"Bailing In" to Avoid a Bail Out: How new legislation is putting your money at risk

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As a result of the 2008 global financial crisis and the bailouts that resulted, Europe and the United States have been actively working to avoid future bailouts. Unfortunately, those attempts are being implemented at the expense of depositors.

In 2014, the member states of the European Union adopted the European Union Bank Recovery and Resolution Directive (BRRD) as a means to protect the financial health of, and the banking services provided by, its banks (called "EEA Financial Institutions"). By January 1, 2016, each European Union member state adopted legislation (collectively, the "Bail-In Legislation") implementing the BRRD, which ultimately gave regulators the power to restructure the liabilities of a distressed bank. The goal of the BRRD is to eliminate the risk of future taxpayer funded "bail outs" of these failing banks like what happened in 2008 by implementing the right to "bail in" the banks. Intuitively, this legislation sounds like a great fix to the hugely unpopular bank bailouts; however, as with most things, the devil is in the details. Under the BRRD, the unwary investor or bank deposit holder (customer) has become the new source of money to save these failing banks, without any recourse against the EEA Financial Institutions.

The BRRD and related Bail-In Legislation gives European bank regulators the ability to write down, modify, cancel and/or convert into equity the liabilities of a failing bank (in addition to cancelling existing shares of stock) before the bank becomes insolvent. Money that is deposited into a checking or savings account is considered an "unsecured debt" of the bank. Thus, before a bank becomes insolvent, the European regulators can simply require the bank to confiscate its customer's deposited money and convert it to shares of equity that have the potential to become worthless on the market or be tied up for years in resolution proceedings. The result is that the distressed bank's customers may very well become the largest class of unsecured creditors of the distressed bank, or worse, the largest class of shareholders of the distressed bank. Unsecured creditors and shareholders are the next to last and last, respectively, parties to be paid in bankruptcy or liquidation proceedings. Perhaps more importantly, Bail-In Legislation does not just impact deposit accounts. It also extends to lender obligations in financing transactions, including lending commitments, indemnities, confidentiality requirements and reimbursement, sharing, turnover

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and other obligations that a lender may have to a borrower by virtue of a credit facility.

This concept is currently used in all European markets so is there any reason for concern in the United States market? The answer is yes. Outside Europe, the BRRD does not automatically apply. Therefore, if a financing agreement is governed by the laws of a jurisdiction in a non-EEA country (e.g., the United States), there is a risk that a court in that jurisdiction may challenge or disregard the application of the bail-in powers of the EEA Financial Institution's resolution authority. As a result, EEA Financial Institutions are *required* to include in their non-EU law-governed (United States) contracts a so-called "contractual recognition of bail-in clause" which purports to get the parties to contractually acknowledge and agree that an EU regulator has the authority to write down, modify, cancel and/or convert into equity a financial institution's liabilities in the event the financial institution becomes insolvent. Since a failure by a covered institution to include a contractual recognition clause in a contract may lead to considerable fines and regulatory sanctions, the ability of counterparties to negotiate the contractual recognition provisions or indeed to strike them out altogether is limited.

Making matters worse, the U.S. Government is not equipped to adequately protect American. bank customers against the long-arm of the Bail-In Legislation. The Dodd-Frank Act ("Dodd Frank") even states it will "protect the American taxpayer by ending bailouts," by imposing the losses of insolvent financial companies on their common and preferred stockholders, debtholders, and other unsecured creditors (i.e., the bank customers). Adding insult to injury, even though derivatives (bets banks have made in the Wall Street casino) are exempted from liabilities that may be written down under Bail-In Legislation, Dodd Frank provides them with more protections by giving them the legal right to demand collateral to cover losses (from the FDIC) in the event of insolvency and priority to collect. As a result, to the extent a depository bank owns any derivatives, these derivative counterparties may get first dibs over the secured deposits of state and local governments, and over the unsecured bank customers. Therefore, while a customer's bank deposits are protected up to the $250,000 insurance limit by the FDIC, getting any reimbursement on a deposit claim could hinge on whether the FDIC has enough money left to pay it after paying off the super priority derivative counterparties, especially in light of the fact that the assets of the FDIC are microscopic (in the billions) compared to the valuation of outstanding derivatives (in the trillions).

In recent months, however, the U.S. Federal Reserve has promulgated a rule, known as the "total loss absorbing capacity" or "TALC requirement", that is designed to protect depositors (in ways Dodd Frank has failed to do so) by requiring the eight (8) largest financial institutions in the United States to purchase enough loss absorbing instruments (such as long term debt that could be quickly converted to equity) to minimize their risk of insolvency. However, compliance with this rule is not required to commence until January 1, 2019 and will not be fully phased in until January 1, 2022, so the bank customers will not get the benefit of this protection, if any, for some time.

So what can bank customers do to protect their investments? When dealing with an EEA Financial Institutions and their U.S. branches, or any American banks that may enter into a syndicated transaction with an EEA Financial Institution, it is important to understand the potential for risk and take appropriate steps to minimize those risks. Whether as a business customer or an individual customer, such actions may include:

1. Diversifying savings across banks and using credit unions;
2. Monitor the current and long-term financial stability of the deposit-taking bank and monitoring the bank's financial stability;
3. Avoiding banks with large derivative books and large mortgage books;
4. Monitoring terms and conditions contained in deposit and savings accounts, as well as credit agreements;
5. Monitoring government policies pertaining to banks and bank deposits and;
6. Negotiating loan documents to ensure that the lender is obligated to make the full amount of the loan, regardless of whether the lender is syndicating or participating the loan to other lenders.