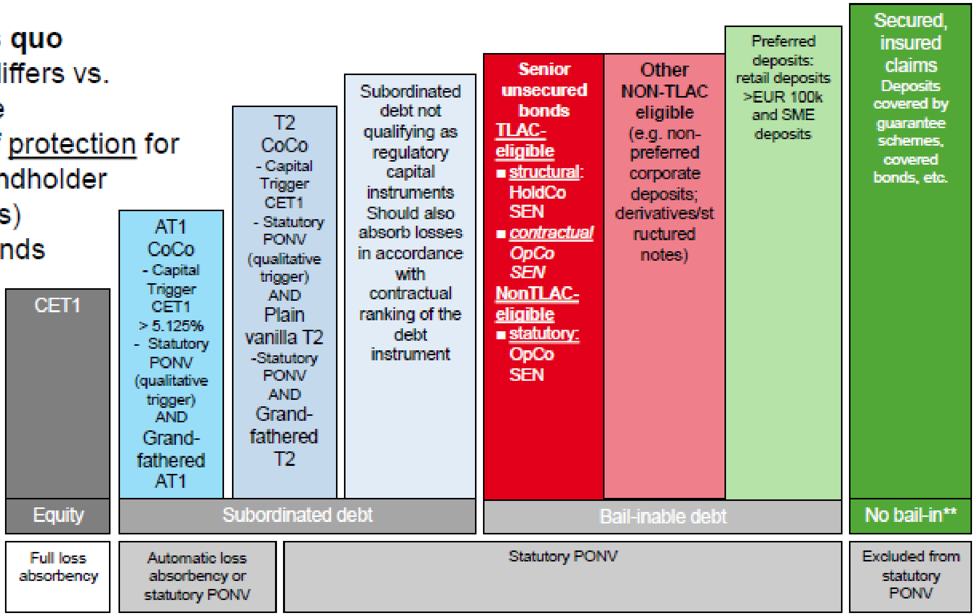
* In BRRD (15.04.2014) (Art. 27), there is reference to Regulation (EU) No 575/2013, Directive 2013/36/EU or Title … of Directive 2014/../EU

Sequence of Bail-in/Hierarchy of Claims under BRRD/Insolvency Law

German insolvency procedure (a) vs. alternative proposal (b)

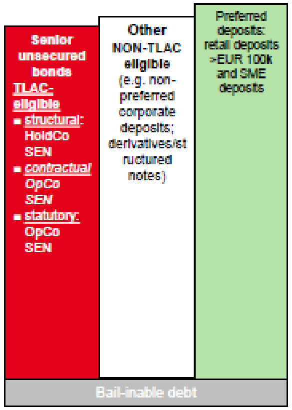
BRRD - current status quo

- Hierarchy of claims differs vs. insolvency procedure
- No creditor worse-off protection for senior unsecured bondholder (compensation claims)
- Senior unsecured bonds not TLAC eligible



a) German proposal on new insolvency hierarchy

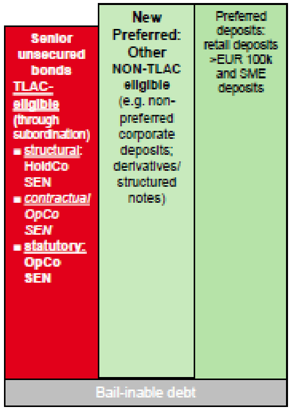
- Tradeable senior unsecured bonds explicitly subordinated
- Resulting in TLAC eligibility
- No creditor worse-off argument no longer applicable



b) Alternative insolvency hierarchy

- Increasing/enlarging the list of preferred liabilities (super senior status), i.e. leaving senior unsecured untouched
- Positive list (naming preferred liabilities)
- Negative list (all preferred but…senior unsecured bonds)

=> implicitly subordinated



* Also includes subordinated debt instruments, which have never been qualifying as own funds.

** Subject to insolvency Code (Germany: Insolvenzordnung)

Source: UniCredit FI Capital

Subordination of Bank Senior Unsecured Bonds in Germany

Draft law sets statutory subordination (expressis verbis) for bank senior unsecured bonds

Three Alternatives to achieve a subordination of TLAC eligible instruments to operating liabilities

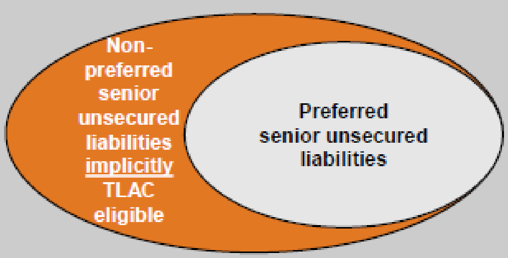
Contractual

- individual „subordination“ language (currently two approaches discussed in the market)
- costly
- legal risk of complete adhoc implementation vs. long transitional period for turnover of existing senior unsecured portfolio

Statutory*

Positive Discrimination (indirect)
- Determination of privileged liabilities -

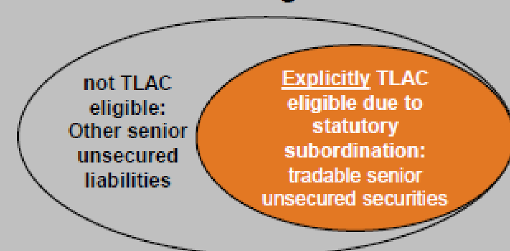
Pros	Cons
■ Potentially more positive investor perception ■ Less legal risk: "Smoother" implementation by privileging operating liabilities ■ Determination of operating liabilities as privileged senior liabilities	■ Uncertainty, if sufficient operating liabilities are excluded to be TLAC compliant **BUT:** list of positive discriminated liabilities can be adapted as soon as TLAC specifications are known



Negative Discrimination (direct)**
- Determination of subordinated liabilities -

Pros	Cons
■ (expected) legal certainty regarding TLAC eligibility **BUT:** Unintended exclusion of other non-operating liabilities as TLAC eligible (e.g., registered bonds, Schuldscheindarlehnen)	■ Negative investor perception on subordination (triggering premium requirement) ■ Arbitrage possible to structure senior debt

German legal draft



Structural

HoldCo: subordination of senior liabilities vs. operating liabilities

* Topic of prohibition of retrospective legislation is well discussed and there is no need for transition period seen

** new proposed §46f (5) KWG: In the insolvency proceeding […] claims of unsecured debt securities with the meaning of § 1 para 11 no. 3 KWG (= Banking Act – tradable securities) are considered subordinated but senior to subordinated obligations in the meaning of § 39 para 1 no. 1 Insolvency Law (Insolvenzordnung). Debt securities featuring the conditionality that the repayment or the redemption amount is (i) depending on the occurrence or non-occurrence of an, at issuance uncertain event or (ii) can happen in non-cash format.

BRRD – Bail-in treatment of shareholders

- Existing shares to be cancelled or transferred to bailed in creditors
- Where, under the resolution valuation, the institution has a positive net asset value, existing shareholders to be diluted by conversion of existing capital instruments or conversion of eligible liabilities
- In such a case, conversions must “severely dilute” the existing shareholdings
- Above applies also to shareholders who had already been converted pursuant to going concern conversion of capital instruments (e.g. Additional Tier One capital) or of other debt instruments

BRRD – Bail-in of Derivatives

- A derivative liability can only be bailed-in once the derivative contract has been terminated and closed out
- Where subject to a netting agreement (e.g. ISDA Master), the liability should be valued (for the purpose of the resolution valuation) on a net basis
- EBA to develop (in consultation with ESMA) draft regulatory technical standards by 3 January 2016 on the methodologies and principles for valuing derivatives liabilities
- Where subject to a netting agreement, EBA “shall take into account the methodology for close-out set out in the netting agreement”

BRRD – Bail-in of Derivatives (cont.)

- In relation to derivatives contracts, Article 71 BRRD gives resolution authority power to suspend termination rights of parties to contracts with institution under resolution, until midnight on the business day following official notice of the resolution action, so long as obligations regarding payments/deliveries/collateral exchange are kept current
- FSB and other regulators concerned that powers such as these might not be enforceable against third country counterparties, where contract governed by the domestic law of the relevant court
- Strongly encouraged derivatives industry to take steps to insert termination suspension provisions into the contracts governing derivatives and ISDA has drafted protocol for parties to be able to modify terms of their ISDA Master Agreement – 18 major global banks have acceded and became bound by the protocol in January 2015
- The language may also be adapted for use in other arrangements such as securities repo contracts
- FSB will recommend that national regulators require regulated entities to adopt similar contractual language

BRRD – Effects of Bail-In

- Different equity conversion ratios may be applied to different classes of capital instruments and liabilities, to reflect:
  - appropriate levels of compensation for loss incurred due to exercise of write down and conversion powers
  - the seniority of the liability that was bailed-in – higher conversion rates for more senior liabilities
- EBA to develop guidelines by 3 January 2016
- Exercise of bail-in tool to recapitalise an institution must be followed by preparation of a business reorganisation plan
- Where principal amounts are written down, they cannot be subsequently written up – compare position on a going concern write-down under CRR

Effect of BRRD on Deposits

- Covered deposits (i.e. the amount of a deposit that is covered by a deposit guarantee scheme) are excluded from bail-in
- BRRD also requires that national insolvency regimes give deposits priority status
- Therefore, in a winding-up proceeding (i.e. not a resolution) the amount of an eligible deposit that is not covered by a deposit guarantee scheme ranks senior to other unsecured liabilities, as do deposits that would have been eligible deposits if they had not been made with a non-EU branch of an EU bank
- In turn, covered deposits and claims for covered deposits subrogated to a deposit guarantee scheme will rank senior to the deposits in the previous bullet point

BRRD – Bail-In Ancillary Provisions

- Resolution authority given powers to complete (or require completion of) all administrative procedures needed to give effect to exercise of bail-in tool, including amending registers, delisting securities, admitting new securities to trading, relisting any debt securities that have been written down (without the need for a PD-compliant prospectus)
- Institutions must maintain sufficient authorised, unissued share capital/common equity tier 1 instruments to ensure any bail-in conversion can be carried out effectively and Member States must ensure no procedural impediments to conversion (e.g. overriding shareholder pre-emption rights or shareholder consents)

BRRD – Bail-In Ancillary Provisions (cont.)

- Where a liability of an institution is:
  - not expressly excluded from bail-in under BRRD
  - not a preferential deposit
  - issued or entered into after the date on which the institution’s Member State implements the BRRD nationally
  - governed by the law of a non-Member State

  the contractual terms of that liability must provide that the creditor recognises that the principal of the liability may be written down or converted and agrees to be bound by any bail-in action by a resolution authority
- The above applies unless the resolution authority determines that the liability can be bailed-in under the bail-in powers of an EU member state resolution authority pursuant to the law of the non-EEA country by which the liability is governed or pursuant to a binding agreement with that non-EEA country

BRRD – Cross-border Recognition of Bail-in

- FSB Consultation of 29 September, 2014 proposed statutory changes to be adopted by countries and also contractual approaches that G-SIBs should implement, in each case to enhance effectiveness of cross-border resolution actions
- Statutory provisions as to recognition of foreign resolution actions are preferable in the long term, but will take time to implement
- In the meantime, FSB recommends mandating contractual clauses providing for recognition of resolution bail-in actions, based on five key principles:
  - there should be a clear agreement by the creditor to be bound by the terms of the bail-in, and that the terms of the bail-in will be given effect
  - the consequences of a bail-in should be prominently disclosed to investors in the instrument, in accordance with applicable disclosure requirements
  - the recognition provisions should be drafted in general terms, in order to ensure no conflict with how the statutory bail-in regime may be applied in practice

BRRD – Cross-border Recognition of Bail-in (cont.)

  - institutions should seek independent legal advice in the jurisdiction of the instrument's governing law, to ensure that the contractual provisions take into account relevant legal issues and
  - institutions should be required to demonstrate the enforceability of any statutory bail-in of instruments governed by foreign law, including through the provision of an independent legal opinion.
- The FSB further recommends that if the laws of the jurisdiction governing the instrument do not provide a bail-in mechanism, the inclusion of the proposed contractual recognition language could be a condition to eligibility of the instrument to count towards loss-absorbing capacity
- Similar provisions are contained in the Basel Committee/CRR requirements for gone concern loss absorption of regulatory capital instruments
- EBA consulted on draft regulatory technical standards on contractual recognition of bail-in in November 2014

UK Implementation of BRRD

- Recent consultations by HM Treasury, PRA and FCA all closed in September/October 2014
- Bail-in tool was implemented as of 1 January 2015, and the remainder of BRRD will be implemented by 1 January 2016
- The requirement for foreign law–governed liabilities to contain contractual bail-in recognition clauses is being phased in – 1 January 2015 for regulatory capital, bonds and other debt market instruments, and 1 January 2016 for other liabilities
- In the UK, the bail-in powers already provided for in Financial Services (Banking Reform) Act 2013, which amends Special Resolution Regime in Banking Act 2009, were amended to comply with BRRD and took effect on 1 January 2015, with the exception of Article 45 concerning the Minimum Requirement for Eligible Liabilities (“MREL”)
- These provisions being delayed until publication of final regulatory technical standards from EBA on the assessment criteria for MREL. The EBA consulted on these in November 2014, following the FSB’s proposals on Core Concern Loss Absorbing Capital for Global SIFIs

The Market for Bailable – In Instruments

- Who will buy unsecured debt instruments issued by banks post – 2015 (or post -2014, in respect of UK institutions)?
- Traditional fixed income investors may not have an investment mandate allowing the holding of equity or contingent convertible instruments – if not, mandates will need to be adjusted either to allow holding of post- conversion equity instruments long term, or at least until they can be disposed of – which may take time in an environment of law liquidity after a major bank failure
- Bail-in consequences will have to be clearly disclosed to ensure investor understanding. Will regulators continue to allow retail investors to invest in unsecured bank debt? Are retail investors capable of understanding bail-in mechanics? How much do they need to understand?
- Regulators have concerns about selling contingent convertible bonds to ordinary retail investors due to concerns about ability to comprehend the loss absorption mechanics and trigger points, and to compare them with other products. FCA has imposed a 12 month ban on sales of CoCos to ordinary retail investors until 30 September 2015. Will they have similar concerns about instruments subject to resolution bail-in?

The Market for Bailable – In Instruments – (cont.)

- Will banks and investment firms still be able to invest in unsecured debt and contingent convertible instruments issued by other banks and investment firms?
- Regulators concerned about possibility of financial contagion in event of bank’s failure
- Article 44(2) BRRD states that, in addition to any large exposure rules that apply to banks and investment firms, resolution authorities must limit the extent to which other institutions hold liabilities eligible for bail-in
- Limits can be imposed as part of resolution authority's powers to remove impediments to resolvability

The Market for Bailable – In Instruments – (cont.)

- Where a liability:
  - is not an excluded liability
  - is not an excluded deposit
  - is governed by the laws of a non-EEA country
  - was issued, entered into or arose after 31 December 2015 (or, in the case of an unsecured transferable debt-security, or an Additional Tier 1 or Tier 2 instrument, issued by a UK bank, after 19 February 2015),

  the contract governing such liability must contain contractual bail-in recognition language, i.e. a recognition that the principal of the liability may be written down or converted at the instigation of the home state resolution authority, and agreement to be bound by such a bail-in action
- What do/will investors make of such wording in the terms of the instrument? Does it make a difference whether the investors are European or not? Does it put them in the same position as creditors under EEA law-governed instruments?

How will senior unsecured bank debt be priced?

- Unsecured debt – bail-inable in a resolution, and so provides gone-concern loss absorption. How will this be priced in comparison with other funding instruments issued by an institution, such as:
  - additional tier 1 capital (which will always have going-concern and gone concern loss absorption)
  - tier 2 capital (which will always have gone concern loss absorption) with going concern loss absorption
  - tier 2 capital without going concern loss absorption
  - other subordinated instruments
  - contingent convertible instruments with a "high trigger point"
  - contingent convertible instruments with a "low trigger point"

What Structures May Become Attractive to Debt Investors?

- Covered bonds
  - expressly excluded from bail-in powers, as are financial instruments used for hedging and forming part of the cover pool
- Other secured liabilities, such as secured bank bonds
  - also expressly excluded from bail-in provisions
- BUT for both covered bonds and other secured liabilities, they are only excluded from the bail-in powers to the extent of the value of the assets securing those liabilities. Any amount of liability in excess of the value of the secured assets will be treated as unsecured and subject to bail-in powers
- For covered bonds with high levels of over-collateralisation, unlikely to be caught by bail-in, but not impossible
- Volumes of secured liabilities that could be issued by an institution will be limited by, inter alia:
  - existing asset encumbrance limits imposed by bank supervisors
  - new national requirements, pursuant to Article 45 BRRD, to maintain minimum levels of regulatory capital and bail-inable liabilities, as a percentage of their total liabilities plus own funds

What Structures May be Attractive to Debt Investors? (cont.)

- Secured bank bonds
  - full recourse secured bonds issued directly to investors, secured by mortgage loans or other financial assets
  - perhaps structured as a continual issuance programme
  - structures may (or may not) allow replenishment of cover pool for flexibility
  - therefore could be similar to covered bonds, but not subject to same collateral tests and other requirements of a statutory covered bond

What Structures May be Attractive to Debt Investors? (cont.)

- Put option
  - for liabilities that cannot be made exempt from bail-in, may be possible to structure in an investor put option
  - would need to trigger well in advance of any resolution decision and would need to be drafted very carefully
  - Article 68 BRRD will prevent any resolution measure, early intervention measure, or exercise of powers to remove impediments to recoverability or resolvability, being used to affect the contractual rights of the institution
  - A put option would affect pricing significantly and difficult to design with any degree of certainty, due to possibility of an institution's financial health deteriorating rapidly

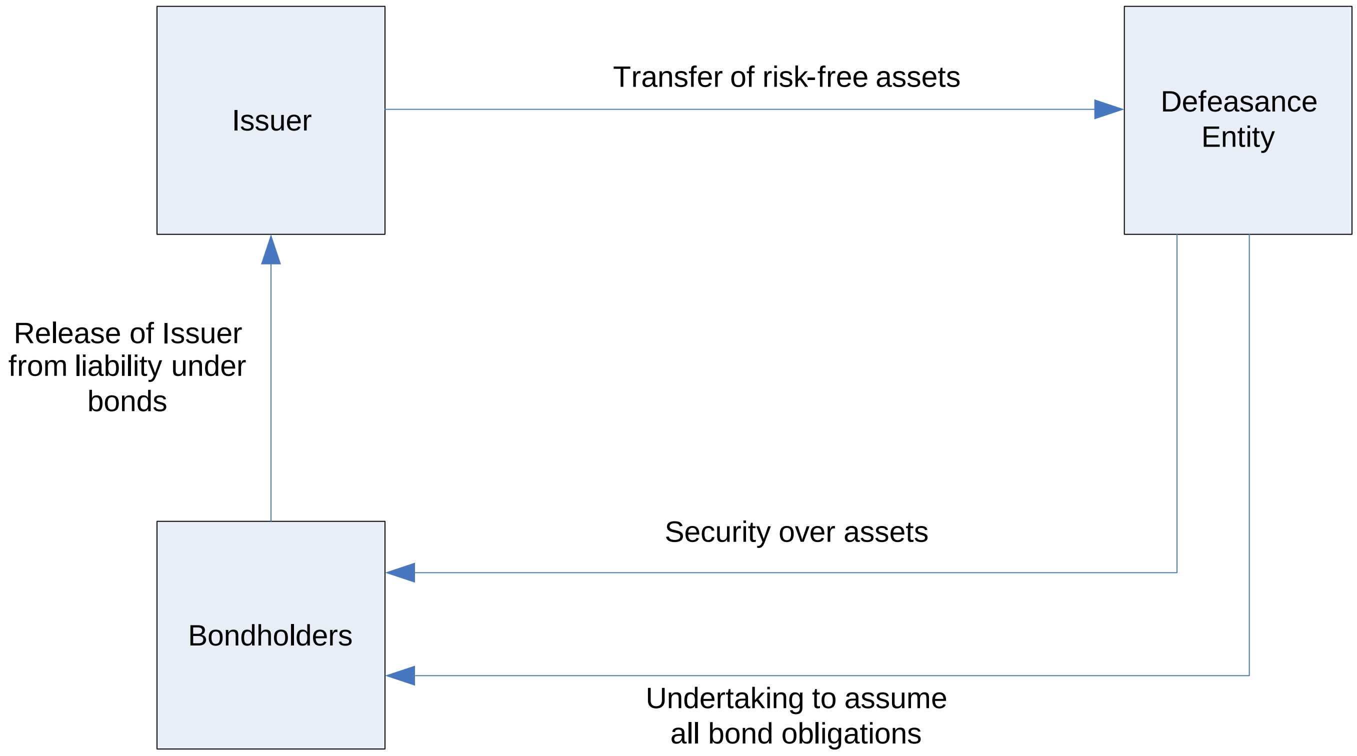
Defeasance Structure

- In cases where it is not possible to structure a bond so as to fall within any exemptions to the bail-in requirements, a defeasance structure could be considered
- Defeasance is the process of (i) releasing the issuer from its bond obligations without redeeming/repurchasing the bond by (ii) substituting for the issuer a risk-free third party to assume the bond obligations
- One way this could be achieved is by the issuer transferring low risk assets to a special purpose vehicle (the “defeasance entity”), which then assumes the primary obligation to make required payments under the bonds and grants a first priority security interest to the bondholders over transferred assets, to secure its bond obligations

Defeasance Structure (cont.)

- The bonds will provide for the issuer to be released from its payment obligations provided certain criteria are satisfied.
- After the defeasance takes effect, any bail-in affecting the issuer should have no effect on bondholders as the bonds are no longer obligations of the original issuer. Any insolvency of the issuer should not affect the bondholders, so long as the transfer of assets to the defeasance entity took place at fair value, prior to the onset of insolvency and the defeasance entity is not a creditor of the original issuer.
- The defeasance entity would be structured so as to be "bankruptcy-remote" in that the rights of the bondholders against the defeasance entity are expressed to be limited in recourse to the value of the pledged risk-free assets, and since the defeasance entity is structured as a single purpose entity there should be no realistic likelihood of the defeasance entity's insolvency.

Defeasance Structure Diagram



Bail-in Case Study: Cyprus

- Cyprus financial system under significant strain in aftermath of financial crisis
  - January 2012 - emergency €2.5bn loan from Russia
  - March 2012 – Cyprus banks downgraded to sub-investment grade by Moody's
  - June 2012 - Cyprus banks downgraded to BB+ by Fitch
  - Cyprus requested bail-out from European Stability Mechanism (ESM)
  - ECB proposed bail-out terms in November 2012 subject to strict austerity measures being put in place – no agreement reached
  - Continued financial pressures meant Cyprus Popular Bank (Laiki) was insolvent

Bail-in Case Study: Cyprus (cont.)

- Initial agreement for €10bn financing for Cyprus agreed on 16/17 March 2013 with European Commission, Eurogroup, ECB and IMF:
  - one off "bank deposit levy" (write-down) of 6.7% for insured deposits on all domestic bank accounts (up to €100,000) and 9.9% for higher deposits)
  - depositors to be compensated with bank shares
  - introduction of capital controls
  - no write-down for other senior creditors/bondholders
  - deal widely criticised
  - rejected by Cyprus Parliament on 19 March 2013

Bail-in Case Study: Cyprus (cont.)

- Subsequent arrangement agreed on 25 March 2013:
  - Laiki to be resolved with full contribution of equity shareholders, subordinated and senior bondholders and uninsured depositors
  - Laiki to be split into good and bank banks
  - Good bank (including insured deposits and various assets including € 9bn of Emergency Liquidity Assistance from Eurozone central banks) transferred to Bank of Cyprus
  - Writedown of uninsured deposits of Bank of Cyprus so it met capital ratio of 9%
  - ECB to provide liquidity support to Laiki
  - Capital controls imposed

Bail-in Case Study: Cyprus (cont.)

- Original Cyprus agreement contrary to fundamental principles in BRRD including principle that creditors should bear losses in accordance with normal priority of their claims, that no creditor should incur greater losses than they would under normal insolvency proceedings and that covered deposits should be fully protected.
- Final agreement more in line with these principles.
- How will BRRD/bail-in impact similar future crises?
- Not clear whether Cyprus deposit guarantee fund was adequately funded and interaction between DGSD and BRRD likely to be complex in future crises.
- BRRD is likely to provide much clearer framework and mechanisms for future use of ESM funds.
- Cyprus crisis was highly politicised which affected terms of both initial and final agreements. BRRD framework and mechanisms may help in setting fairer parameters for future restructurings but considerable scope for political involvement remains.

Bail-in Case Study: Cyprus (cont.)

- BRRD likely to add complexity to future restructurings which may make obtaining agreement more difficult. At the same time it will provide a clearer framework of principles and rules that may assist in establishing more consistent templates.

Final Thoughts

- The full effect of BRRD will not be known until we have the final detailed standards still being prepared by EBA
- Of crucial importance to bank sector are the final provisions regarding MREL, to be submitted to European Commission by July 2015 – FSB work on levels of GLAC for G-SIBs delivered at November 2014 G-20 summit in Brisbane will be relevant to MREL discussion
- Unsecured debt may become more expensive for banks to raise – how much will depend on many factors, including the extent to which national regulators are perceived to be prepared to tackle too-big-to-fail, and to bail in senior debt
- Will certainly become more challenging for banks to price different elements of their funding due to complex matrix of instruments that can absorb losses

Final Thoughts (cont.)

- Some traditional senior unsecured debt investors will in future be minded to focus on secured debt. Some may be tempted by better pricing of subordinated instruments, if they believe that senior unsecured debt could actually be bailed in. Others will keep on investing in senior unsecured, if the price is right. Some will stop investing in financial institutions altogether
- In cross-border cases, co-operation between different countries and recognition of foreign resolution actions will be crucial to the success of resolution regimes.
- Within the EU, the combination of the Credit Institutions Winding Up Directive and BRRD address many relevant issues. However, successful resolution of the biggest, global banks will hinge upon the ability to reach international agreements between supervisors and resolution authorities. This has to be addressed at G-20 level.
- The FSB has consulted on these issues – especially on contractual bail-in recognition clauses, as an interim measure to be mandated for regulated firms by their supervisors – and by end of 2015 expects FSB members to take action to promote widespread adoption of contractual clauses recognising stays on early termination rights and exercise of bail-in powers

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