Client Alert

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# Valuing Derivatives in a Bank Bail-In

Under the EU's Bank Recovery and Resolution Directive ("BRRD")[1], one of the key powers given to national resolution authorities is the ability to impose losses on, or "bail-in", certain financial liabilities of the failing bank in a resolution action, either by writing down the principal amount of the liability or converting it into equity. One of the main aims of a bail-in is to ensure that creditors and/or shareholders can be made to bear an appropriate proportion of the failing institution's losses, in order to minimise the need for the application of public funds (a "bail-out").

The BRRD provides that all liabilities of the bank in resolution can be bailed-in, unless they are contained on an express list of excluded liabilities, or are excluded from bail-in pursuant to the discretion of the relevant resolution authority, which can be exercised in exceptional circumstances. As a result, derivatives liabilities are eligible for bail-in, except to the extent that they meet the criteria for one of the express exclusions. In order to facilitate such a bail-in of a derivative liability, however, such transactions firstly need to be terminated and closed-out and valued for the purpose of Article 36 of the BRRD. This process raises significant issues for market participants, who will no doubt be keen to ensure that, in the event that their derivatives transactions are mandatorily terminated earlier than intended, their net exposure is valued in a way that is consistent with expectations resulting from their contractually negotiated trading documentation.

The European Banking Authority ("EBA") recently published draft regulatory technical standards (the "RTS")[2] applicable to the valuation of derivatives following the application of the bail-in power to such contracts. The EBA's authority to release the publication stems from Article 49(5) of the BRRD, which requires it to set out (i) appropriate methodologies for valuing derivative transactions, (ii) principles for establishing the relevant point in time at which valuations should be established, and (iii) methodologies for comparing the destruction in value that might arise from close-out and bail-in, with the amount of losses that would be borne by derivatives in a bail-in. We consider the EBA's approach to each of these issues below.

## Scope

There are general exclusions from the scope of bail-in under Article 44(2) of the BRRD, including (but not limited to) covered deposits, certain liabilities with a maturity of less than seven days and liabilities to employees, trade creditors or taxing authorities. Some of these exclusions will be relevant to derivatives as well as other financial instruments. In particular, it should be noted that secured liabilities are excluded to the extent that the value of the liability does not exceed the value of the collateral, as are liabilities of less than seven days' remaining maturity to payment and settlement systems. Accordingly, since over-the-counter derivatives of EU banks are increasingly

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[1] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32014L0059
[2] http://www.eba.europa.eu/documents/10180/1073039/EBA-CP-201-10+CP+on+RTS+on+derivatives+valuation.pdf.

 

likely to be subject to either (a) mandatory clearing (resulting in the mandatory application of stringent margin requirements) or (b) collateralisation requirements in respect of uncleared trades (in each case, under the European Market Infrastructure Regulation ("EMIR"[3])), the universe of derivatives that are likely to be subject to bail-in is likely to become increasingly limited in the future.

**Close-Out and Netting**

As a first step in the bail-in process, the BRRD itself lays down the parameters for valuing derivatives liabilities. In particular, Article 49(2) of the BRRD provides that write-down and conversion powers apply only upon or after relevant derivatives have been closed-out. Accordingly, resolution authorities have the power to terminate and close-out any derivative contract (that is not excluded from application of the bail-in tool) for that purpose. In addition, Article 49(3) requires that, where derivative transactions are subject to a netting agreement, the liability arising from such transactions must be determined on a net basis, in accordance with the terms of the underlying netting agreement.

**Valuation Methodology**

*Uncleared Transactions*

Once the derivative liabilities in the relevant "netting set" have been closed-out, the principal guiding methodology of the RTS, in valuing the closed-out liability, is that of the "replacement cost" of the relevant derivatives. A derivative's value is intended to be determined by reference to the costs incurred by a non-defaulting party in replacing the terminated contract (having taken any posted or received collateral into account).

This methodology may therefore result in a different valuation from one derived from the methodology elected by the two counterparties in their contractual agreement, the latter being disregarded for the purpose of the Article 36 valuation.

Article 2 of the draft RTS sets out the following steps for closing-out and valuing trades that are not centrally cleared:

1. The resolution authority must notify the relevant counterparty that its derivative contract(s) is/are to be terminated, specifying the proposed date for close-out.

2. The resolution authority will also notify the relevant counterparty of a date by which the counterparty must provide (a) evidence of commercially reasonable replacement trades and (b) a summary of any replacement trades. For more illiquid trades where replacement quotes might be less forthcoming, a counterparty may find it difficult to present the required valuation evidence. There is also no guidance with respect to precisely what constitutes appropriate evidence in this regard.

So long as evidence of actual commercially reasonable replacement trades is provided within the requisite time period, the applicable valuer (an independent valuation agent appointed in accordance with Article 36 of the BRRD or, where this is not possible, the resolution authority) will determine the early termination amount at the prices of those replacement trades.

However, in circumstances where the valuer concludes that the replacement trades were not concluded on commercially reasonable terms, or where the counterparty fails to provide sufficient or acceptable evidence by the deadline provided, the valuer will determine the close-out amount based on (1) mid-market end-of-day prices on the specified close-out date or (if that is not commercially reasonable) the time at which a price is available in the

[3] Regulation (EU) No. 648/2012.

market for the underlying asset, (2) the mid-to-bid or mid-to-offer spread (depending on the direction of the netted risk position) in order to estimate loss or cost incurred as a result of close-out in liquidating, obtaining or re-establishing a hedge or related trading position, and (3) adjustments to (2) above in order to reflect the size of the exposure and credit-worthiness of the counterparty.

For this purpose, the valuer may take into account valuations generated on its own systems, data extracted from the institution under resolution (such as internal models and valuations) and third-party market and price information, as well as any other relevant data.

In order to provide certainty for the resolution authority in relation to the valuation, the BRRD provides for no automatic right of challenge or appeal for a creditor. However, it is a fundamental principle of the BRRD, contained in Article 73, that no creditor should be worse off in the bail-in action than it would have been in a conventional insolvency action. In order to give effect to that principle, Article 74 provides for a second independent valuation to be performed as soon as possible after the bail-in action has been effected. The purpose of this valuation is to assess whether shareholders or creditors would have fared better in an insolvency proceeding and, if so, by how much, so that the resolution authority can assess how much compensation would be payable to the relevant shareholder or creditor in order to reflect the "no creditor worse off" principle.

*Cleared Transactions*

For derivatives trades that are centrally cleared, the resolution authority will notify the central clearing counterparty ("CCP") that it wishes to terminate the applicable transactions, and close-out shall take place either immediately or at a later close-out date specified in the notification. In these circumstances, the valuer must establish the value of liabilities which arise from derivatives contained in groups of transactions covered by the same netting agreement ("netting sets") entered into between the institution under resolution (in its capacity as a clearing member) and the CCP. The RTS suggest that, in this case, the CCP will assume responsibility for determining the early termination amount in accordance with its standard default procedures. CCPs are required (under EMIR) to have default procedures in place which will typically include, as a first step, compulsory efforts to transfer or "port" the cleared trades to another clearing member and, failing that, an attempt by the CCP to auction off the defaulted trades to non-defaulting clearing members. The auction price will represent a cost or gain for the CCP and should therefore adequately reflect such transaction's replacement cost. Following this procedure, the CCP will then have to report the early termination amount applicable to each affected netting set and provide the resolution authority with the default management steps undertaken to liquidate or re-hedge the positions of the defaulted clearing member.

In most cases, the defaulting clearing member is highly unlikely to generate losses in excess of posted collateral. As such, the bailing-in of cleared derivatives is itself generally unlikely to occur in normal market conditions because of the express bail-in exclusion for secured liabilities.

**Point in Time for Establishing Derivatives Liabilities**

The value of derivative liabilities shall be determined by the applicable valuer at the following points in time:

1. where the valuer determines an early termination amount at the prices of replacement trades provided by the counterparty, the day and time of the replacement trades;

2. where the valuer determines an early termination amount in accordance with CCP default procedures, the day and time when the early termination amount is determined by the CCP; or

3. in all other cases, the close-out date or, if that is not commercially reasonable, the date and time when a price for the underlying asset is available in the market.

## Destruction in Value

As an additional step in the valuation process, the BRRD requires that resolution authorities should also make efforts to avoid any unnecessary destruction in value in relation to the relevant derivatives transaction.

Therefore, Article 44(3)(d) of BRRD provides that one ground on which a resolution authority is permitted to exclude a liability from bail-in is where the bail-in of that liability would cause a destruction in value resulting in the losses borne by other creditors being higher than if that liability were not bailed-in. For this purpose, Article 49(5) of BRRD directs the EBA to develop RTS, specifying appropriate methodologies for comparing the destruction in value that would arise from the close-out and bail-in of derivatives liabilities with the amount of losses that would be borne by the bailed-in derivatives liabilities. Article 8 of the RTS therefore provides an additional safeguard, by requiring that resolution authorities must (prior to making a decision that results in close-out of the applicable transaction(s)) make a comparison between (a) the amount of losses that would be borne by derivatives contracts in a bail-in scenario and (b) the destruction in value based on an assessment of the costs, expenses or other impairment of value that is expected to be incurred as a result of the close-out of the derivatives contracts. Elements to be considered as part of the possible destruction in value include (i) the risk of an increased counterparty close-out claim arising from re-hedging costs, (ii) the cost expected to be incurred by the bank in resolution in re-establishing hedges or maintaining an acceptable risk profile, (iii) any reduction to franchise value arising from close-out and any impact to funding costs or income levels, and (iv) any precautionary buffer against possible adverse implications from close-out, such as errors and disputes in respect of transactions or collateral exchange.

## Implementation

ESMA has invited market participants to provide comments on the draft RTS by 13 August 2015. The draft RTS are required to be submitted to the European Commission by 3 January 2016.


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