BAIL-IN WORKING GROUP
OF THE AMIC

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Dear Mr Constâncio and Ms Lautenschläger

The ICMA[1] is a pan-European self-regulatory organisation and an influential voice for the global capital market. The Bail-In Working Group (BIWG), which is a committee of, and reports into, the Asset Management and Investors Council (AMIC)[2] of ICMA, has compiled this discussion paper, the purpose of which is to set out further views on the operation of the bail-in mechanism. These views have evolved since the presentation of a position paper by the BIWG to the ECB in July 2015. As such, this paper represents a considered view of the bail-in proposals from the buy-side perspective.

Bail-in:

It is recognised, in the new world of "bail-in", that the investment community, particularly in the bond market, must bear some of the brunt of future bank failures. Senior debt has moved from *pari passu* with depositors and other creditors to subordinated. The BIWG has previously expressed its collective views on the markets' need for clarity and transparency, allowing comparability and predictability of the new regulatory environment in which the banks throughout Europe operate. It has also called for consistency and clear communication, with the aim of reassuring the market, creating a positive consensus view on the advantages that can stem from banking union, as well as

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[1] www.icmagroup.org. ICMA has a membership of over 500 firms and represents a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges and other venues, central banks, law firms and other professional advisers. The ICMA's market conventions and standards have been the pillars of the international debt market for over 50 years.

[2] http://www.icmagroup.org/About-ICMA/icma-councils-and-committees/Asset-Management-and-Investors-Council-AMIC-/

the preservation of confidence. The recent market turmoil post Brexit has evidenced the fragility of that confidence, particularly among the weakest links in the European banking system.

Regulatory/political consistency:

Inconsistencies over the application of bail-in at a political, regulatory and national discretion level (for example, with regards to regulatory forbearance) drive investor confusion and market distortion, which in turn have an effect on the pricing and marketability of bank securities. Collaboration of all parties is needed in order to achieve a consistent and comprehensive banking union, where political and regulatory bodies will need to speak clearly with one voice.

While it is appreciated that the ECB has a dual mandate to set euro-area monetary policy as well as supervise the banking system, investors are entitled to expect that these two mandates will not give rise to contradictory outcomes. Therefore, the BIWG stresses the importance of consistent, clear communication and disclosure requirements which are harmonised across all the jurisdictions that form part of the banking union, with limited loopholes that might create conflicts or contradictions in the ECB's mandate.

As a final point, there is some concern not only over the consistency of application of the bail-in tool, but around the timing of its application (when the 'point of non-viability' is established, on what grounds and why). Once resolution is embarked upon, there will also be further concerns over the calculations of write-downs with the suspicion that regulators may penalise debt investors both in terms of precipitous action or over judicious quantum of the write-down. It is recognised that regulators will tend towards prudent and conservative actions, but these may nevertheless veer towards being prejudicial to the interests of noteholders, inadvertently breaching the 'no creditor worse off' principle.

State aid:

Notwithstanding the requirement for a consistent application of bail-in, the BIWG urges regulators to recognise that imposing state aid rules without flexibility may lead to further risk aversion and confusion, especially in times of market tension or heightened systemic risk. A flexible approach to state aid could help to minimise a distorting effect on the market for bank securities.

Macro issues:

The BIWG notes the enormous challenges faced by bank management teams, and the costly investment and human capital allocated by banks as they adapt to a new and more demanding regulatory environment. This is all taking place against a background of an adverse operating environment of very low interest rates stemming from the weakness of the economic cycle. The collective view of the BIWG is that all of these issues require focused and coordinated attention on the part of the regulators as they bear heavily on the creditworthiness and resilience of the banking system.

European SMEs are heavily relied upon to grow the real economy and create jobs. They in turn are dependent upon bank funding as their main source of credit, as well as on banks' payment functions. It follows that the health of the European banking system and its ability to lend are absolutely crucial for economic growth generation. Consequently, the safe implementation of a robust bail-in regime should be predicated on a proper, effective and thorough clean-up of the European banking system; something which appears now to have been widely acknowledged, though the mechanisms for doing so remain inconsistent and uncertain.

The BIWG believes that enforcing clear, transparent, consistent, predictable and measured rules, applied with sensitivity, is not only in the interest of investors, but also that of the wider economy.

Micro issues – bad loans:

An important first step in cleaning-up the banking system would be the resolution of the non-performing loan situation throughout the euro-area. The BIWG recognises, however, the significant accomplishments thus far on the part of both the ECB and EBA to improve disclosure and harmonisation of accounting for bad loans, which will go some way to improving investor confidence (although considerable discrepancies in reporting standards remain). The BIWG would welcome proposals to address the non-performing loans situation in certain jurisdictions.

In this regard, the BIWG agrees with Danièle Nouy's recent comments in a letter to members of the European Parliament: "*Non-performing loans* (*NPLs) have reached elevated levels in several Member States…[and] there is no one-size-fits-all solution to the NPL problems.…[national and European legislative authorities] should consider streamlining legal processes related to debt recovery, removing impediments to the enforcement of loan collateral, introducing out-of-court debt work-out solutions, and fostering the development of distressed debt markets*."

Banks' profitability:

The ECB should be commended for providing much needed liquidity support, particularly through the TLTRO programmes, for banks who might otherwise run a risk of failing precipitously due to a very weak macroeconomic environment and heightened investor risk aversion. However, there is a danger that this supportive action may delay the "moment of reckoning" for many banks who would not otherwise be able to fund themselves through the issuance of senior unsecured debt. The issuance of market priced bail-inable debt, in the current environment, would likely continue to have negative implications for the profitability of the banking sector, thus further eroding the European banking systems propensity to lend and spur economic growth.

For this reason, again it is important that state aid rules are applied in a flexible manner to allow more far-reaching solutions to banks' solvency problems, which in turn would allow banks to return to the markets to fund themselves.

Achieving subordination:

There is not yet a consistent or clear methodology on the manner in which subordination of bail-inable debt will be achieved across the Member States; whether by structural, contractual or statutory subordination. Although the risks to bondholders will be broadly similar in terms of the probability of bail-in, an inconsistent, patchwork approach poses a significant challenge for the buy-side in terms of predictability, adds complexity to the task of resolving cross-border banks and may give rise to multiple legal challenges should the bail-in tool be exercised. The inconsistent approach will complicate the analysis of creditor hierarchies in some cases, possibly leading to pricing anomalies. As another consideration, it is noted that collateral pledged to central banks, or any emergency liquidity assistance, none of which has to be disclosed to the market, may further super-subordinate bondholders.

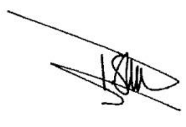
The BIWG firmly believes that the future development and success of the market for regulatory capital instruments would be best served by a high degree of standardisation and homogeneity, including a common framework for achieving subordination. In a similar vein, a regulatory requirement for parity of reporting and transparency of a bank's debt structure, including asset encumbrance levels, as between the regulatory authorities and the market would encourage market discipline, and go some way to assuaging bondholders' concerns over consistency of information.

Corporate governance - Bondholders' position:
Were the bail-in tool to be exercised and a bondholder's debt converted to equity, there would consequently be a change of ownership of the bank in resolution. Bondholders – as post-conversion equity holders – are now the "new" owners of the bank. Given this *potential* re-characterisation of the bondholders' position from a creditor to an owner, it follows that this responsibility should be reflected in some way in the rights and obligations attaching to the bail-inable debt from the outset. This requires a wider debate around the governance of banks and the roles of all stakeholders, including a comprehensive review of rights and obligations, including, for instance, providing bondholders under certain circumstances with limited voting rights on dividend policy, remuneration and board nominations.

Conclusion:
The BIWG is seeking to provide a constructive voice in the debate on the future shape of banks' balance sheets, in order to ensure that the asset class remains a sustainable and investible proposition, with debt markets available at reasonable prices to provide banks with necessary term liquidity.

Members of the BIWG therefore look forward to engaging with central banks and regulatory bodies in a constructive and open dialogue to achieve the ultimate goal of fortifying the safety, soundness and, ultimately, the long-term stability of the financial system.

Yours sincerely



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