## EUROPEAN REGULATION

Perhaps it's the longer days or the summer sun, but I find myself more optimistic over Europe and the flood of regulations affecting the financial markets. Common sense has prevailed in the case of Solvency II for pensions, as explained opposite, and even the worst excesses of the proposed financial transaction tax look as if they might be abandoned. That said, banking reform and bail-in are high on the agenda and will, in the end, lead to massive changes in banks' risk profiles.

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{ IN DEPTH }

# BANKING BAIL-IN EXPLAINED

G20 leaders, politicians and regulators are all determined to solve the 'too big to fail' problem. The issue of how to rescue a failing bank without the state footing the bill is being addressed through capital adequacy and resolution regimes that protect depositors while allowing an orderly winding down, sale or recapitalisation.

The established toolkit for dealing with a failing bank can involve a liquidation and payout to the depositors covered by a deposit guarantee scheme. Alternatively, some form of break-up can occur with 'good' parts being sold, some parts being held for subsequent sale if they can be remedied, and the balance going into liquidation.

For a large and complex international investment bank these techniques may not be practical, however, especially for instant application over a weekend. This is where the bail-in concept can be applied. Bail-in is invoked before the bank reaches a winding-up stage, with authorities making an upfront judgement of the losses that might be expected and reconstructing the capital accordingly. Following the creditor hierarchy that would apply in liquidation, the various layers – equity, subordinated debt, senior unsecured debt, etc – are written down until the losses are covered. And then the last surviving layer(s) of debt are partially converted into equity to recapitalise the continuing parts of the business, which is thus under new ownership. Writing off debt creates new capital, but does not restore liquidity – the assumption is that with the reconstructed entity now having adequate capital, central banks and the normal markets would be willing to provide liquidity.

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So far so good, but in the case of banking groups, ensuring fairness is not so easy. The bail-in could be applied at the holding company level and the recapitalised parent can then route capital down to the problem subsidiary. This is referred to as single point of entry. Multiple-point-of-entry resolution would involve bail-in at subsidiary level, at regional holding company level, at top company level or some combination of the three. Even then, would the resolution authority in one country be able to impose bail-in in another jurisdiction, or indeed in a solvent subsidiary elsewhere in the group?

The relative lack of bond creditors in the recent reconstruction of Cypriot banks meant that depositors were bailed in. Ideally, there should be sufficient 'bail-inable' debt, but this also prompts the debate on whether any classes of creditor should be protected in a bail-in. The presumption is that retail depositors covered by deposit guarantee schemes should be preferred, but whether that should also apply to wholesale depositors is still open.

It is exactly these questions that are being debated as the European Parliament reviews the draft Recovery and Resolution Directive. In May, the EU Economic and Monetary Affairs Committee voted that guaranteed deposits up to €100,000, covered bonds, short-term interbank loans and some liabilities related to banks' core functions should be on the list of protected instruments. Knowing exactly where your claim on a bank sits in the bail-in hierarchy will become crucial for treasurers.

## YOUR SHOUT

**The long-awaited revision to the International Accounting Standards Board's exposure draft on accounting for leases has been published for comment by 13 September 2013 – see opposite page. Do feed your views back directly to the IASB or to the ACT (technical@treasurers.org).**

{ INTERNATIONAL }

# IASB ISSUES LEASE PROPOSALS

After much deliberation, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board have issued a new exposure draft (ED) on accounting for leases. For lessees, it proposes that *all* leases of more than 12 months are accounted for on the balance sheet. By contrast, IAS 17, *Leases*, requires that finance lease assets are accounted for on the lessee's balance sheet and operating leases remain off the balance sheet.

Although there is a single approach for leased assets, a dual approach has been introduced for lease expenses. A lessee of equipment or vehicles, in effect, consumes a part of any equipment or vehicles that it leases because the asset's value declines over its economic life. Accordingly, the ED proposes that lessees amortise the leased asset similar to the way plant and equipment is depreciated, and account for interest on the lease liability in the same way as interest on other similar financial liabilities. But with leases of land and/or a building (property), the lessee is not consuming a significant portion of the asset and hence lease payments should be accounted on a straight-line basis.

The 2010 ED put forward two different accounting models for the lessor, however, the revised ED no longer proposes the recognition of a liability by the lessor. Instead, for most equipment and vehicles leases a lessor would recognise both a lease receivable and a residual interest in the asset, and for property leases the lessor would not recognise the lease receivable, but rather include the asset being leased.

{ WATCH THIS SPACE }

## DERIVATIVE REPORTING MUDDLE

The European Market Infrastructure Regulation affecting derivatives has already come into effect in law, with phased start dates, but the mechanics required to enable compliance are far from ready. The European Securities and Markets Authority (ESMA) has quietly acknowledged this by putting the expected start date for reporting all interest rate and credit derivatives back from September to November 2013. Derivatives will have to be reported to trade repositories and so far seven are believed to have applied for registration – namely UnaVista; IntercontinentalExchange (ICE) Trade Vault; REGIS-TR; Harmony TR Connect; DTCC Derivatives Repository; CME Group; and KDPW. ESMA is not expecting to announce any registrations until later in the summer, however.

Even once the repositories are up and running, there are further hurdles for companies needing to report. Companies will have to apply for a legal entity identifier (LEI), but as yet the final system for creating these reference numbers does not exist. Instead, pre-LEIs are being generated by pre-local operating units, such as the Irish Stock Exchange, the London Stock Exchange, WM Datenservice based in Germany and the established CFTC Interim Compliant Identifier utility in the US. To cap it all, every derivative trade will have to have a unique trade identifier (UTI), yet no internationally agreed system to generate these exists. Company or bank-generated references should be acceptable, but must be created in a way that avoids any duplication by any other entity and, of course, the company and bank at either end of a transaction must use the same UTI.

{ TECHNICAL ROUND-UP }

# PENSIONS, INSOLVENCY AND CRAs

**Solvency II-style solvency requirements** are to be dropped from the new European Institutions for Occupational Retirement Provision directive. The original proposals would have treated pension assets and liabilities more like insurance companies and required them to have substantial capital buffers. The ACT opposed this concept for its failure to adequately allow for sponsor support and is pleased that UK pension schemes will avoid a colossal £450bn additional funding requirement.

**The balance sheet insolvency test** in section 123(2) of the Insolvency Act 1986 and the judgement as to whether a company is "unable to pay its debts as they fall due", can be based on the balance of probabilities rather than a literal view of the statutory reported balance sheet. This is according to a recent ruling of the UK Supreme Court in the case of *Eurosail*, an issuer of residential-backed mortgage securities. In testing for a deficiency of assets, the court should bear in mind that longer-term bond liabilities will not fall due for many years, during which time conditions may improve. This is relevant when considering directors' duties and for contractual insolvency termination events.

CRA3

**New European regulation** for credit rating agencies (CRAs) came into force on 20 June 2013. Known as CRA3, key changes include: publication of unsolicited sovereign debt ratings restricted to set dates and a maximum of three times per year; the introduction of a civil liability regime; a requirement to give issuers a full working day's prior notice of any ratings change; and mandatory rotation of rating agencies for re-securitisations every four years. There is also a clause that could extend mandatory rotation to other instruments in the future. While these changes are far less stringent than those originally put forward, they will bring important changes to the CRA industry.