

## Greek bank bonds: brace yourself for bail-in

**Greek bank bonds suffered heavy losses this week after Eurozone finance ministers agreed that senior bondholders would be bailed-in when Greece's banks are restructured later this year.**

### Sovereign bail-out; bank bail-in

Eurozone finance ministers approved an €86bn bail-out for Greece last week, on 14 August (although doubts remain regarding the IMF's involvement in the deal). A planned bail-in of Greece's banking sector was also announced<sup>1</sup>. The main focus of the strategy is on restoring financial stability and improving bank viability, by strengthening bank capital (amongst other things).

This was almost a footnote in press coverage of the bail-out, but is doubtless of even greater interest to our clients.

Greek banks are largely funded through deposits, but the bail-in of depositors has explicitly been excluded – so no Cypriot-style haircuts for Greek depositors.

### BRRD: purpose, powers and principles

Greece's parliament approved draft legislation (the **Draft Law**) to implement the [European Bank Recovery and Resolution Directive](#) (the **BRRD**) into Greek law on 23 July. This transposition is one of the reforms required to secure the new bail-out deal.

The BRRD is designed to equip nationalised authorities with harmonised tools and powers to tackle crises at banks (and systemically important investment firms). It represents a deliberate policy decision by the EU authorities to shift the burden of a failing institution from taxpayers to the existing stakeholders of the institution.

The BRRD gives authorities resolution powers and tools intended to ensure the continuity of essential services and to manage the failure of a firm in an orderly way. These tools are the sale of business tool, the bridge institution tool, the asset separation tool, and the bail-in tool. The tools may be applied individually or in combination.

In accordance with the "no creditor worse off" principle, shareholders or creditors that have incurred greater losses in a resolution than they would have incurred in a winding-up under normal insolvency proceedings are entitled to the payment of the difference from the resolution financing arrangement.

### New stress tests

The Greek banks will undergo accelerated asset quality reviews and stress tests in the autumn. Recapitalisation will occur on the basis of the capital shortfalls revealed; the goal is to complete the recapitalisation by the end of this year. (Greek banks underwent stress tests and asset quality reviews last year as part of the broader Europe-wide exercise, but the state of the four main Greek banks – National Bank, Piraeus, Eurobank and Alpha – has since worsened dramatically.)

### How do you solve a problem like Piraeus (& co.)?

The Bank of Greece has a number of resolution tools to choose from (as the national resolution authority for Greek credit institutions), described above. One expects that equity and subordinated instruments will absorb losses first in the usual way.

On a bail-in, resolution authorities should apply the bail-in tool in a way that respects the *pari passu* treatment of creditors and the statutory ranking of claims under the applicable insolvency law. First, losses should first be absorbed by shareholders (through the cancellation or transfer of shares, or through severe dilution). Where those instruments are not sufficient, then subordinated debt should be converted or written down. Senior liabilities should only be converted or written down if the subordinate classes have been converted or written down entirely<sup>2</sup>.

The bail-in powers do not apply to secured liabilities, including covered bonds, nor to deposits which are covered by a deposit guarantee scheme. Client money in respect of which the bank is acting as a fiduciary is also excluded from bail-in. Finally, financial market contracts that rely on netting and set-off, collateral and certain other arrangements will be protected in the resolution process (although note the provisions in the BRRD allowing for short-term moratoriums to be imposed in relation to closing out derivative contracts and excluding terminations by reason of certain stabilisation measures)<sup>3</sup>. Generally, the claims of those creditors which are "bailed in" will be converted into common equity.

It is worth noting that the provisions on the bail-in tool, along with the powers of write down and conversion

associated with the bail-in tool, will apply in Greece only from 1 January 2016<sup>4</sup>. That doesn't preclude the use of other resolution tools within this year – such as the transfer of senior bonds to a “bad bank”.

The Bank of Greece must obtain the prior consent of the Greek Ministry of Finance before adopting any decision to use its resolution tools, under the current Draft Law – regardless of whether the decision has a direct fiscal impact or systemic implication. This represents an important step beyond the BRRD; the ECB has raised concerns in this regard, inviting Greece to revise the relevant provision<sup>5</sup>.

## Setting a benchmark

The resolutions of the Greek banks will set a key precedent for future use of the BRRD resolution tools. It may also inspire non-EU countries to adopt similar legislative tools, for example, Ukraine has undertaken and will need to continue to undertake significant steps to recapitalise its banking sector.

The market is also closely watching Heta Asset Resolution, which has been described as Europe's biggest distressed debt opportunity (where the Austrian government ordered a 15 month moratorium on principal and interest payments for c.€10bn bonds, in March – the subject of extensive, ongoing litigation).

## Remaining uncertainties

The biggest uncertainty is the exact terms of the bank resolutions, including:

- the extent of any bail-in,
- how equity and unsecured claims would be written down or converted;
- the relative ranking of written down/converted debt and non-written down/converted debt (including whether such write down/conversion is permanent, has an equity upside or can be restored to a debt claim in the future); and
- how any resolution will affect contracts or other arrangements governed by the law of a non-EU country.

## Crumbs of comfort

Creditors can however draw some comfort from the “no creditor worse off” safeguard mentioned above, which requires that no shareholder or creditor be left worse off after the use of stabilisation tools than they would have been had the whole firm been placed into an insolvency proceeding. The degree of protection afforded by this safeguard will depend on a proper valuation being carried out. (In addition, the baseline comparator for the investor's position in an insolvency will now see unsecured senior creditors being subordinated to deposit creditors, following the new insolvency creditor hierarchy in the BRRD.)

Any resolution action must also be “necessary in the public interest” – i.e. necessary for the achievement of, and proportionate to, one or more of the resolution objectives<sup>6</sup>.

Finally, financial market contracts that rely on netting and set-off, collateral and certain other arrangements will be protected in the resolution process. Accordingly, counterparties to financial market contracts can continue to exercise their close-out rights – the regime will not undermine the original purpose of arrangements designed to mitigate credit risk.

As ever, early engagement with these issues will be critical to protecting stakeholders' positions.

## Related posts

For further information on the BRRD and related issues, see our previous articles:

- [The EU Bank Recovery and Resolution Directive: moving towards full implementation](#) (25 March 2015)
- [Bank of England's New Strategy for Resolving Failing Financial Institutions](#) (10 November 2014)
- [The EU Recovery and Resolution Directive: preventing another financial crisis](#) (30 November 2013)
- [Can ISDA's Close-out Protocol Stay the Next Lehman Brothers?](#) (21 May 2015)

Weil is representing a group of bondholders, led by Ukraine's biggest creditor Franklin Templeton Investments, regarding Ukrainian debt restructuring negotiations with the Ukrainian government. The bondholder group also includes T. Rowe Price, TCW Group and BTG Pactual Europe.

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<sup>1</sup> See the full [announcement](#) of the new deal from Jeroen Dijsselbloem, Eurogroup President and Dutch Finance Minister, and the draft [memorandum of understanding](#) for Greece's three-year European Stability Mechanism programme.

<sup>2</sup> Recital 77 of the BRRD. Only in exceptional circumstances may the resolution authorities exclude certain liabilities from the application of the write-down or conversion powers: see Article 44 of the BRRD.

<sup>3</sup> Article 44 of the BRRD. See also our related post, [Can ISDA's Close-out Protocol Stay the Next Lehman Brothers?](#).

<sup>4</sup> Article 132(1) of the Draft Law.

<sup>5</sup> See the [ECB's opinion dated 20 July 2015](#).

<sup>6</sup> Article 32 of the BRRD.

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