

EBA/GL/2017/03

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11/07/2017

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# Final Guidelines

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on the rate of conversion of debt to equity in bail-in

# 1. Compliance and reporting obligations

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## Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC as subsequently amended by Regulation (EU) No 1022/2013 (the EBA Regulation). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the guidelines.
2. Guidelines set out the EBA's view of appropriate supervisory or resolution practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities and financial institutions to which guidelines are addressed to comply with guidelines. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

## Reporting requirements

3. Pursuant to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by 11/09/2017. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu) with the reference 'EBA/GL/2017/03'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.
4. Notifications will be published on the EBA website, in line with Article 16(3).

## **Title I – Subject matter, scope and definitions**

### **1. Subject matter**

- 1.1. These guidelines, which have been prepared pursuant to Article 50(4) of Directive 2014/59/EU (the BRRD), are on the setting of conversion rates of debt to equity in bail-in. They are also relevant to the conversion of relevant capital instruments at the point of non-viability, because Article 60(3)(d) makes compliance with Article 50, including the EBA guidelines, a condition for converting the relevant capital instruments.
- 1.2. Article 50(1) provides that resolution authorities, when applying the bail-in tool, may apply a different rate of conversion to different classes of capital instruments and liabilities. If they do, this must be done in accordance with: (i) the principle that the conversion rate shall represent appropriate compensation to the affected creditor for any loss incurred through write-down or conversion (Article 50(2)); and (ii) the principle that conversion rates applicable to liabilities that are considered senior under applicable insolvency law shall be higher than the conversion rate applicable to subordinated liabilities (Article 50(3)).
- 1.3. Article 50(4) requires that these guidelines indicate, in particular, how affected creditors may be appropriately compensated by means of the conversion rate, and the relative conversion rates that might be appropriate to reflect the priority of senior liabilities under applicable insolvency law.
- 1.4. Resolution authorities are not obliged by the BRRD to set differential conversion rates, and may choose, when applying the bail-in tool or the power to write down or convert capital instruments, to convert each instrument or liability into equity at the same rate, provided that they achieve the resolution objectives and respect the sequence of write-down and conversion in Article 48, the resolution principles in Article 34, the right to property under the Charter of Fundamental Rights of the European Union and, in the case of the bail-in tool, the 'no creditor worse off' safeguard embodied in Article 75. These guidelines provide guidance on the setting of conversion rates taking those factors into consideration.
- 1.5. These guidelines provide for the setting of differential conversion rates for classes of instruments which differ in their ranking in the relevant national insolvency creditor hierarchy for either statutory or contractual reasons. They do not provide for any setting of differential conversion rates for classes of instruments which differ in, for example, their regulatory or accounting treatment, but not in their ranking in the relevant national insolvency creditor hierarchy.

### **2. Scope and level of application**

- 1.6. These guidelines are addressed to resolution authorities if they are compensating creditors with differential conversion rates while applying the bail-in tool to an institution, an entity referred to in Article 1(b), (c), or (d) of the BRRD, or to claims or debt instruments that are

transferred to a bridge institution or under the sale of business tool or the asset separation tool and making use of the possibility of establishing differential conversion rates. They are also relevant to resolution authorities when applying the power to write down or convert relevant capital instruments at the point of non-viability. This is based on Article 60(3)(d), which requires that such instruments may be converted only when the conversion rate that determines the number of Common Equity Tier 1 instruments that are provided in respect of each relevant capital instrument complies with the principles set out in Article 50 and these guidelines.

## Title II – Guidelines on the rate of conversion of debt to equity

### *Guiding principles*

- 1.7. The guiding principles set out below relate directly to the requirements of the BRRD, and do not extend the resolution principles or safeguards set out in that directive. They aim to clarify how resolution authorities, having regard to those principles and safeguards, may ensure that creditors may be appropriately compensated by means of a differential conversion rate.
- 1.8. **Guiding principle 1: no creditor worse off.** Resolution authorities should seek to ensure, when setting conversion rates, that no creditor or shareholder is expected to receive treatment which is worse than the treatment they would have received if the firm had entered national insolvency proceedings at the point at which the decision to trigger resolution is made. They should base their assessment of expected actual treatment on the valuation carried pursuant to Article 36 (4)(b) to (g) the BRRD. They should base their assessment of expected treatment in insolvency on an estimate of the treatment that each class of shareholders and creditors would have been expected to receive if the firm were wound up under normal insolvency proceedings, as required by Article 36(8) of the BRRD.
- 1.9. When setting conversion rates when the bail-in tool or the power to write down or convert relevant capital instruments is used, resolution authorities should also assess whether appropriate regard has been had to the right to property under the EU Charter of Fundamental Rights.
- 1.10. **Guiding principle 2: creditor hierarchy.** Subject to achieving the aims of guiding principle 1, resolution authorities should set differential conversion rates only in order to achieve the resolution objectives or respect the other principles set out in Article 34 of the BRRD. In particular, when setting conversion rates resolution authorities should seek to ensure that:
  - a. shareholders of the institution under resolution bear first loss;
  - b. except where expressly otherwise provided in the BRRD, creditors of the institution under resolution bear losses after the shareholders and in accordance with the order of priority of their claims under normal insolvency proceedings; and

c. creditors of the same class are treated in an equitable manner.

1.11. When setting conversion rates when applying the power to write down or convert relevant capital instruments provided in Article 59 of the BRRD, authorities should also ensure that shareholders bear first loss, creditors bear losses in accordance with the order of priority of their claims under normal insolvency proceedings, and creditors of the same class are treated in an equitable manner, unless this would be inconsistent with the need to have regard to the right to property under the EU Charter of Fundamental Rights.

1.12. Guidance on how resolution authorities should apply these guiding principles is set out below.

#### *Valuation*

1.13. Before applying the bail-in tool or the power to write down or convert capital instruments at the point of non-viability, a valuation of the assets and liabilities of the institution shall be made according to Article 36 (4) (b) to (g) of the BRRD. This must involve a fair, prudent and realistic valuation of the assets and liabilities of the firm.

1.14. That valuation is to inform a number of decisions to be taken by the resolution authority, including on the extent of cancellation or dilution of shares or other instruments of ownership and the extent of losses which should be recognised at the point of resolution. The valuation should include an estimate of the post-conversion equity value of new shares transferred or issued as consideration to holders of converted instruments.

1.15. Article 36(8) of the BRRD also requires that the valuation include an estimate of the treatment that each class of shareholders and creditors would have been expected to receive if the firm were wound up under normal insolvency proceedings. An ex post independent valuation must also be made according to Article 74(2) to determine whether the actual treatment that shareholders and creditors received as a result of the application of the bail-in tool was worse than that which they would have received had the firm entered normal insolvency proceedings (the ex post valuation).

#### *Applying guiding principle 1: ensuring that no creditor or shareholder is worse off than in insolvency*

1.16. **When applying the bail-in tool, authorities should set conversion rates so that for each shareholder or creditor the expected value of their combined equity and debt claims after application of resolution powers, according to the valuation carried pursuant to Article 36 (4)(b) to (g) of the BRRD, is equal to or greater than the expected value that they would have realised had the institution entered normal insolvency proceedings, according to the estimate produced pursuant to Article 36 (8) of the BRRD.**

1.17. **The write-down or conversion powers referred to in Article 59 of the BRRD may be applied on their own, not in conjunction with the exercise of the bail-in or any other**

**resolution tool. In this case, if authorities choose to employ differential conversion rates they should set conversion rates so that for each shareholder or creditor the expected actual treatment they receive (as determined by the value of their combined equity and debt claims after application of resolution powers according to the valuation carried pursuant to Article 36 (4)(b) to (g) of the BRRD) is expected to be equal to or greater than the expected value that they would have realised had the institution entered normal insolvency proceedings, according to the estimate produced pursuant to Article 36 (8) of the BRRD , to the extent that is necessary to uphold fundamental property rights.**

- 1.18. Where creditor claims are fully written down, their claims no longer have any value. When a liability or other instrument is converted to equity, the equity claim may have more, less, or the same value as the original converted debt claim. The value of this equity claim must form part of the assessment of the actual treatment received by a creditor.
- 1.19. Where the total estimated value of equity received by the affected creditors following write-down and conversion is expected to be greater than the aggregate amount of debt claims written down or converted to equity, guiding principle 1 can be satisfied with no application of differential conversion rates.
- 1.20. Where the total expected value of the equity received by the affected creditors following write-down and conversion is lower than the aggregate amount of debt claims written down or converted to equity, differential conversion rates may be necessary.
- 1.21. Where there is a need to set differential conversion rates to prevent creditors from being made worse off than in insolvency or to protect fundamental property rights or other resolution objectives, the conversion rates should be set so that senior creditors are not expected to be made worse off than in insolvency or so that fundamental property rights are protected. Resolution authorities should not set differential conversion rates which transfer more value to senior creditors than is necessary to respect guiding principle 2, to prevent senior creditors being made worse off than in insolvency, or to protect fundamental property rights or other resolution objectives.
- 1.22. For any creditor whose claim has been wholly converted to equity, the expected value of equity they receive should therefore be *at least* as large as their expected recovery in insolvency.
- 1.23. For any creditor whose claim has been only partially converted to equity, the expected value of equity they receive should therefore be *at least* as large as their expected recovery in insolvency, less the expected value of their remaining debt claim.

*Applying guiding principle 2: respecting the other Article 34 principles for resolution*

- 1.24. **Authorities should set conversion rates to ensure, as far as reasonably possible and subject to respecting creditor safeguards and fundamental property rights, that the creditor hierarchy is fully respected. This means that if a given class of creditor is expected to take a**

**loss – that is, if the total value of remaining debt and equity claims after the application of resolution powers, according to the valuation carried pursuant to Article 36 (4)(b) to (g) of the BRRD, is less than the value of the claims of that class before resolution – the resolution authority should set a conversion rate equal to or close to zero for all more junior classes of liabilities and instruments.**

- 1.25. This means that shareholders will take the first loss. Any value preserved by resolution will be allocated first to senior and subordinated creditors' claims. As such, differential conversion rates aim to ensure that the creditors bear losses after the shareholders in accordance with the order of priority of the claims under insolvency. However, conversion rates may be set that allow the original shareholders (and shareholders whose claims resulted from the conversion of relevant capital instruments at the point of non-viability) to retain some claims with positive value, or for equity to be shared in some proportion by two or more classes of creditors. Shareholders could retain some positive value when there is no need to write down any creditors, i.e. where the bail-in requires only conversion.
- 1.26. Equity could be shared in some proportion by two or more classes of creditors where one creditor class had been fully converted to equity but more conversion were still required, and the partial or full conversion of the more senior creditor class did not result in a loss (i.e. the more senior creditors receive a total debt and equity claim value at least equal to the value of their original debt claim).

#### *Final provisions*

- 1.27. **Resolution authorities should apply differential conversion rates only where necessary to meet the guiding principles above.** Where there are no significant concerns about protecting creditor safeguards or fundamental property rights, and resolution authorities are satisfied that applying the same conversion rates would comply with the Article 34 principles and achieve the resolution objectives, there should not be any need for differential conversion rates.
- 1.28. **Where differential conversion rates are applied, authorities should set the conversion rates so that they are reasonably confident that junior creditors or shareholders are not made worse off than in insolvency (in the case of bail-in) and that their fundamental property rights are protected.** This means that conversion rates for senior creditors should not be disproportionately high. Disproportionate benefit would arise if such creditors would be expected to have claims of a significantly higher value under the estimate produced pursuant to Article 36 (8) of the BRRD.

### **Title III – Final provisions and implementation**

These guidelines should be implemented into national resolution practices by relevant resolution authorities by 6 months after publication.