Bail-in, CDS protection and set-off

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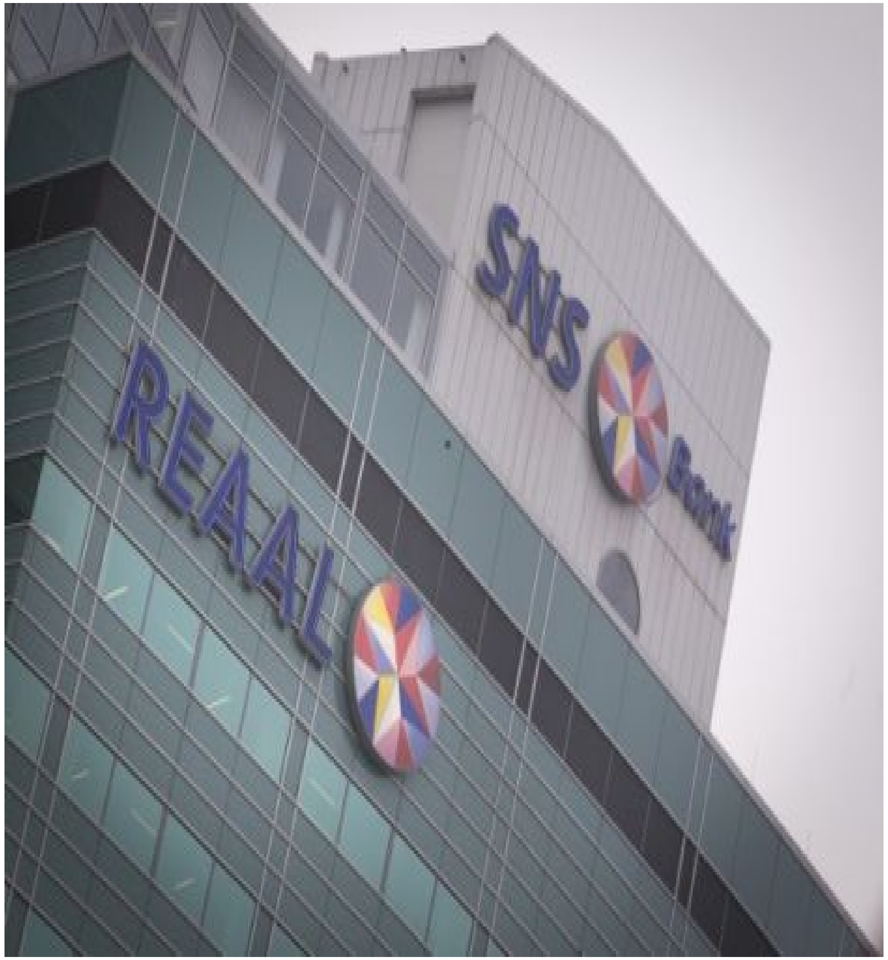
Introduction



- In crises situations the theory of existing concepts are tested (e.g. CDS)
- Crises prompts new concepts and legislation (e.g. bail-in)
- Consistency of different concepts is another challenge
- The case of SNS Bank demonstrates the above points
- This part II deals with
  1. Bail in and CDS; and
  2. Bail-in and set-off

1. Bail-in compatibility with CDS effectiveness

Requirements for the bail-in approach for the effectiveness of CDS contracts:

1. The bail in approach should constitute a credit event;
2. Enough deliverable obligations should be left to settle the CDS contracts;
3. The resulting market price should be in line with the losses suffered when bonds are bailed in.

Is expropriation a credit event?

Credit events under European bank CDS contracts:

- Bankruptcy
- Failure to pay
- Restructuring

- Expropriation is not explicitly covered

Decision of the EMEA Credit Derivatives Determinations Committee:

- A restructuring credit event occurred under S.4.7(a)(ii) of ISDA 2003 Credit Derivatives Definition

Availability of deliverables?

- Need for determining the relevant recovery rate
- Need for auctions
- Need for deliverable obligations
- But: with expropriation there will be no sub. bonds outstanding

- Similar problem when conversion to equity – not deliverable (also write-down)
- Senior bonds not bailed-in; traded close to par; hardly any recovery value
- Luck in Greek PSI: new GGBs traded down (so available recovery for old GGBs)

Possible solutions

In bail-in legislation:

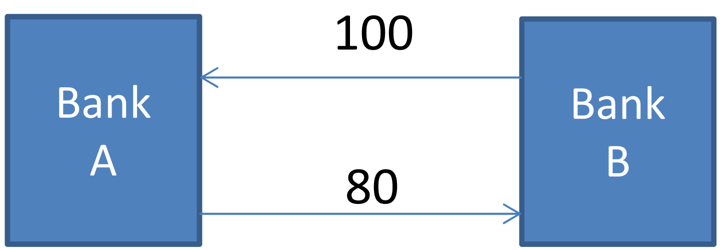
- Deliberate delayed settlement on some of the subordinated bond write-downs (so bonds available for auctions)
- Conversion to equity or expropriation in staggered fashion (first trigger CDS, conversion only later)

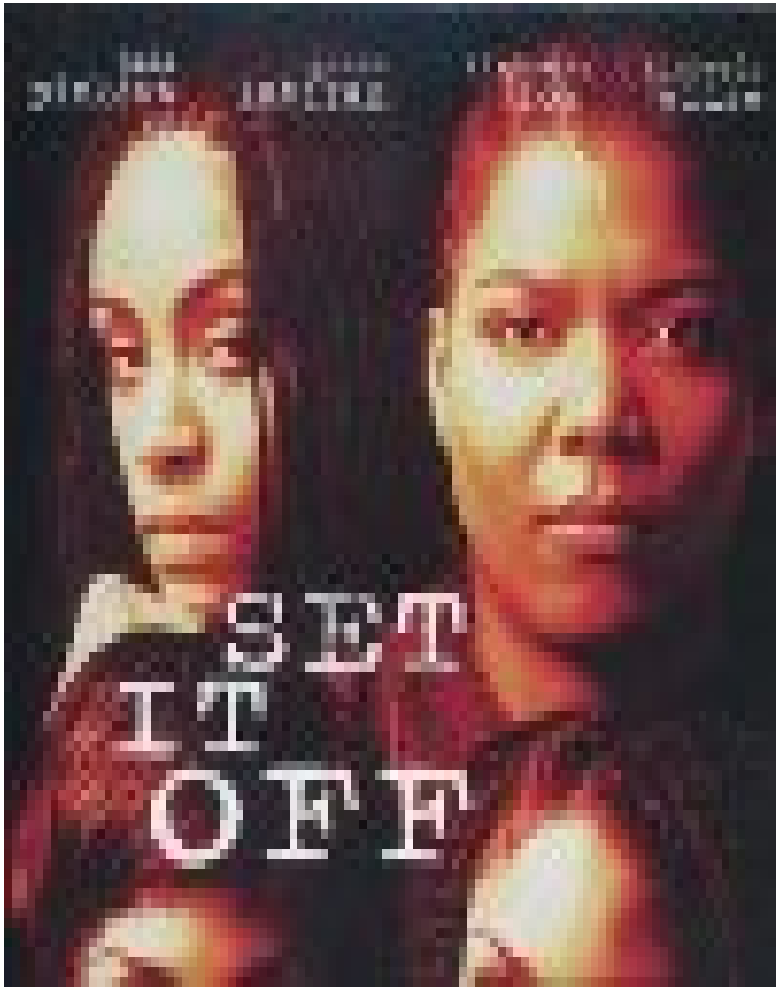
Amending CDS contracts:

- In new CDS contracts bail-in (in different forms) as explicit credit event
- Allowing for the deliverability of whatever investors are left with (claims on government, equity)
- This cannot be applied retroactively

2. Bail-in and set-off

- Two banks owe each other
- A's set-off (netting) rights are protected in B's jurisdiction
- A's exposure is 20

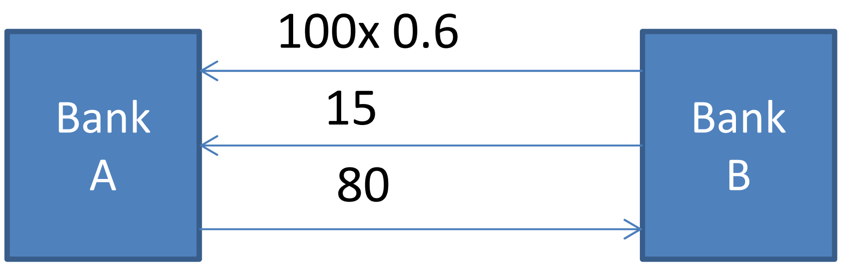




Two scenarios compared

Bail-in scenario:

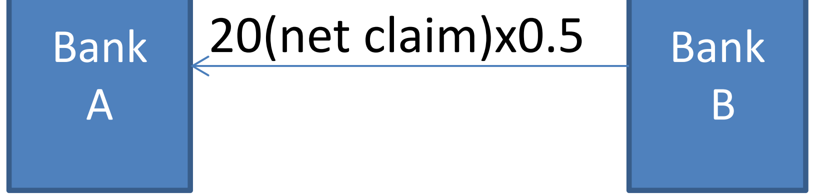
- 40 % of claims bailed-in
- Receipt of shares worth 15%
- But: set-off not recognised



Bank A’s net loss: 25

Liquidation scenario:

- 50% recovery rate
- But: set-off recognised



Bank A’s net loss: 10

Findings: set-off and bail-in

- Set-off is not protected in case of bail-in
- Bank A is worse of in case of bail-in than in case of liquidiation
- Art. 65 of draft BRD: no creditor worse-off rule
- Bail-in of set-off amount only?- no advance knowledge of amounts
- Compensation payments from resolution funds?