**Institute of International Finance**
**The Clearing House Association**

**Cross-Border Resolution Colloquium**

# Post-Resolution-Weekend Process: Reorganization and re-launch of the post-resolution firm Timing, valuation, treatment of creditors, liquidity support

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**Handouts**

## Handout 1: Reasonable Resolution Scenario

1. The party being resolved is a group of affiliated companies that has been designated by the FSB as a G-SIB.
2. The G-SIB's top-tier parent is either a holding company or a universal bank.
3. The G-SIB will be resolved using an SPE strategy.
4. The G-SIB's top-tier parent is placed in a resolution proceeding under a special resolution regime or, if the applicable bankruptcy regime provides a framework for SPE, in a bankruptcy proceeding.
5. The G-SIB's material counterparties have agreed to adhere to the ISDA protocol with respect to all financial contracts.
6. The G-SIB's top-tier parent has enough external TLAC to recapitalize the parent and enough assets, including internal TLAC, to recapitalize its operating subsidiaries, if the G-SIB is put into a resolution or bankruptcy proceeding before balance-sheet insolvency.
7. When necessary, foreign investors in external TLAC have consented to bail-in.
8. The G-SIB has triggered and executed its recovery plan without success, and is unable to raise more capital or other loss-absorbing resources from the market.
9. The G-SIB fails as a result of a common shock similar to the severely adverse economic scenario defined in the Federal Reserve's 2015 CCAR stress testing process – that is, one that causes the stock market to rapidly fall by 50% and housing prices by 24%, with unemployment rapidly rising to over 10%.
10. During such a severely adverse economic scenario, the ordinary valuation markets are dysfunctional and asset values are highly uncertain.
11. The SPE strategy is executed either by a direct bail-in or a bridge bail-in of the top-tier parent's TLAC.
12. The top-tier parent's operating subsidiaries:
    - are recapitalized by a contribution of assets from the top-tier parent, including internal TLAC, and
    - they remain open and operating outside of any resolution or bankruptcy proceeding.
13. The recapitalized G-SIB has access to enough liquidity during the resolution or bankruptcy proceeding to avoid the need to sell assets at fire sale prices.
14. The resolution authority has a duty to preserve and maximize the value of the G-SIB or bridge institution for the benefit of the G-SIB's claimants, except to the extent inconsistent with preserving financial stability.

## Handout 2: Six Key Stages of Bail-in within Resolution Process

**Stage 1**. Deciding whether and when to trigger a resolution proceeding.

- Valuation issues arise.

**Stage 2**. Deciding the proper accounting method and what to disclose to the market about the value of the company at the start of the resolution period.

- Valuation, accounting and financial disclosure issues arise.

**Stage 3**. Deciding the amount and identity of the holder of each bail-inable claim.

- Valuation and exchange mechanics issues arise.

**Stage 4**. Determining the residual value of the G-SIB and how to distribute that value to the holders of bail-inable claims and, if the amount of value is sufficient, to any junior claimants (including equity interests) in satisfaction of their claims.

- Valuation and exchange mechanics issues arise.

**Stage 5**. Deciding the proper accounting method and what to disclose to the market about the value of the recapitalized G-SIB upon exit from resolution.

- Valuation, accounting and financial reporting issues arise.

**Stage 6**. Deciding the hypothetical liquidation value of the G-SIB on the starting date of the resolution proceeding for purposes of determining whether any claimants that were treated worse than other claimants ***within the same class*** are entitled to any NCWOL compensation.

- Valuation issues arise.

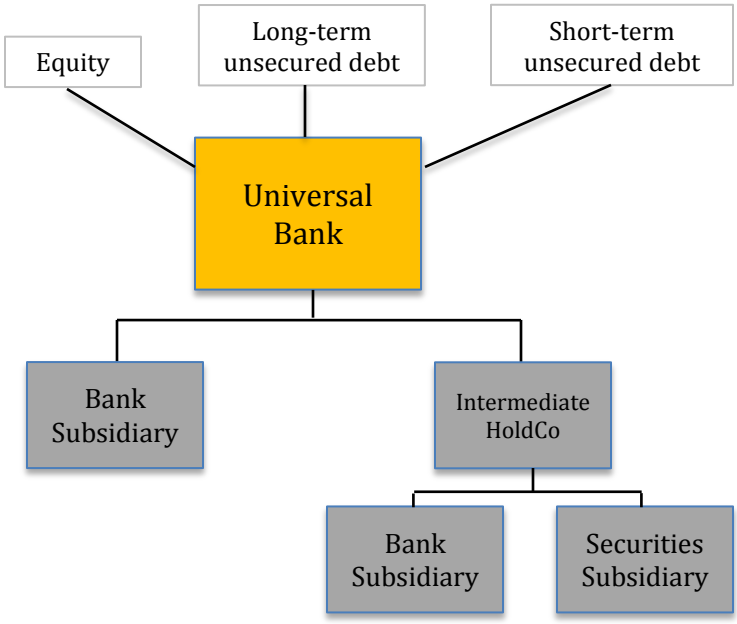
## Handout 3: Direct Bail-in vs. Bridge Bail-in

**Direct Bail-in**: Exchange of a legal entity's unsecured debt for equity in the same legal entity, including a write-down of the debt to reflect any shortfall in the value of the equity.

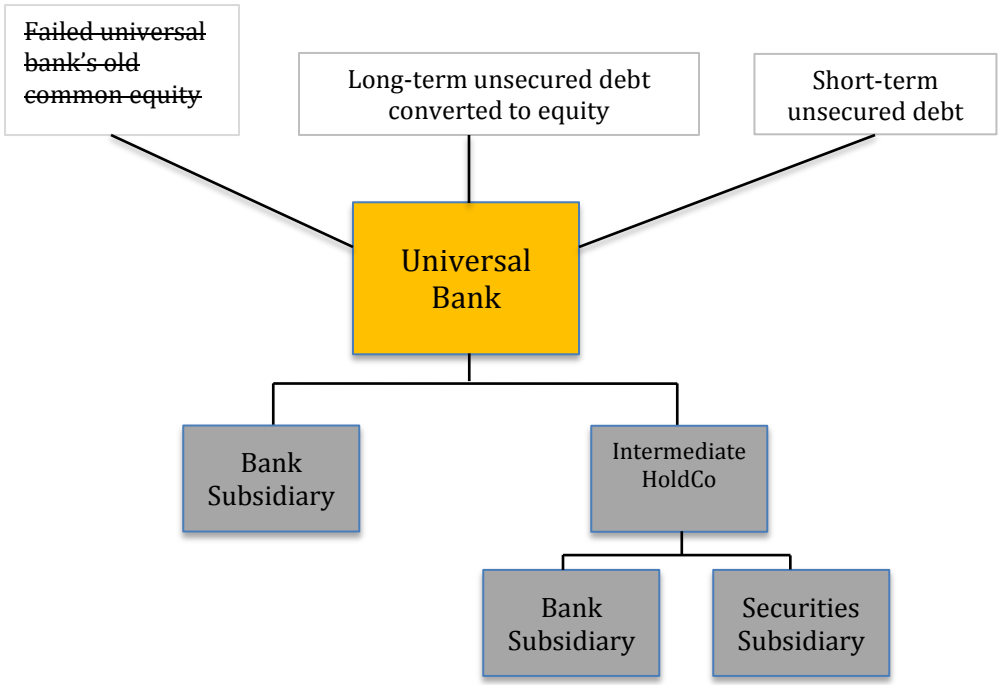
**Bridge Bail-in**: Exchange of a legal entity's unsecured debt for equity in a bridge legal entity to which all or any portion of the first legal entity's assets have previously been transferred.

## Handout 4: Simplified Illustration of Direct Bail-in

1) Before Resolution Weekend



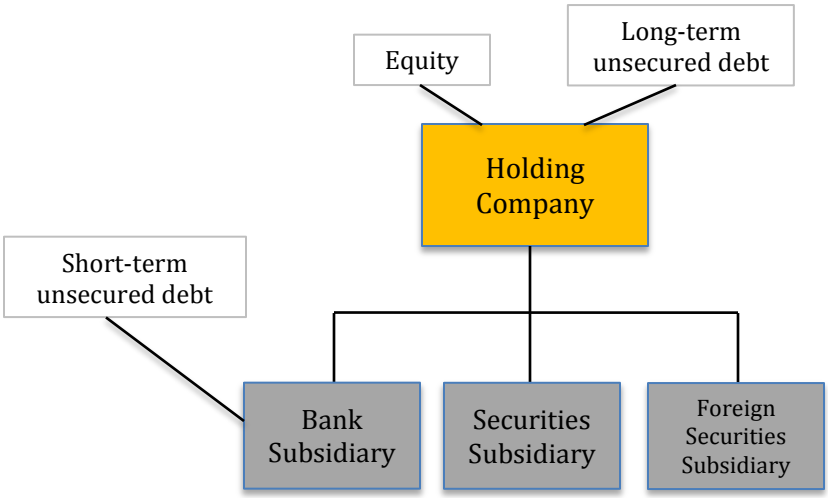

2) Upon Completion[1]



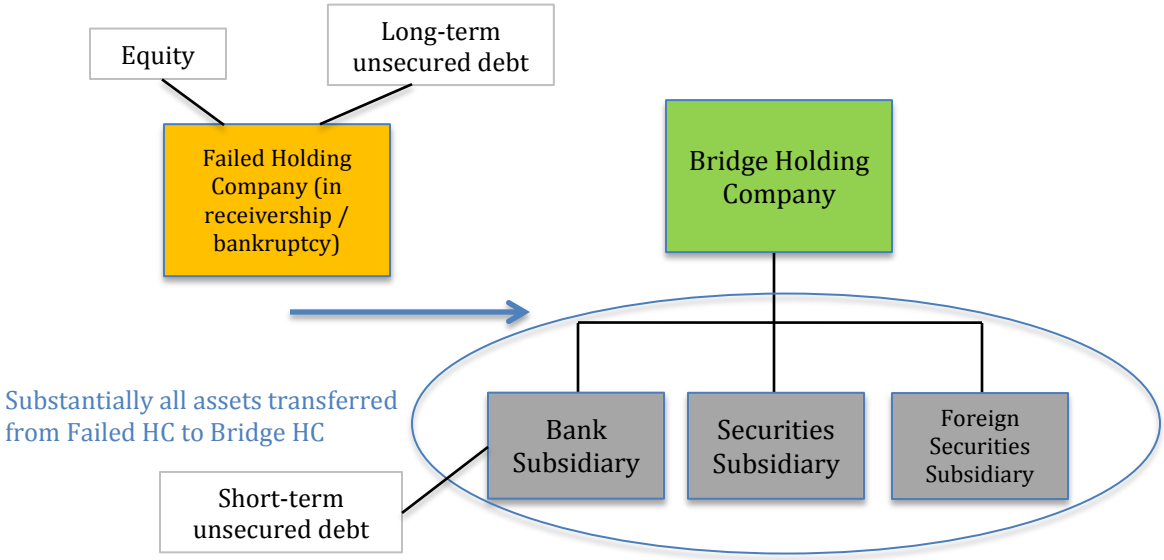

[1] See Handout 8 regarding time frame debate – Must direct bail-in be completed by Monday morning after resolution weekend? Within a few days or weeks of resolution weekend? 6-9 months (or longer) after resolution weekend?

## Handout 5: Simplified Illustration of Bridge Bail-in

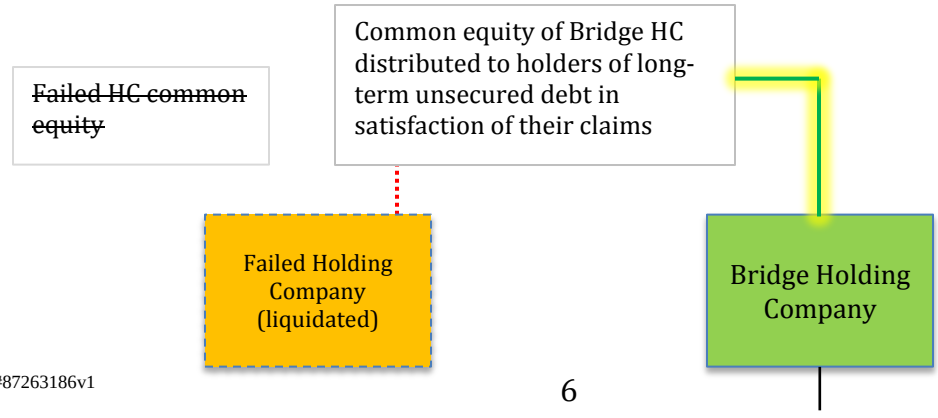
1) Before Resolution Weekend




2) Monday Morning Following Resolution Weekend




3) 6-9 Months Later



## Handout 6: New Capital Created by Bail-in

The capital of a G-SIB is determined by the following formula:

C = A – L,

Where:

C = Capital

A = Assets

L = Liabilities

The amount of new capital created by bail-in is determined by the following formula:

NC = A – LNB,

Where:

NC = New Capital Created by Bail-in

A = Assets

LNB = Liabilities not bailed-in = L – LB

L = Total liabilities before bail-in

LB = Liabilities bailed-in = TLAC + OL

TLAC = Liabilities included in TLAC

OL = Other Liabilities

Based on this formula, it is clear that the amount of new capital created by bail-in is maximized if LNB is minimized. LNB is minimized if LB is maximized. LB is maximized if OL is maximized – that is, if the TLAC proposal allows all liabilities that are not required to be senior to TLAC for contagion purposes to be included in TLAC or allowed to rank pari passu and be bailed-in pro rata with TLAC.

This can be illustrated by assuming that the variables above have the following values:

A = 100

LNB = 70

TLAC = 40

OL = 10

The values in the example above mean that the G-SIB was insolvent before bail-in, with negative capital of –20:

100 – 70 – 40 – 10 = –20

If OL ranks senior to TLAC and is not bailed-in, the amount of new capital created by bail-in will be the following:

100 – 70 – 10 = 20

In contrast, if OL is allowed to rank pari passu and be bailed in pro rata with TLAC, the amount of new capital created will be the following:

100 – 70 = 30.

This example shows that the amount of new capital created is maximized when OL is bailed-in pro rata with TLAC (30 compared to 20).

Moreover, the holders of TLAC would clearly prefer to share any losses with OL. If OL ranks senior to TLAC and is excluded from bail-in, the holders of TLAC will receive equity worth 20 in exchange for their claims of 40, resulting in a loss (or write down) of 20, or 50%. In contrast, if OL ranks pari passu and is bailed-in pro rata with TLAC, the holders of TLAC will receive equity worth 24 in exchange for their claims of 40, resulting in a loss (or write down) to them of only 16, or 40%. This is because the holders of OL will share pro rata in such losses, receiving equity worth 6 in exchange for their claims of 10, resulting in a loss (or write down) to them of 4, or 40%.

The public policy argument in favor of allowing OL to rank pari passu and be bailed in pro rata with TLAC is even more compelling if OL consists of liabilities that fluctuate in value, assuming OL does not need to be senior to reduce the risk of contagion and policymakers want bail-in to maximize the amount of new capital created by bail-in. This can be illustrated by assuming that OL fluctuates between 10 and 30 in the example above:

A = 100

LNB = 70

TLAC = 40

OL = Fluctuating amount from 10 to 30

If OL ranks senior to TLAC and is not bailed-in, the amount of new capital created will be the following:

100 – 70 – {from 10 to 30} = uncertain answer ranging from 20 to 0

In contrast, if OL is allowed to rank pari passu and be bailed-in pro rata with TLAC, the amount of new capital created will always be 100-70=30.

## Handout 7: NCWOL

The holder of a claim is entitled to NCWOL compensation only if the claim received less than other claims for the same amount ***within the same class*** of claims.

It is impossible for an NCWOL claim to arise if other liabilities, including liabilities with fluctuating value, are included in TLAC or allowed to rank pari passu and be bailed-in pro rata with TLAC. If the other liabilities (OL) are bailed-in pro rata with TLAC, the holders of OL will not have received less than other claims for the same amount within the same class because both OL and TLAC would have been part of the same class, both would have been bailed-in pro rata with each other, and both otherwise would have been treated exactly alike.

In contrast, if OL are required to rank senior to TLAC and pari passu with all other excluded liabilities, that classification can give rise to an NCWOL claim by the holders of OL. The reason is that if OL are bailed-in, but the other excluded liabilities within the same class are assumed or paid in full by the bailed-in G-SIB or bridge, then the OL will have been treated worse than other claims within the same class and be entitled to NCWOL compensation.

## Handout 8: Direct Bail-in vs. Bridge Bail-in Revisited

**Valuation, Accounting, Financial Disclosure and Exchange Mechanics Issues Are More Challenging in Direct Bail-in than Bridge Bail-in, *if* the Timeframe for Completing Direct Bail-in is Substantially More Compressed than for Bridge Bail-in**. Although direct bail-in has many advantages over bridge bail-in, the valuation, accounting, financial disclosure and exchange mechanics issues would be far more challenging to address in a direct bail-in compared to a bridge bail-in, ***if*** the timeframe for completing a direct bail-in (i.e., actual conversion of debt to equity) is substantially more compressed than for a bridge bail-in.

- **Completion of Bridge Bail-in**
  - **Separation Between Good Bank and Bad Bank**. The only thing that needs to be completed in a bridge bail-in by Monday morning following resolution weekend is the separation of the failed G-SIB into a good bank and bad bank by transferring all of the failed G-SIB's assets to a bridge bank (good bank) and causing the bridge bank to assume all of the short-term and other runnable liabilities of the failed G-SIB that must be senior to eligible TLAC in order to prevent contagion. Eligible TLAC and all other liabilities that do not need to be senior to eligible TLAC in order to avoid contagion are left behind in the receivership or bankruptcy proceeding of the failed G-SIB (bad bank).
    - **Preserving Critical Operations and Going Concern Value**. The debt-free bridge bank, or good bank, can continue to perform the group's critical operations and preserve its going concern value for the benefit of the bail-inable debt and other claims left behind in the bad bank.
  - **Determination of Bail-inable Claims and Other Exchange Mechanics**. The rest of the bail-in process can be completed over a 6-9 month period (or longer) without fostering contagion or otherwise adversely affecting financial stability, including:
    - the determination of the amount and identify of the holders of any bail-inable claims,
    - the determination of the residual value of the bridge,
    - the revaluation of the G-SIB's balance sheet,
    - the publication of new financial statements,
    - the liquidation of the bad bank, and
    - the distribution of the residual value of the enterprise to the holders of bail-inable claims and junior claims.

- **Debate over the Timeframe for Completing Direct Bail-in**
  - **Shorter Time Frame**
    - **Resolution Weekend**. Many people have argued that direct bail-in must be completed (i.e., actual conversion of debt to equity) by Monday morning following resolution weekend.
    - **A Few Weeks Later**. Others have argued that such a compressed time frame is unrealistic, but that direct bail-in must be completed within at least a few weeks after resolution weekend.
  - **Disadvantages.** If the timeframe for completing a direct bail-in is this compressed, then the valuation, accounting, financial disclosure and exchange mechanics issues will be much more challenging in a direct bail-in compared to a bridge bail-in. For example:
    - There will be a lot less time to determine the validity, amount and identity of the holders of any bail-inable claims, making it more difficult to maximize the amount of capital created by bail-in without creating NCWOL issues.
    - The failed G-SIB's assets will need to be revalued during a severely adverse economic scenario when ordinary valuation markets are dysfunctional and there is substantial uncertainty about asset values.
      - This uncertainty will increase resistance by junior stakeholders and other powerful political interests to an early trigger of direct bail-in, making it less likely that the bail-in will be successful.
      - It will also increase the risk of a successful legal challenge by junior stakeholders that the G-SIB was undervalued and their legitimate property rights were taken from them without due process.
  - **Longer Period**. Some people have argued that there is no reason why a direct bail-in needs to be completed any quicker than a bridge bail-in. Under this line of reasoning, the only thing that needs to be completed in a direct bail-in by Monday morning following resolution weekend is the following:
    - identify the short-term and other runnable liabilities that must be senior to eligible TLAC to avoid contagion, and
    - impose a stay on eligible TLAC ***and*** all other liabilities that do not need to be senior to eligible TLAC to avoid contagion.
  - The second category would include unsecured debt with an original maturity of one year or more, but that otherwise does not qualify as eligible TLAC, such as otherwise long-term unsecured debt that has a remaining maturity of less than one year.

- Once short-term and other runnable liabilities are separated from long-term unsecured liabilities, there is no financial stability reason why the administrative or judicial process for determining the validity, amount and identity of bail-in-able claims could not take just as much time in a direct bail-in as a bridge bail-in (i.e., 6-9 months or longer).
- In order to increase the liquidity of such claims, the relevant administrative or judicial authority could issue a tradable claim certificate in respect of each claim as soon as the validity and amount of such claim has been determined. Such certificates could then be traded on the market, allowing holders who need cash to sell their tradable certificates to market participants who want to invest in the tradable certificates.

**Handout 9: Example of Alternative Form of Value that Can Be Distributed to Bail-inable Debt to Avoid Valuing the G-SIB or Bridge in the Middle of a Financial Crisis When Asset Values are Highly Uncertain**

The table below contains various forms of value that could be exchanged for bail-inable debt and other pari passu and junior claims that would preserve the relative priority of the bail-inable debt and these other claims, without the need to make a final determination of the residual value of the bailed-in G-SIB or bridge during a severely adverse economic scenario when ordinary valuation markets are dysfunctional and there is substantial uncertainty about asset values.

| **Type of Claim (in Order of Priority)** | **Form of value** |
|---|---|
| Short-term debt, secured debt, tax liabilities, critical vendor liabilities, derivative liabilities, and other claims that need to be senior to a layer of bail-inable debt in order to reduce the risk of contagion | Liabilities assumed or paid by recapitalized G-SIB or bridge entity (consistent with assumption that the G-SIB has enough TLAC to recapitalize the top-tier parent and its operating subsidiaries, if the resolution or bankruptcy proceeding is triggered before balance-sheet insolvency) |
| TLAC and other bail-inable unsecured long-term debt, litigation claims and other pari passu claims | Senior PIK preferred stock with a liquidation value equal to the principal amount of the claim, plus paid-in-kind (PIK) dividends equal to, say, 10%, that are redeemable by the company within, say, three years, by paying the liquidation value plus accrued dividends. The senior PIK preferred stock would be coupled with warrants that expire upon the redemption of the senior PIK preferred stock, but are otherwise exercisable after three years into massive amounts of the outstanding preferred stock and common stock at an exercise price of zero or close to zero. The senior PIK preferred stock would need to have voting rights that allow them to share control of the company during the initial three-year period, other than voting rights with respect to a redemption decision. |
| Preferred stock | Stay in place, subject to possible redemption of the senior PIK preferred stock or exercise of the warrants. |
| Common stock | Stay in place, subject to possible redemption of the senior PIK preferred stock or exercise of the warrants. |