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Technical advice on the delegated acts on the circumstances when exclusions from the bail-in tool are necessary

Delegated acts on the circumstances when exclusions from the bail-in tool are necessary

Background and principles

1. The mandate for the delegated acts is set out in Article 44(11) of the Bank Recovery and Resolution Directive (BRRD)¹:

The Commission shall be empowered to adopt Delegated Acts in accordance with Article 115 in order to specify further the circumstances when exclusion is necessary to achieve the objectives specified in paragraph 3 of this Article.

2. Article 44 of the BRRD sets out the scope of the bail-in tool, including types of liabilities to which the tool may be applied. Article 44(1) specifies that authorities must be empowered to apply the tool to all liabilities (claims and debt instruments) other than those which are explicitly excluded under Article 44(2).
3. Article 44(3) gives resolution authorities the discretion to exclude other liabilities from bail-in, subject to constraints on the reasons and the circumstances in which they may do so:

In exceptional circumstances, where the bail-in tool is applied, the resolution authority may exclude or partially exclude certain liabilities from the application of the write-down or conversion powers where:

(a) it is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority;

¹ All references to legal provisions in this advice refer to Articles of the BRRD.

(b) the exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions;

(c) the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union; or

(d) the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.

4. Article 44(9) requires resolution authorities, when exercising the discretions under Article 44(3), to

...give due consideration to:

(a) the principle that losses should be borne first by shareholders and next, in general, by creditors of the institution under resolution in order of preference;

(b) the level of loss absorbing capacity that would remain in the institution under resolution if the liability or class of liabilities were excluded; and

(c) the need to maintain adequate resources for resolution financing.

5. In combination these requirements provide the overall framework which the European Banking Authority (EBA) has considered when preparing this advice on the circumstances in which exclusions from the application of the bail-in tool are necessary. This advice encompasses a number of general criteria and principles which the EBA recommends be reflected in the delegated acts. These are complemented by a number of general factors and specific considerations on each of the cases under Article 44(3).

General criteria and principles

- the decision to use the bail-in tool (or other resolution tools) will be taken to pursue the resolution objectives in Article 31(2) – the resolution objectives should also inform decisions regarding how to use the tool, including any liabilities to be excluded from the application;
- in principle all liabilities not explicitly excluded under Article 44(2) are within the scope of the bail-in tool – the delegated act should not suggest that some liability types should *always* be excluded from bail-in, as this would be contrary to the Level 1 text;

- the characteristics of an institution (e.g. size, interconnectedness or complexity) should be taken into account where relevant in the cases under Article 44(3) but do not automatically justify exemptions of such an institution's liabilities from bail-in. Exclusions should be considered on a case-by-case basis by analysing relevant considerations under each of the potential reasons for exclusion under Article 44(3), rather than by considering the specific nature of the institutions concerned in isolation. This approach will ensure consistent consideration of exceptional circumstances and avoid unnecessary competitive distortions;
- the delegated acts should not affect resolution authorities' responsibilities to ensure that institutions and groups are resolvable and have sufficient minimum requirements for own funds and eligible liabilities (MREL) to absorb losses in resolution and ensure recapitalisation in accordance with the resolution plan. The draft EBA regulatory technical standards (RTS) on MREL requires authorities to take into account likely exclusions when ensuring sufficient MREL. The potential to exclude liabilities from bail-in should not be considered a substitute for other actions to ensure resolvability. Application of exclusions could substantially reduce the level of loss absorbing capacity available in resolution. As a consequence, a need for exclusions, if not fully addressed when setting MREL in accordance with Article 45(6)(c), may be a substantive impediment to resolvability which should be addressed under Article 17;
- where the resolution authorities have, when setting the MREL for an institution, assumed that certain liabilities would credibly and feasibly contribute to loss absorption, this should be reflected in the conditions justifying an exclusion of these liabilities from bail-in. In this case resolution authorities should explain factors justifying the exclusion which had not been foreseen in the resolution planning phase when setting the MREL. The need to explain these factors should be applied proportionately and appropriately with respect to the need for timely resolution action;
- Article 44(3) allows ad hoc exclusions for specific reasons and in exceptional circumstances. These exclusions represent exceptions from the general principle of equitable treatment of creditors of the same class beyond that required by Article 44(2). This, and the fact that exclusions are only to be made in exceptional circumstances implies that the provisions of Article 44(3) should be interpreted restrictively; where creditors within the same class are treated differently in the context of resolution action, such distinctions must be justified in the public interest (see Recital 47 of the BRRD). The advice aims at describing more specifically the exceptional circumstances specified in Article 44(3);
- the ability to exclude liabilities from bail-in does not affect the safeguards protecting other creditors (namely the 'no creditor worse off' (NCWO) safeguard of Article 75 and ECHR requirements). Resolution authorities should be mindful of the need to

respect these safeguards and the risk that creditors have to be compensated due to a breach of these safeguards when making exclusions under Article 44(3). These considerations should be reflected in the delegated act;

- Article 44 establishes further constraints on making exclusions, in particular Article 44(5) requires that losses which are not fully absorbed by creditors due to exclusions may only be covered by the resolution financing arrangement when creditors have contributed an amount equivalent to 8% of the institution's total liabilities. This limits the overall capacity of the resolution authority to make exclusions, and these limits should be reflected in the delegated acts.
6. In line with these principles, the use of the exclusions referred to in Article 44(3) should be limited to the minimum necessary to achieve the objective which justifies the exclusion. Resolution authorities for example should make use of the option to partially exclude a liability (Article 44(3) and (10)), where this is sufficient to achieve the objective, and limit the extent of the write-down rather than completely exclude the liability.
 7. When preparing the advice, the EBA has analysed the circumstances potentially relevant to each of the cases referred to in Article 44(3) alongside particular liabilities, to ensure its deliberations were grounded in specific examples and to consider exceptional circumstances in sufficient detail. For the delegated acts there are also the two options of specifying the circumstances **either with or without reference to specific liabilities**. Dealing with specific liabilities would achieve the highest degree of convergence in the practices applied by the resolution authorities. However, in light of the analysis by the EBA and the Commission's mandate, the option that the delegated acts do not refer to specific liabilities seems preferable. Mentioning specific liabilities could create a list of *de facto* exclusions in addition to the list in Article 44(2) and/or misleading expectations in the market, thereby resulting in wrong incentives and a moral hazard risk. It could also limit the flexibility of the resolution authorities to deal with unexpected situations requiring the exclusion of some liabilities not explicitly mentioned in the delegated acts.

General factors affecting the possible need for exclusions

8. Article 44(1) requires the Commission to 'further specify the circumstances' where exclusion is necessary under Article 44(3), which itself states that exclusions can only be made under 'exceptional circumstances'. Article 44(3) (a) to (d) establishes a closed list of such circumstances. In preparing this advice the EBA has considered therefore the details of the exceptional circumstances which potentially could fall under Article 44(3) (a) to (d) and which the EBA considers might make exclusion necessary. The remainder of this advice is divided into sections dealing separately with each of the cases referred to in Article 44(3), under which the kinds of circumstances and the broad types of liabilities that might be relevant for each case are considered. It may however be useful to consider some overarching issues that might apply to each of the cases under Article 44(3) (a) to (d). In all cases the circumstances would need to meet the test of 'exceptionality', i.e. they would need to be unusual. In addition,

resolution authorities would be expected to make efforts to remove or reduce the number and likelihood of circumstances resulting in a potential exclusion which could be foreseen in the resolution planning process.

9. Some general factors may affect the likelihood that exceptional circumstances, as defined in Article 44(3), will arise. These general factors are:

- **Market conditions.** For example, if the rest of the banking/financial system is under significant stress the potential for contagion following the bail-in might be higher. The substitutability of services provided by the institution may also be reduced if other providers are less able to take on new business;
- **The level of losses incurred by the institution and to be absorbed by the bail-in.** Exceptionally severe losses (beyond what has to be considered in resolution planning) might increase the need to exclude particular creditors from the application of the bail-in tool, if it is thought that they would not be able to bear the required level of losses without giving rise to e.g. contagion or damaging the continuity of a critical function. However, it should be noted that if the high level of losses implies relatively low value preservation in resolution compared with insolvency there could be a heightened risk of breaching NCWO in relation to those creditors to whose liabilities the bail-in tool is applied;
- **The circumstances of failure.** The time after which the imminent failure of an institution without orderly resolution would cause a threat to financial stability and the environment of the failure may vary. If there is only limited time to prevent a negative impact on financial stability, and/or there has been limited time available for deciding on the detailed implementation of the resolution strategy by the resolution authority it is more likely that there will be instances where it is impossible to apply the bail-in tool to all eligible liabilities in a reasonable time.

(a) Not possible to bail-in a liability within a reasonable time

“it is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority”

10. The BRRD does not define ‘reasonable time’. Intuitively we expect this to be connected to the speed and certainty required in the bail-in process, for example if the resolution authority has determined that the bail-in must be finalised by a certain date to effectively stabilise the firm, but it is not possible to perform all the tasks needed to bail-in certain liabilities by that date, then they can be considered to be impossible to bail in ‘within a reasonable time’.

11. The dependence on the specific circumstances of the failure and the market condition may limit the extent to which the advice can elaborate on ‘reasonable time’, but suggests that the

circumstances which make a rapid application and conclusion of a bail-in particularly important should guide the determination of what is a reasonable time – the resolution authorities should assess when the write-down amount has to be ultimately determined and when the effects of the bail-in have to be achieved to meet the resolution objectives, taking into account the market situation at the time of the resolution and in particular:

- (a) the need to publish a final bail-in decision and to determine the bail-in amount and its final allocation to the various classes of creditors;
- (b) the consequences of delaying the bail-in decision for market confidence, potential market reactions such as liquidity outflows and the effectiveness of resolution action, taking into account (i) whether the distress and risk of failure of the institution is known to market participants and (ii) the visibility of the consequences of the distress or potential failure of the institutions;
- (c) the opening times of markets important for critical functions or relevant for contagion effects;
- (d) the reference dates when, following the recapitalisation through a conversion of liabilities, capital requirements have to be complied with; and
- (e) when payments of the institutions are due, and the maturity of the liabilities concerned.

Legal impossibility

12. In terms of the potential obstacles which can make bail-in impossible within a reasonable time, these can be of a legal or practical nature (although it may not always be possible to draw a clear line between the two).
13. With regard to the legal framework for bail-in, following transposition of the BRRD all liabilities governed by the law of a Member State should be within the scope of bail-in, unless they fall under one of the explicit exclusions in Article 44(2). In particular the BRRD does not permit grandfathering and fully addresses concerns relating to the protection of property rights. Therefore there is no case for excluding EEA law-governed liabilities for reasons of legal impossibility. The same appears to be true:
 - for constraints preventing creditors from holding equity instruments or equity in credit institutions. This should not exclude a conversion of debt of these holders into equity, as there are options to solve this problem, such as an immediate disposal of this equity, changing the legal framework for these creditors, changing the legal form of incorporation of the credit institution, certificates of entitlement substituting equity or arrangements to hold these liabilities in trust on behalf of these creditors;

- for liabilities to public authorities in general – Article 44(2)(g)(iii) supports the conclusion that these liabilities are only to be excluded from bail-in if they are preferred in insolvency; and
- for the uncertainty following from a judicial review required in the Member State’s legal system. The advice assumes that, although courts may review the resolution authority’s decision to exclude a liability, the fact that this legal review may occur should not result in further potential exclusions.

Therefore the delegated act should ensure that liabilities are not excluded solely on grounds of legal impossibility described above.

14. The BRRD expects liabilities issued under the law of a non-EEA jurisdiction to be capable to be bailed-in in the same way as liabilities governed by the law of a Member State and requires this to be implemented contractually (Article 55) where a third-country law or international agreement does not ensure the recognition of the application of resolution powers by a Member State resolution authority. Nevertheless, there is a residual risk that the application of the bail-in tool may not be recognised by third-country authorities. For instance, under international law the Member State’s statutory bail-in instrument may derogate from the chosen foreign law, in these cases the effective implementation of the bail-in may depend on the recognition by this third country and its courts, as otherwise there is the risk that the courts of the third country will not recognise the write-down or conversion and enforce the liability. This may have important implications in terms of the effectiveness of the application of the bail-in tool (e.g. other EEA-law liabilities may need to be bailed-in to a greater extent to make up the shortfall in recapitalisation).
15. As the overall effect on the level of loss absorption/recapitalisation would be the same whether such liabilities were excluded or if the bail-in were not effective in relation to those liabilities (i.e. in both cases those liabilities would not effectively be written down or converted), there is no reason why the risk of non-recognition per se could possibly justify exclusion. Using potential problems with bailing in non-EEA law governed liabilities as a justification for exclusion could create incentives to issue liabilities under third country law which, in the absence of a contractual recognition clause or statutory regime to secure recognition, might be perceived as being less capable of being bailed-in within a reasonable timeframe; this should be avoided.
16. The reference to the ‘reasonable timeframe’ and ‘good faith efforts’ within which it should be possible to bail-in the liabilities seems to suggest that the resolution authority should endeavour to achieve recognition of the bail-in in other relevant jurisdictions. The delegated act should ensure that liabilities are not excluded solely due to problems of recognition under third country law. The risk may be considered, though, on the basis of their impact on the other reasons for exclusion, such as maintaining the continuity of critical functions.

Practical impossibility

17. A practical obstacle may be, for example, that the amount of the liability is not determined at the point in time when the resolution authority applies the bail-in tool, i.e. the liability is already in existence, but it is not quantifiable. This may be the case for various kinds of liabilities which are contingent on uncertain events in the future (as far as they are in the scope of the bail-in). Obligations which are usually not accounted for as liabilities or have not yet crystallised as liabilities (such as off-balance sheet items, undrawn commitments) may be out of scope, depending on whether they qualify as liabilities under the BBRD.
18. One important case where determining the liability to be bailed-in is difficult is derivatives; however Article 49 clearly stipulates how derivatives may be bailed-in (following a close-out – although it may be difficult to determine the netted amount following the close out within a short time). The example of derivatives shows that there may still be ways to overcome obstacles relating to non-quantifiable liabilities, e.g. cancelling the liability and determining the value by estimation, using a relevant valuation methodology, or applying a ‘virtual’ percentage hair-cut ratio.
19. The decision as to whether to exclude unquantified liabilities should take into account the risk of setting incentives to structure liabilities in a way that makes quantification and valuation, and consequently the application of the bail-in power, more difficult (e.g. through embedded derivative components).
20. Another example may be secured liabilities exceeding the value of the relevant collateral. An exclusion on the basis of practical impossibility might be relevant where the resolution authority is not able to determine the value of the collateral in time, i.e. it may be practically impossible to apply the bail-in. This risk should generally be mitigated by the ability to make use of a provisional valuation under Article 36.
21. In some of these cases it may be infeasible or difficult to bail-in a liability within a reasonable time, notwithstanding good faith efforts, for example if it is not possible to assess or estimate the effect of a bail-in. This could be the case where it is difficult to obtain a reliable valuation within the time available for the resolution decision, i.e. through the valuation required under Article 36. Where this valuation is performed by an independent valuer, the impossibility would be determined by the inability of the valuer to provide reliable values for the relevant assets or liabilities within the required time, or the determination of the resolution authority would be supported by the findings of the valuer. It should be borne in mind that, under the draft RTS on the content of resolution plans and the assessment of resolvability, institutions are required to demonstrate their capability to provide information to carry out a valuation for the purpose of resolution. Furthermore, the guidelines on impediments to resolvability require resolution authorities to ensure that institutions are in the position to produce up-to-date information required within the timeframe necessary under the resolution strategy, in particular to support a credible valuation before and during resolution under Article 36. In addition, the guidelines stipulate that resolution authorities should consider requiring institutions to divest assets which significantly impair the feasibility of the valuation.

22. In accordance with these considerations, the decision as to when 'difficult' amounts to 'impossible' should be made based on the criteria defining a 'reasonable time' in paragraph 11 above.
23. Problems in bailing-in liabilities within a reasonable time are affected by the circumstances of failure, such as how quickly resolution actions have to be implemented to avoid negative impacts on financial markets and the real economy. In addition, they are more likely to occur when there has been limited time available for detailed planning and preparation before the use of the bail-in tool. If the authorities have been able to carry out extensive contingency planning, i.e. building on resolution plans to developed detailed execution plans, prior to failure, including where a temporary administrator appointed by the authorities has managed the bank for a certain period of time, the EBA expects the need for exclusions under this reason to be significantly reduced. Therefore resolution authorities should explain the factors why these practical obstacles to the bail-in have not been addressed in the course of the resolution planning.
24. Conclusion: The case for exclusions due to legal impossibility should be very limited, as in the EBA's view there is no reason to exclude EEA law governed liabilities, and it is hard to think of a situation where potential risks of a non-recognition in third countries in general could justify an exclusion.
25. Resolution authorities should only exclude liabilities on grounds of practical obstacles to exercising the bail-in power if these obstacles make it effectively impossible to implement the bail-in of those liabilities in a reasonable time despite every best effort of the resolution authority. What this reasonable time is should be assessed based on the criteria specified above. In this case resolution authorities should explain why these obstacles have not been addressed in the course of the resolution planning. Where the resolution authority excludes liabilities due to the impossibility to evaluate them, the resolution authority should explain why this problem in particular has not been addressed in resolution planning, and why it cannot be addressed by a provisional or an appropriate method of valuation pursuant to Article 36.

(b) Continuity of critical functions

"The exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions"

26. The continuity of critical functions is a resolution objective under Article 31(2)(a). Critical functions are defined under Article 2, and will be further specified in delegated acts. Recovery and resolution plans have to identify critical functions so that potential exclusions can be identified in advance and resolution plans be adjusted such that – with a view to a cautious use of exceptions to the principle of equitable treatment of creditors – the need for these exclusions is reduced. If the expected need for these exclusions is considered a barrier to resolution then resolution authorities may make use of their powers to require the institution

to take action (e.g. increase its MREL) to remove this barrier. However, the decision to exclude a liability based on Article 44(3)(b) requires the assessment of what is a critical function at the time of the application of the bail-in tool.

27. The definition of critical functions in point (35) of Article 2(1) refers to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, as well as the substitutability of a function. As a consequence, these institution and function-specific circumstances are relevant for an exclusion under Article 44(3)(b). However, critical functions should be assessed on a case-by-case basis at the time of the resolution decision, taking into account all elements of the definition.
28. Article 44(3)(b) also mentions core business lines, a term which is defined in point (36) of Article 2(1) and to be further specified in delegated acts by the Commission. This seems to extend the option to exclude liabilities from bail-in beyond solely maintaining the continuity of critical functions. However, Article 44(3)(b) also states that the purpose of the continuity of core business lines (and critical functions) is to “maintain the ability of the institution under resolution to continue to operate key operations, services and transactions”. This seems to suggest that a business line being profitable is not in itself a sufficient reason for exclusion, but exclusion might be justified if maintaining a core business line if it is critical to achieving the resolution objectives (including maintaining critical functions), where these are furthered by the continuation of “key operations, services and transactions”.
29. Article 44(3)(b) requires that the exclusion is strictly necessary and proportionate, i.e. if critical functions can be maintained in another way then exclusion should be avoided.
30. When considering using this reason to exclude liabilities, resolution authorities should explain why excluding these liabilities is necessary to achieve the continuity of critical functions and core business lines, and in particular why they are more relevant for clearly specified critical functions or core business lines than liabilities which are not to be excluded. The section below provides more detail on how liabilities may be linked to critical functions.

Relationship between critical functions and liabilities

31. Liabilities may be linked to critical functions, and an exclusion may be necessary for their continuity, in two principal ways:
 - (a) the bail-in of the liability would undermine the function due to the availability of funding or a dependence on counterparties such as hedging counterparties, infrastructure or service providers to the institution, which may be prevented from continuing or unwilling to continue transactions with the institution following a bail-in; or
 - (b) the critical function in question is a service provided by the institution to third parties which depends on the uninterrupted performance of the liability, for example where the institution provides payment services to third parties.

Each of these aspects (in particular the expected consequences in the market/for counterparties or for the recipients of these services) should be verified by the resolution authority when explaining the use of the exclusion.

32. Liabilities which are required for risk management (hedging) purposes in the context of critical functions should only be excluded where:
 - (a) the risk management is recognised for prudential purposes and is vitally necessary for maintaining operations related to critical functions in the sense that if the hedge were unwound, the continuity of the critical function would be seriously jeopardised; and
 - (b) if the risk management measure were unwound, it would be impossible for the institution to replace it on reasonable terms within the time required for maintaining the critical function (e.g. due to spreads or uncertainty in valuation).
33. Excluding a liability to maintain a funding relationship should be possible only under very limited circumstances, namely:
 - (a) where the authority assesses that the funding is vitally necessary for maintaining a critical function; and
 - (b) it would be impossible for the institution to replace the funding within the time required for maintaining the critical function.
34. Liabilities should not be excluded solely based on (i) their maturity or (ii) on the expectation of an increase in funding costs which does not jeopardise the continuity of the critical function.
35. Market circumstances at the time of failure may also affect the determination of whether exclusion is necessary to maintain critical functions. One of the issues to be considered in defining critical economic functions under Article 2 is that of substitutability, i.e. whether users of an institution's services can easily and cheaply swap to another provider. It may be more difficult for other providers to take on clients of the failing institution if the banking system as a whole is under significant stress; if other providers are not in a position to quickly take up business from the failing institution there may be a stronger case for ensuring that the relevant parts of the institution can continue to operate. A stressed market situation for a certain critical function may be indicated by a significant increase in prices or other market conditions for the provision of this function, changes to its availability, or the expectation of counterparties and other market participants in this respect. Indicators for a stressed situation of the market as a whole are specified below under paragraph 50.
36. Where the critical function in question is a service provided by the institution to third parties which depends on the uninterrupted performance of the liability, this generally means it is

unlikely that the function provided is substitutable², which in turn can increase the need for exclusion of the liabilities concerned.

37. At the same time, exclusions based on the type of transaction should be applied in a restrictive way. In general all transactions and products should be subject to bail-in, because otherwise this would provide an incentive for institutions and their counterparties to structure transactions in a way that makes bail-in more difficult and exclusion more likely (e.g. embedded derivatives or secured funding).
38. Conclusions: Critical functions, core business lines and the related liabilities should be assessed on a case-by-case basis at the time of the resolution action, taking into account all elements of the definition. Where they are considering an exclusion for these purposes, resolution authorities should verify that either a) the bail-in of the liability would undermine the critical function due to the availability of funding or a dependence on counterparties such as hedging counterparties, infrastructure or service providers to the institution; or b) the critical function in question is a service provided by the institution to third parties which depends on the uninterrupted performance of the liability.
39. To exclude liabilities to maintain core business lines is only justified, if this is required to achieve the resolution objectives.
40. Liabilities required for risk management purposes should only be excluded where the risk management is recognised for prudential purposes and is vitally necessary for maintaining its operations related to critical functions in the sense that if the hedge were unwound, the continuity of the critical function would be seriously jeopardised, and, if the risk management measure were unwound, it would be impossible for the institution to replace it on reasonable terms.
41. Excluding a liability to maintain a funding relationship should be possible only in very limited circumstances.

(c) Avoid widespread contagion

“The exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union”

42. Avoiding contagion is a further resolution objective which can justify an exclusion from the application of the bail-in tool. It is again qualified by the requirement that the exclusion is strictly necessary and proportionate, but also that the contagion must be so severe that it would a) be widespread and b) severely disrupt the functioning of financial markets in a

² In the absence of other resolution actions such as a transfer of these liabilities/function to another institution.

manner that could cause a serious disturbance to the economy. This implies that contagion to individual firms that are not in themselves systemically important will not be sufficient for the exemption to be applied; there must be a severe systemic impact.

43. It should also be pointed out that a certain risk of some contagion is inherent to the bail-in tool. The legislative decision to enshrine the tool in the BRRD as a key resolution tool, together with the principle that creditors and shareholders should bear losses, means that this necessary risk of contagion must not be considered a reason to exclude liabilities. Resolution authorities should therefore explain why the bail-in of liabilities it intends to exclude would be more likely to cause widespread contagious effects of the type described in Article 44(3)(c) than those not excluded.
44. The need for this exclusion is clearly likely to be affected by market conditions at the time of the bail-in. If the failure of the firm being resolved is an idiosyncratic event and the rest of the financial system is stable and considered safe, the risk of contagion from its failure is likely to be relatively low (particularly if resolution preserves value and ensures its failure is relatively orderly). However, if the rest of the financial system is under significant stress or suffering from a lack of confidence then widespread contagion may be more likely.

Types of contagion

45. In principle, two types of contagion potentially resulting from bail-in can be distinguished:
 - (a) Direct contagion means that direct losses of counterparties of the institution under resolution, resulting from the write-down of the institution's liabilities, lead to default or solvency issues for those counterparties, and in turn in losses for their counterparties, and for counterparties of these counterparties and so on. The same applies to issuers of credit default swaps (CDS) relating to these liabilities where they are triggered.
 - (b) Indirect contagion is caused by the reactions of market participants to the failure or the resolution action. An important channel of indirect contagion may be the loss of confidence in funding markets (retail and wholesale) – drying up of supply, higher margin requirements in general or for institutions with similar characteristics as the failing institution, fire sales of assets by institutions with liquidity shortfalls.
46. Article 44(3) mentions eligible deposits held by natural persons and micro, small and medium sized enterprises (i.e. deposits above the coverage level provided for in the Deposit Guarantee Scheme (DGS) Directive (see Recital (72)) as an example of liabilities which should particularly be considered under this exclusion. The objective of an exclusion of these liabilities would be to avoid a loss of confidence among depositors (which may cause a run and indirect contagion to further institutions) and to protect the economic functions of these enterprises. This makes clear that the BRRD recognises indirect contagion as a potential reason to exclude liabilities. However, the resolution authority would have to assess whether this effect results from, or is significantly aggravated by, the application of the bail-in tool to the liabilities in question, or in fact arises from the failure of the institution in and of itself.

47. When considering exclusions based on the risk of direct contagion, resolution authorities should assess the interconnectedness of the institution under resolution, and in particular exposures to relevant counter-parties with regard to the risk that bail-in of these exposures might cause knock-on failures, and the systemic importance of counterparties which are at risk of failing, in particular with regard to other financial market participants and financial market infrastructure providers.
48. The following indicators may help to identify further situations where a loss of confidence, as an indirect form of contagion, might justify an exceptional exclusion:
- (a) number, size and interconnectedness of institutions with similar characteristics as the institution under resolution;
 - (b) the number of natural persons directly and indirectly affected by the bail-in, visibility and press coverage of the resolution action;
 - (c) the number, size, interconnectedness of counterparties affected by the bail-in, including market participants from the non-banking sector, and the importance of critical functions performed by these counterparties;
 - (d) whether counterparties will be able to access alternative service providers for functions which have been assessed as substitutable, given the specific situation; and
 - (e) market expectation of loss levels (taking into account, however, the principle that losses have to be borne by shareholders and creditors and the objective to limit moral hazard).
49. When considering exclusions from bail-in on grounds of indirect contagion, resolution authorities should assess whether counterparties, including depositors, would withdraw funding or cease making transactions with the bailed-in institution or other institutions following the bail-in, or if markets would cease functioning properly as a consequence of the bail-in of these market participants, in particular in the event of generalised loss of market confidence or panic.
50. Market circumstances at the time of failure may also affect the determination of whether exclusion is necessary to prevent contagion. Indicators for a higher risk of indirect contagion may be the following:
- (a) the number, size or significance of institutions which are at risk of meeting the conditions for early intervention, or of requiring (public) financial support, or the extent of extraordinary liquidity facilities being provided by central banks;
 - (b) the risk of a discontinuance of critical functions or a significant increase in prices for the provision of these functions, as evident from changes in market conditions for these functions or their availability, or the expectation of counterparties and other market participants in this respect;

- (c) widespread withdrawal of short term funding or deposits;
- (d) general decreases in share prices of institutions or in prices of assets held by institutions, in particular where they can have an impact on the capital situation of institutions;
- (e) general and widespread reduction in short or medium term funding available to institutions;
- (f) impairment to the functioning of the interbank funding market, as particularly apparent from a significant increase of margin requirements and decrease of collateral available to institutions;
- (g) widespread increases in prices for credit default insurance or deterioration in credit ratings of institutions or other market participants which are relevant for the financial situation of institutions.

Exclusion of some or all liabilities owed to certain creditors

51. Exceptional exclusions might be made in relation to certain types of creditors, as some types of creditors are more likely to multiply contagious effects than others and thereby cause widespread contagion. These types of creditors might be small groups of counterparties, or even individual creditors. Resolution authorities may not be in a position to know who the holders of particular liabilities are, and for this reason it may not be possible for the resolution authority to distinguish between small groups of creditors within the same class. This information should, however, be more readily available in the future, for example by the clear determination of covered deposits required by the DGS Directive or other measures requiring a 'single customer view', for example in the resolvability assessment. The exclusion of some or all liabilities to individual creditors (rather than classes of liabilities), however, would be the most extensive deviation of the *pari passu* principle, which may be problematic from a legal perspective and regarding its impact.
52. It cannot be ruled out that the BRRD allows this differentiation: in accordance with Article 34(1)(f) of the BRRD, which contains the general principles governing resolution, creditors of the same class have to be treated in an equitable manner except where otherwise provided in the BRRD. The exclusions from bail-in justified by the reasons in Article 44(3) can be considered among the exceptions mentioned in Article 34(1)(f), which may justify a different treatment among creditors of the same class, and there do not seem to be further constraints on deviating from the *pari passu* principle. One further argument that has been made to support this interpretation is that the equitable treatment among creditors of the same class is not expressly repeated among principles that should be considered by the resolution authority when deciding on exclusions in Article 44(9), whereas the principle that losses should be borne first by shareholders and then by creditors in order of preference (Article 34(1)(a) and (b)) is expressly mentioned in Article 44(9)(a).

53. Furthermore some deviation from the *pari passu* principle is explicitly acknowledged by Article 48(2), which notes that liabilities excluded from bail-in in accordance with Article 44(2) and (3) may receive a more favourable treatment than eligible liabilities that are of the same rank in insolvency proceedings. Arguments have been brought forward that Member States' laws may allow an exclusion of all or some liabilities owed to particular creditors.
54. However, deviating from *pari passu* treatment without clear criteria may result in uncertainty in the market, increase the legal risk to the resolution authority and have unintended negative consequences for funding costs. Therefore resolution authorities should be very careful in making a decision to exclude certain counterparties. Departures from the principle of *pari passu* treatment should be based on objective, non-discriminatory criteria allowing the identification of homogeneous types of liabilities. However, it cannot be ruled out that there may be situations where a homogenous 'group' of liabilities is owed to only one or a small number of counterparties. In addition, it may be necessary to exclude all or some of the liabilities owed to these counterparties to effectively avoid the risk of contagion or ensure the continuity of critical functions. In this case, the selection of these counterparties should again be based on objective, non-discriminatory criteria.
55. Conclusions: Resolution authorities should consider the need for exclusions from bail-in to prevent widespread contagion in the context of the circumstances at the time of resolution. They should take into account the fact that resolution necessarily involves the absorption of losses by creditors, and therefore some direct contagion is unavoidable. To justify exclusion of liabilities any potential contagion must be widespread. In making their assessment of the potential for contagion resolution authorities should consider the factors outlined above. Exclusions of small groups or individual creditors can in principle be made, but as with all exclusions they should be made based on objective, non-discriminatory criteria.

(d) Destruction in value

"The application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in"

56. The last case for exceptional exclusions requires that the exclusion avoids destruction in value such that other creditors are made better off if those liabilities are excluded. This means that the value destroyed by inclusion of the liabilities would need to be strictly greater than the amount of liabilities which needed to be excluded, i.e. the benefit of exclusion for other creditors would need to outweigh the reduction in loss absorbency caused by the exclusion.
57. To assess the situation of creditors, resolution authorities should compare and evaluate the outcome for all creditors resulting from the two hypothetical scenarios following or without the bail-out of the liabilities concerned. The assessment should follow the same criteria as the valuation under Article 36 of the BRRD for informing the decisions on the extent of the write-

down or conversion of capital and debt instruments, and the appropriate resolution actions. These criteria will be specified in the RTS on valuation.

58. The delegated act should consider whether the decision may be based on indirect and uncertain advantages such as a continued franchise value, given that creditors may benefit from potential upsides following a conversion of their claims into equity. The option to include these advantages is advisable as long as it is ensured that the following can be verified in a reliable manner (e.g. by an independent valuation):
- the causality between the exclusion of a certain liability and the expected advantage;
 - the monetary value of these expectations; and
 - the benefit of creditors.
59. According to the current consultation paper, the EBA draft RTS on valuation allow for franchise value to be counted, where ‘franchise value’ is defined as the present value of cash flows that can reasonably be expected to result from business opportunities, including those stemming from the different resolution actions and expectations resulting from renewal of assets or from the refinancing of an open portfolio in the context of the resolution actions. The same criteria should be applied in the context of assessing the potential benefits in terms of value preservation of an exclusion from bail-in.
60. The BRRD gives a potential example for this exclusion relating to derivatives. Pursuant to Article 49(2) resolution authorities shall exercise the write-down and conversion powers in relation to a liability arising from a derivative only upon or after closing-out the derivatives. However, depending on the applicable methodology additional losses may crystallise from the close out (stemming, for example, from replacement costs incurred for the counterparty, or costs incurred by the institution under resolution to re-establish hedges left open) that are not reflected in the going concern value of derivatives. Where these additional losses stemming from the close out of derivatives exceed the bail-in potential of the corresponding liability, the excess loss will increase the burden of bail-in for other creditors of the institution under resolution.
61. An additional source of losses may be the method of valuation chosen for this close-out; for example, pursuant to the ISDA 2002 Master Agreement, where close-out is triggered by a default event, the non-defaulting counterparty will act as the “determining party” (i.e. the party determining the close-out amount) and will charge contract replacement costs to the estate of the defaulting counterparty. These costs could be substantially influenced by the idiosyncratic situation of the determining party. In contrast, in non-default-related termination, the close-out amount follows a more even-handed approach to the two counterparties, taking into account, for example, contracts valued at mid-market prices. The upcoming RTS to be adopted pursuant to Article 49(5) will specify the applicable valuation methodology.

62. Therefore resolution authorities, as part of the valuation under Article 36 and in line with the upcoming RTS, should perform a comparison between additional losses stemming from a possible close-out and the bail-in potential of the corresponding liabilities, taking into account the applicable valuation methodology and valuation date, before they decide to close-out and bail-in or to apply the exclusion.
63. A further case where destruction in value could occur is if certain liabilities form part of a successful business line which would otherwise add significant value to the bank, e.g. in a sale to a private sector purchaser. However, that exclusion would add value to the failed bank's estate would not be sufficient; as noted above the additional value would need to be sufficient to (potentially) improve the situation of non-excluded creditors.
64. Resolution authorities should be careful in justifying exclusions based on the possibility of uncertain future profits. Where, for example, the institution's net position in a given portfolio has depreciated (i.e. it is 'out of the money'), the uncertain or speculative expectation of a possible future recovery should not in itself justify exclusion. The situation may be different where there are good reasons to assume that the depreciation is due to stress caused by the failure of the institution, and the value will recover following the resolution action.
65. Conclusions: When comparing the situation of creditors, resolution authorities should have the option to include in the valuation indirect and uncertain advantages such as a continued franchise value, if the monetary value of these expectations and the benefit for creditors can be verified and estimated in a reliable manner following the same criteria as the valuation under Article 36 of the BRRD. When evaluating derivatives, the valuation should reflect replacement costs for the institution, where it is necessary to replace derivatives following a close-out, and the applicable valuation methodology and date. Purely speculative expectations of a possible future recovery should not in themselves justify exclusion.

Annex: permanent exclusions from bail-in under Article 44(2)

Pursuant to Article 44 of the BRRD, in principle all liabilities of an institution under resolution are in the scope of the bail-in tool unless they are excluded explicitly under Article 44(2) ('explicit exclusions') or by the resolution authorities on a case-by-case basis in exceptional circumstances in accordance with Article 44(3) ('exceptional exclusions').

The following list tries to capture the possible reasoning behind the explicit exclusions under Article 44(2):

- to avoid run risks (exclusions for covered deposits, liabilities to DGS) – depositors lose confidence in other banks and in the reliability of the DGS;
- to preserve the function of certain transaction types (secured liabilities, covered bonds, client money, fiduciary relationships) – the transactions concerned require a special treatment in insolvency which should be replicated in bail-in;
- to avoid contagion to key financial markets and infrastructure:
 - FMIs (CCPs);
 - Interbank funding markets (exclusion of certain short term liabilities);
 - DGS (with respect to *ex-post* contributions);
- to ensure the continuance of the operations of the institution (liabilities to employees, commercial and trade creditors, social authorities), also by avoiding enforcement of security interests, which could reduce the assets of the institution (secured liabilities);
- to state fiscal interest (e.g. tax authorities), where it is protected under national insolvency law;
- to reflect the insolvency ranking of the liability to ensure consistency with and confidence in the Member State's legal system as a whole, and comply with fundamental rights, also with a view to the no-creditor-worse-off principle (client assets or money, fiduciary relationships, covered bonds, tax and social authorities)

These possible reasons may provide an insight into the legislators' thinking, which in turn should inform the consideration of the discretionary exclusions under Article 44(3).