Financial Institutions

Credit Research • Financial Institutions • Europe

Contributors
Pieter Fyfer
+44 20 7883 4279
pieter.fyfer@credit-suisse.com

Stephane Suchet
+44 20 7883 4278
stephane.suchet@credit-suisse.com

Atif Ali
+44 20 7883 7978
atif.ali@credit-suisse.com

EC Proposals for Resolution Regime

Implications for valuations of existing bank debt

Senior: Positive

Relative to expectations in this regard, we believe that the proposals from the EC regarding resolution regime reform are positive for existing senior debt valuations in that **only new senior debt** will be exposed to losses outside a liquidation through the debt write-down resolution tool. We believe the general expectation was that the EC proposals in this regard would be applicable to existing senior debt as well, similar to the legislation passed in Germany in December that now governs the handling of distressed banks in that country.

Subordinated: Neutral

It is unclear to us whether existing subordinated debt will be exposed to losses outside liquidation through the debt write-down resolution tool or whether it is only applicable to new debt, as is the case for senior debt. We lean towards an interpretation that it would apply to existing subordinated debt as well, which is largely in line with what market participants have expected in this regard by our reckoning. In any case, existing subordinated debt can still be exposed to losses outside a liquidation similar to those that can be achieved with the debt write-down tool under the proposed transfer powers within the suite of resolution powers.

Covered bonds: Neutral

As expected, the proposals on debt write-down state that the debt write-down resolution tool should not apply to covered bonds. The safeguards to secured liabilities regarding the implications from the transfer powers will prevent the transfer of assets against which such covered bonds are secured unless the covered bonds are also transferred.

EC Proposals for Resolution Regime

Following the publication on 20 October 2010 of a European crisis management framework for the financial sector[1], the European Commission launched a consultation on technical details underpinning the framework. The Commission intends to come forward with a legislative proposal for a comprehensive framework for dealing with failing banks before the summer of 2011 (a proposal for a directive on crisis management was originally due in spring 2011). The deadline for contributions to this consultation is 3 March 2011.

[1] See our note "EU Framework for Crisis Management in the Financial Sector: Uncertainty Remains" (21-Oct-10)

ANALYST CERTIFICATIONS AND IMPORTANT DISCLOSURES ARE IN THE DISCLOSURE APPENDIX. FOR OTHER IMPORTANT DISCLOSURES, PLEASE REFER TO https://firesearchdisclosure.credit-suisse.com.

Background and Description of the Concept

The change of resolution regimes for banks stems from regulators and politicians realising that the existing legal framework that governs the resolution of distressed banks provided limited options. The insolvency laws did not allow governments to support only certain bank activities or creditors. In other words, although governments mainly had an interest in protecting depositors and creditors that were key in the functioning of the banking system, the legal infrastructure did not allow for such preferential treatment of creditors in most countries. Additionally, the legal framework did not allow for any form of rapid restructuring of a bank's liability structure. Given the confidence sensitivity of the banks' business model, any restructuring needs to be executed very rapidly (i.e., in a matter of days) to ensure that bank operations are not permanently impaired. The bank insolvency laws in most countries did not facilitate such rapid restructuring. Given the lack of flexibility in the legal frameworks of countries in dealing with distressed banks, the governments were mainly left with the option of liquidating the entire bank or supporting the entire bank as a going concern through the provision of government funds, with governments choosing the latter route in most cases. However, the extent of such support placed a large burden on governments globally, and in Europe, it placed almost unsustainable additional pressure on the already stretched fiscal positions of some countries.

Governments and regulators thus realised during the crisis that the legal framework in dealing with distressed banks lacked flexibility and required fundamental changes to make the resolution of distressed banks more orderly and, of course, less costly from the government's perspective. This initiative is referred to as an introduction of resolution regimes and will provide governments with other options and tools in addition to the costly options of liquidation of the entire bank or the support of the entire bank as a going concern through government capital and funding support. The main formal driver behind this development is the G20, which called for the introduction of resolution regimes in their communiqué on 2 April 2009 [2] and confirmed this stance in their most recent communication on 12 November 2010[3].

The G-20 said in this regard: "We reaffirmed our view that no firm should be too big or too complicated to fail and that taxpayers should not bear the costs of resolution. We endorsed the policy framework, work processes, and timelines proposed by the FSB to reduce the moral hazard risks posed by systemically important financial institutions (SIFIs) and address the too-big-to fail problem. This requires a multi-pronged framework combining: a resolution framework and other measures to ensure that all financial institutions can be resolved safely, quickly and without destabilizing the financial system and exposing the taxpayers to the risk of loss; a requirement that SIFIs and initially in particular financial institutions that are globally systemic (G-SIFIs) should have higher loss absorbency capacity to reflect the greater risk that the failure of these firms poses to the global financial system; […] we encourage further progress on the feasibility of contingent capital and other instruments. We encouraged the FSB, BCBS and other relevant bodies to complete their remaining work in accordance with the endorsed work processes and timelines in 2011 and 2012. In addition, we agreed that G-SIFIs should be subject to a sustained process of mandatory international recovery and resolution planning."

---

2 http://www.financialstabilityboard.org/publications/r_0904c.pdf

3 http://www.g20.utoronto.ca/2010/g20seoul-doc.pdf

Consultation Paper

The **consultation paper from the EC in this regard** is organised as follows:

- Scope and Authorities;
- Supervision, Preparation and Prevention;
- Early Intervention;
- Resolution tools, powers and mechanisms and ancillary provisions;
- Group Resolution;
- Financial arrangements; and
- Annexes on debt write-down and possible changes to company law.

In this report, we focus predominantly on the resolution tools, powers and mechanisms and ancillary provisions, debt write-down and implications for bank credit valuations.

Scope and Authorities

This consultation focuses on measures for banks and investment firms. The Commission will report by the end of 2011 on appropriate measures for other kinds of financial institution, including insurers.

Supervision, Preparation and Prevention & Early Intervention

For Supervision, the EC believes **supervisory stress tests** and **enhanced supervision** should complement other reforms to reduce risks in the financial system.

The EC believes that **recovery plans** are a necessary component of an effective crisis management regime. **Intra-group financial support** allowing transfer of assets within a group, including in situations where group entities are experiencing liquidity stress is another measure.

The EC consider that **early intervention powers** should be granted to the supervisors in those cases where any credit institution does not meet the requirements of the CRD or is likely to fail to meet the requirements of the CRD. These powers will include the power to prohibit distributions by the credit institution (including payments to hybrid instruments holders); the requirement to replace board members or managing directors; the requirement for a bank to divest itself of activities or business lines that pose an excessive risk to its financial soundness, amongst others.

Resolution Tools, Powers and Mechanisms

Conditions for Resolutions

In its consultation paper, the EC mentioned three options for possible trigger conditions for resolution, which might be adopted singly or in combination.

In our view, governments, through their resolution authorities, have **a lot of discretion for the implementation of these resolution powers**.

Under Option 1, a credit institution is failing or likely to fail if one or more of the following circumstances applies:

(a) it has incurred or is likely to incur in losses that will deplete its equity;

(b) the assets of the credit institution are or are likely to be less than its obligations; or

(c) it is or is likely to be unable to pay its obligations in the normal course of business.

Under Option 2, a credit institution is failing or likely to fail if the credit institution no longer fulfils, or is likely to fail to fulfil, the financial conditions for authorization.

Under Option 3 a credit institution is failing or likely to fail if the credit institution no longer possesses, or is likely to fail to possess, sufficient Tier 1 instruments, as required under Chapter 2 of Title V of the CRD, to meet the requirements of Article 75 of the CRD.

In addition to a condition that the institution is failing or likely to fail, however this is defined, the EC suggests two supplementary conditions.

- The first is that no other measures[4] are likely to avert failure and restore the condition of the institution in a reasonable time frame. This should ensure that resolution is a "last resort."
- The second, mentioned in the EC's Communication of the 20 October 2010[5], is that the application of resolution tool is necessary in the public interest. The EC suggests that the public interest should be defined by reference to a set of resolution objectives, based on financial stability, continuity of essential services, protection of public funds and protection of depositors.

Resolution Objectives

Resolution authorities should use these powers in order to achieve certain resolution objectives. The following objectives were suggested:

(a) to ensure the continuity of essential financial services;

(b) to avoid adverse effects on financial stability, including by preventing contagion;

(c) to protect public funds; and

(d) to protect insured depositors.

Where the use of resolution tools or powers are not necessary with regard to the resolution objectives, the EC considers that a credit institution that is failing or is likely to fail should be liquidated under the applicable insolvency proceedings.

---

4 Such as fresh capital rising by the ailing institutions or asset disposal, and excluding public support measures

5 http://ec.europa.eu/internal_market/bank/docs/crisis-management/framework/com2010_579_en.pdf

General Principles Governing Resolution

The EC suggests that when applying the resolution tools and exercising the resolution powers, resolution authorities should take all appropriate measures to ensure that:

(a) shareholders first bear the losses of the credit institution;

(b) unsecured creditors bear the residual losses;

(c) where appropriate, senior management of the credit institution is replaced and bear losses in accordance with its responsibility;

(d) creditors of the same class are treated in fair and equitable manner, and no creditor incurs greater losses that would be incurred under liquidation; and

(e) interference with property rights does not contravene the European Convention on Human Rights and fundamental freedoms, including as they result from the constitutional conventions common to member states.

Resolution Tools: General

The following Resolution Tools were proposed the in the consultation paper:

(a) the sale of business tool;

(b) the bridge bank tool;

(c) the asset separation tool; and

(d) the debt write-down and the debt-to-equity conversion tool.

The use of these tools is without prejudice to the application of state aid rules, where applicable.

Sales of Business Tool

Under the sales of business tool resolution, authorities would be able to effect a sale of the credit institution or the whole or part of its assets and liabilities to one or more purchasers on commercial terms, without requiring the consent of the shareholders or complying with procedural requirements that would otherwise apply.

The process must be open, transparent, unconditional, non-discriminatory, and free from any conflict of interest and does not confer any unfair advantage on any potential acquirer. The resolution authority should establish that the sale of the business is less costly compared to alternative options (e.g., partial or total liquidation).

Bridge Bank Tool

Under this tool, resolution authorities would be able to transfer all or part of the business of the credit institution to a bridge bank.

A "bridge bank" means a company or other legal person that is wholly owned by one or more public authorities (which may include the resolution authority). It is suggested that the resolution authorities would specify the contents of the constitutional documents of the bridge bank.

Asset Separation Tool

The purpose of the asset separation tool would be to enable resolution authorities to transfer certain assets of a credit institution to an asset management vehicle for the purpose of facilitating the use or ensuring the effectiveness of another resolution tool. In this context, an "asset management vehicle" refers to a legal entity that is wholly owned by one or more public authorities (which may include the resolution authority).

The Asset Separation Tool would be used in the following way. First, in order to address concerns about moral hazard associated with the use of this tool that might otherwise arise, it should only be used in conjunction with another resolution tool. Then, the selected assets should be transferred to an asset management vehicle for fair consideration. Lastly, the resolution authority should appoint asset managers to manage the assets transferred to the asset management vehicle with the objective of maximising their value through eventual sale, while avoiding conflicts of interest, and in accordance with any other objectives imposed by the resolution authority.

Shareholders of the affected credit institution, and its creditors, should not have any rights over the asset management vehicle or it assets.

Debt Write-down Tool

The EC considers that a mechanism which that enable resolution authorities to write down the claims of some or all of the unsecured creditors of a failing institution and, possibly, to convert debt claims to equity, would offer a valuable additional resolution tool that would allow authorities greater flexibility in their response to the failure of large, complex financial institutions.

The consultation paper mentions that, “It is important to note that this consultation concerns possible future legislative changes which would be subject to a full impact assessment, appropriate transitional provisions and transitional periods of sufficient length and designed in such a way so as to avoid any market instability or unintended consequences.”

With regard to which debt might be affected, the consultation paper specifically states in this respect that: “It is **not envisaged to apply** measures ultimately adopted in this area **to any debt currently in issue** [emphasis added].”

Subsequently, the EC clarifies further its view in this respect saying that, “In addition to the power to write off equity and write down or convert subordinated debt that is outlined above, **resolution authorities could be given a statutory power, exercisable in conjunction with the core power** [emphasis added, core power referring to statutory power to write off all equity, and either write off subordinated debt or convert it into an equity claim] when an institution meets the trigger conditions for entry into resolution, to write down by a discretionary amount or convert to an equity claim, **all senior debt** [emphasis added] deemed necessary to ensure the credit institution is returned to solvency.” The EC thus intends to apply the new Debt Write-down Tool to only **new senior debt**.

Even though the EC states that the Debt Write-down Tool would not apply to “any debt currently in issue”, we think this statement might potentially only refer to senior debt. Several statements in the consultation paper suggest to us that existing subordinated debt can be impacted by the Debt Write-down Tool. First, the EC states in the document when it starts discussing the Debt Write-down Tool in more detail that, “**Resolution authorities could be given a statutory power, exercisable when an institution meets the trigger conditions for entry into resolution, to write off all equity, and either write off subordinated debt or convert it into an equity claim** [emphasis added]. However, in some cases this will not be sufficient to ensure that an institution in difficulty returns to viability so as to maintain market and creditor confidence when the markets next open.” (This suggests to us that the two alternative proposals for additional debt write-down specifically apply to new senior debt as mentioned above). Second, the EC adds that, ”An alternative [ ] would be for resolution authorities to require credit institutions to issue a fixed volume of 'bail-in able' debt which, in addition to the power to write off all equity, and either **write off existing subordinated debt** [emphasis added] or convert it into an equity claim, could written down or converted into equity on a statutory trigger.” (The reference to existing subordinated debt suggests that write-down on subordinated is not applicable only to new bonds). Last, the EC states as regards the compliance with the ranking in the capital shortfall by stating that. “ [ ] equity should be wiped out before any debt is written down, and **subordinated debt should be written down completely** [emphasis added] before senior debt holders bear any losses." (This would be impossible to adhere to if certain subordinated bonds cannot be written down).

The EC suggests two potential approaches for the Debt Write-down Tool: **1)** A "comprehensive" approach, which aims to make a broad range of senior creditors face the real risk associated with bank failure and **2)** a "targeted" approach, which aims to create a more focused tool for resolving in particular, institutions that have been assessed as likely to prove difficult to resolve with traditional resolution tools at a time of fast-moving idiosyncratic or systemic crisis.

1) As regards the comprehensive approach in addition to the power to write off equity and write down or convert subordinated debt that is outlined above, resolution authorities could be given a statutory power to write down by a discretionary amount[6] or convert to an equity claim, **all senior debt deemed necessary** to ensure the credit institution is returned to solvency.

Such a power would only apply to new debt issued (or existing debt contracts renewed or rolled over) after the power enters into force. It would be exercisable in principle in relation to all senior debt, and resolution authorities would have a discretion as to which classes of debt would be written down or converted in a particular case, the extent of the "haircut" and, where relevant, the rate of conversion.

Interestingly enough the EC states, "The exercise of that discretion might take into account, among other things the **systemic risks of writing down certain creditors** [emphasis added]." In this respect, the EC mentions some **potential exclusions**: **1)** swap; **2)** repo and derivatives counterparties and other trade creditors; **3) short-term debt** (defined by a specified maximum maturity); and **4) retail and wholesale deposits** and secured debt (including covered bonds). Although senior debt ranks equal to deposits in a liquidation under current rules in Europe, the debt write down feature will thus expose senior bondholders to losses outside a liquidation while depositors are protected.

The EC also adds, "It is also questionable whether the power could in practice be exercised to **claims that are covered by master netting agreements** [emphasis added] (even if uncollateralised). However, to prevent further withdrawal of liquidity, measures would be needed to ensure that acceleration or termination rights under excluded claims were not triggered by the use of this tool."

The EC seems to suggest that, going forward, senior bondholders could receive different payouts when the resolution regime applies. In this regard, it stated that, " [ ] it must be recognised that **a power to write down some, but not all senior debt in resolution** [emphasis added] - with some senior liabilities either excluded entirely from the regime or excluded through exercise of discretion by the resolution authority on a case-by-case basis – would subvert the normal rankings and the principle of *pari passu* treatment of creditors within the same class."

The EC goes on to say that, "to encourage the availability of funding to the newly restored institution, creditors that provided (unsecured) **funds in the period immediately following the resolution could receive temporary (or permanent) 'super senior' status** [emphasis added]."

This potential differentiated treatment among senior bondholders is in line with the proposals made by the US-based Federal Deposit Insurance Corporation (FIDC) on 12 October 2009[7]. At the time the FDIC said, "Specifically, this section [Treatment of Similarly Situated Creditors] would put creditors of a potential covered financial company on notice that bond holders of such an entity that hold **certain unsecured senior debt with a term**

6 Possibly with a fixed upper cap

7 http://www.fdic.gov/news/news/press/2010/pr10224a.pdf

of more than 360 days will not receive additional payments compared to other general creditors [emphasis added] such as general trade creditors or any general or senior liability of the covered financial company, nor will exceptions be made for favorable treatment of holders of subordinated debt, shareholders or other equity holders."

However, the EC clearly specifies that **the ranking in the capital waterfall should be respected** when the Debt Write-down Tool is used. The EC specifically states, "As a matter of principle, the design and exercise of a debt write down power should preserve as far as possible the ranking of claims on insolvency. For this reason, equity should be wiped out before any debt is written down, and subordinated debt should be written down completely before senior debt holders bear any losses."

On potential financial institutions that could be impacted by the Debt Write-down Tool **the EC seems to suggest that in all likelihood the Systematically Important Financial Institutions (SIFIs) are more likely to be impacted by the Debt Write-down Tool**. In this respect, the EC states that, "In practice, such a tool might be most useful in the case of systemically important institutions which are considered to be **'too big to fail'**, or in a generalised situation of stress where there is unlikely to be a large pool of potential third party purchasers."

Lastly, the EC seems to suggest that bonds issued under the jurisdiction of a country outside the European Union should include a clause recognizing this statutory power. They state in this respect, "To ensure that the power could be exercised effectively in relation to debt that is booked in or governed by the law of a third country, new debt issued by EU credit institutions would be required to include a clause recognising the statutory power. This contractual recognition should minimise the risk that any write down pursuant to the power would not be recognized or enforced by foreign courts."

2) For the targeted approach, the EC proposes to require credit institutions to issue a fixed volume of "bail-in able" debt, which, in addition to the power to write off all equity and either write off existing subordinated debt or convert it into an equity claim, could be written down or converted into equity on a **statutory trigger**.

Such debt would need to include a contractual term that would specify that the relevant government through its resolution authority could use a statutory power to write down the debt when the institution meets the trigger conditions for entry into resolution. The amount of the write-down or conversion rate could be either specified in the instrument, or it could be left to the discretion of the government through the resolution authorities (subject to the principle that the affected debt holder should be "no worse off than in liquidation").

The requirement could include a fixed minimum[8] for all institutions (for example as a percentage of total liabilities) and the power for authorities to increase it further in the event that resolution plans identify impediments to resolution by other means. The EC adds, "Additionally, the bulk of issuance could be **restricted solely to SIFIs** [emphasis added]."

As regards the interaction between the Debt Write-down Tool and Contingent Capital the EC states that: "More generally, enhanced regulatory requirements such as contingent capital can complement additional resolution tools by making the likelihood and impact of a resolution much smaller. In a non-zero failure regulatory regime, enhanced prevention can complement the need to be prepared with a wide set of resolution tools which adequately address the too big to fail problem. While forms of contingent capital and bail-in debt may in theory be complementary, **any coexisting regimes, if developed, would need to be coordinated** [emphasis added]." We read this statement as a mixed endorsement by the EC of contingent capital.

---

8 The public interventions during the crisis ranked between 4 and 19 per cent in terms of risk weighted assets

Resolution Powers

The EC considers that in order to apply the resolution tools, governments through their resolution authorities would need the following resolution powers[9]:

(a) the power to take control of the affected credit institution;

(b) the power to transfer shares and other instruments of ownership issued by an affected credit institution. For the purposes of this power, instruments of ownership should include instruments that confer ownership in mutual associations, instruments that are convertible into or give the right to acquire shares or instruments of ownership, instruments representing interests in shares or instrument of ownership;

(c) the power to transfer debt instruments issued by an affected credit institution. For the purposes of this power, "debt instruments" would encompass bonds and other forms of transferable debt, any instrument creating or acknowledging a debt, and instruments giving rights to acquire debt instruments;

(d) the power to transfer to another undertaking or person specified rights, assets and liabilities of a credit institution to which resolution tools are applied;

(e) the power to write off or cancel the shares or other instruments of ownership issued by the affected credit institution;

(f) the power to reduce or write off the claims of unsecured creditors of an affected credit institution;

(g) the power to convert certain debt instruments or other non-core Tier 1 instruments issued by an affected credit institution or an affiliate into shares or other instruments of ownership in that credit institution or in a parent credit institution or parent financial holding company;

(h) the power to require the conversion of debt instruments that contain a contractual term for conversion on an official action or decision that an institution is failing or that intervention by resolution authorities is or is likely to be necessary;

(i) the power to remove or replace the senior management of an affected credit institution; and

(j) the power to issue new shares.

The EC believes it is important that, subject to the provision of adequate compensation, resolution authorities should be able to exercise the resolution powers without complying with any procedural requirements, or receiving any consent from the creditors or shareholders of the credit institution to which the resolution tools are applied, that would otherwise apply by virtue of EU or national law.

We refer to b) to d) as "Transfer Powers."

[9] The powers suggested in (e) to (h) to write off shares and write down or convert debt should be available in connection with the use of all resolution tools (and are not proposed only for the purpose of the possible debt write down tool)

Safeguards

The provisions suggested in this section are intended to safeguard the interests of counterparties under netting agreements and the security rights of investors. The objective is to prevent resolution authorities from :"cherry picking" rights and liabilities under such protected arrangements. They must either all be transferred together, or not at all.

Below, we focus specifically on the safeguards for security holders, although there is protection for counterparties, financial collateral, set-off and netting arrangements, trading, clearing and settlement systems.

Appropriate protection for security arrangements

The EC considers that the appropriate safeguards for liabilities secured under a security arrangement should prevent:

- the transfer of assets against which the liability is secured unless that liability and benefit of the security are also transferred;
- the transfer of a secured liability unless the benefit of the security are also transferred;
- the transfer of the benefit unless the secured liability is also transferred; and
- the modification or termination a security arrangement through the use of ancillary powers, if the effect of that modification or termination is that the liability ceases to be secured.

Partial transfers: Compensation for third parties

An EU framework should require member states to put in place arrangements to ensure that where a resolution authority transfers some, but not all, of the property, rights or liabilities of a credit institution to another entity, creditors receive adequate compensation. This principle should apply both in the case of partial transfers from a credit institution to a bridge bank or a private sector purchaser, and partial transfers from a bridge bank to a private sector purchaser.

The compensation arrangements under consideration should include provision for the appointment of an independent valuer to determine which creditors, if any, should be paid compensation and the amount of compensation that should be paid to each such creditor. That assessment should take into account the treatment that each creditor or class of creditor would have received if the credit institution had entered insolvency at the time of (and instead of) the partial transfer being made.

Implications from Resolution Regime Reform

Resolution regimes expose bondholders to losses outside liquidation

Resolution Regime reform will enable governments to enforce losses on to bondholders in distressed banks outside of traditional liquidation through the suite of resolution tools and related powers, including involuntary debt-for-equity swaps, principal write-downs or transfers to other legal entities. We believe that the use of these tools and related parties will likely have negative consequences for bondholders, and in particular for subordinated bondholders, relative to the current status quo. During the banking crisis, and particularly in the early stages of the crisis before legal reform in this regard in countries like the UK, Germany and Ireland, bondholders were only exposed to principal losses in a liquidation of the entire bank under the combination of the current insolvency regimes (in most countries) and the terms and conditions of the bonds.

Loss of alignment of interest of bondholders with those creditors the government has an interest to protect

Although the current limited powers of governments to deal with distressed banks can be viewed as inappropriate from a taxpayer's perspective, it has benefited bondholders very materially. During the crisis, governments and regulatory authorities were left with the only option of either letting the bank collapse (e.g., Lehman Brothers) or to support the entire bank as a going concern. Supporting the entire bank as a going concern meant that bondholders, including the most subordinated bondholders, benefited very profoundly. As long as the bank remained a going concern, there was no risk of any principal loss absorption to bondholders. The combination of the legal infrastructure and the terms and conditions of the bonds did not provide the government with any rights to enforce losses to such bondholders on an involuntary basis. Expressed differently, bondholders had a very strong alignment with the interest of the creditors (like depositors and interbank creditors) that governments had a strong interest to protect.

Resolution regimes remove this alignment of interest given the powers of the government effectively to support certain operations and related creditors while leaving other creditors, particularly more junior creditors, in a position where they will absorb losses.

Likelihood of state support to a bank will be much lower post implementation of resolution regimes

The range of alternative options available to governments in dealing with distressed banks will thus result in a lower likelihood of state support to distressed banks. The above resolution tools and related transfer powers will allow the governments' considerable flexibility to deal with a distressed bank without the need to inject taxpayer funds. The government can move the creditors that it would like to protect (like depositors and interbank creditors) into a separate legal entity, leaving bondholders exposed in the original legal entity to absorb losses. Additionally, the government can create capital in the bank by reducing the principal claim of bondholders or involuntarily swapping the bondholders into equity.

Mathematical expression of the impact of resolution regimes

The equation of the cost of bank credit will thus be meaningfully affected by the introduction of resolution regimes. The extent of the impact will depend on how significant the reform will be and the extent and range of powers given to governments to deal with distressed banks. However, based on the most probable outcome for government powers under resolution regimes, the current credit equation of loss given default multiplied by the probability of default becomes somewhat redundant. This is because a default in banks could only occur in an eventual liquidation, whereas bank bondholders will also be exposed to loss absorption outside liquidation through the restructuring powers provided under the suite of tools under the new resolution regimes. We have expressed this below in Exhibit 1.

It is clear that losses on bank bonds, particularly subordinated bonds, will be much more likely given bank distress following implementation of these resolution regimes. However, it should be considered against the opposing factor that the probability of bank distress going forward will be much lower under the Basel III regulatory reform, which will ensure increased liquidity pools, better matched funding profiles and strengthened capital positions.

Exhibit 1: Function of the Cost of Bank Credit Pre and Post Resolution Regimes

Loss Profile for Bondholders Pre-Resolution Regime

[a * b]

[Probability of Default in Liquidation * Loss Given Default in Liquidation]

Currently, bank bondholders in most European countries can only absorb principal losses in a liquidation

Should Resolution Regimes be implemented, bank bondholders will be exposed to principal losses outside liquidation

Loss Profile for Bondholders Post-Resolution Regime

[a * b] + [c * d]

[Probability of Default in Liquidation * Loss Given Default in Liquidation] + [Probability of Restructuring outside a Liquidation * Loss Given Restructuring outside a Liquidation]

Source: Credit Suisse

Subordinated bondholders most exposed, probability of default no longer equal to that of senior bondholders

We believe that junior bondholders will be most negatively impacted by the introduction of resolution regimes. Junior bondholders in most countries have the benefit that it is impossible to default on junior bonds without defaulting on senior bonds. Non-payment of interest on principal of Lower Tier 2 subordinated bonds allowed the holders to commence procedures for liquidation of the entire bank. In essence, junior bondholders thus gained the most from the going support that was provided by governments to distressed banks, as these junior ranking bonds had the most to lose in the alternative to liquidation.

The resolution tools of transferring powers and debt write-down and conversion tool will allow governments to treat junior bondholders differently from other creditors. This can be done by leaving subordinated bondholders exposed in a bad bank while the rest of the creditors are transferred to a good bank that is supported as going concern. Alternatively, the haircut of principal or involuntary swaps of debt into equity will first be applied to junior bonds before senior debt will be affected. On that basis, the differentiation between senior and subordinated bonds in terms of cost of credit should no longer be purely on grounds of recovery, but also based on a higher probability of default (or loss absorbency) on subordinated debt relative to senior debt. Resolution regimes will remove the aspect of equal probability of default of subordinated bonds relative to senior bonds.

Under the EC proposals, senior bonds would also potentially have loss absorption risk outside liquidation under the debt write-down proposals. However, the debt write-down proposal is clear that subordinated debt should be fully written down (in addition to equity) before senior debt will be impacted in this regard.

Existing versus New debt

With regard to senior debt, the EC consultation paper indicates that the debt write-down resolution tool will only apply to new debt. However, it is unclear whether this is also the case for subordinated debt as explained in the section called “Debt write-down tool”.

The transfer power under the suite of Resolution powers proposed by the EC will, however, be applicable to existing and new debt. With regard to subordinated debt, loss absorption similar to that under the debt write-down tool can effectively be achieved by the transfer power. The equity and subordinated debt can be retained in the existing legal entity while all the other assets and liabilities of the bank are moved to a separate legal entity (i.e., bridge bank or “good bank”). The only safeguard based on the proposal for such bondholders would be that they would be entitled to not receive a less favorable treatment following partial transfer of assets and liabilities than what they would have received should the bank have entered insolvency. (See Partial Transfers: Compensation for third parties in this regard.) In such instance, it would not be difficult to argue successfully that sub debt would have received a recovery of zero in a liquidation given the low loss attachment point in the capital structure and hence this safeguard is thus of limited value for a subordinated bondholder. Although senior bondholders can be left in the remaining entity with the subordinated debt, the safeguard of at least a similar treatment as in liquidation is much more supportive for senior bondholders, particularly as deposits rank similar to senior debt in liquidations in most European countries.

Implications on existing valuations relative to expectations

Senior: Positive

We believe that today’s proposals from the EC regarding resolution regime reform are positive for existing senior debt valuations in that only new senior debt will be exposed to losses outside a liquidation through the debt write-down resolution tool. We believe the expectation was generally that the EC proposals in this regard would be applicable to existing senior debt as well, similar to the legislation passed in Germany in December that now governs the handling of distressed banks in that country.

This positive implication is reduced because of market participants’ general expectation that governments in Europe will, in most cases, not use powers to write down senior debt because of negative consequences for funding access for such a country’s banks. This was recently evident in Ireland in the case of Anglo Irish Bank, whereas in the UK, the government went as far as to guarantee existing senior debt in the case of Northern Rock and Bradford & Bingley.

Subordinated: Neutral

It is unclear to us whether existing subordinated debt will be exposed to losses outside a liquidation through the debt write-down resolution tool based on our read of the consultation document or whether it will only applicable to new debt, as is the case for senior debt. We lean towards an interpretation that it would apply to existing subordinated debt as well, which is largely in line with what market participants expected in this regard by our reckoning. In any case, existing subordinated debt can still be exposed to losses outside liquidation under the transfer powers under the proposed resolution powers similar to those that can be achieved with the debt write-down tool. The transfer power under the suite of proposed resolution tools and powers will apply to existing debt as well.

Covered bonds: Neutral

As expected, the proposals on debt write-down state that the debt write-down resolution tool should not apply to covered bonds. The safeguards to secured liabilities regarding implications from the transfer powers will prevent the transfer of assets against which such covered bonds are secured unless the covered bonds is also transferred.

CREDIT SUISSE

Global Credit Products - Credit Research - Europe

Ben Booth, Managing Director, Head of European Fundamental Credit Research
William Porter, Managing Director, Head of European Credit Strategy

LEVERAGED FINANCE - EUROPE

Gaming, Retail, Consumer Products, Publishing, Healthcare

Ben Booth	Managing Director	(44) 20 7888 1721

Cable, Broadcasting and Telecom

Marco Gironi	Director	(44) 20 7888 7477

Chemicals, Basic Materials, Paper & Packaging

Lisa Barash	Director	(44) 20 7888 0163

Industrials, Transportation, Services, Technology

Alex Field	Vice President	(44) 20 7888 0940

Utilities, Infrastructure, Energy

Tom Gibney	Vice President	(44) 20 7888 0326

Automotive

Hayley Walker	Director	(44) 20 7883 5569

INVESTMENT GRADE - EUROPE

Consumer Products, Retail, Autos

Hayley Walker	Director	(44) 20 7883 5569

Capital Goods, Chemicals, Energy & Pharmaceuticals

Ben Maurer	Vice President	(44) 20 7888 5045

Financial Institutions

Pieter Fyfer	Managing Director	(44) 20 7883 4279
Stephane Suchet	Vice President	(44) 20 7883 4278
Atif Ali	Associate	(44) 20 7883 7978

Telecom, Media, Technology

Madeleine King, CFA	Vice President	(44) 20 7888 4909

Industrials, Metals & Mining

Alex Field	Vice President	(44) 20 7888 0940

Utilities, Infrastructure, Real Estate

Tom Gibney, CFA,	Vice President	(44) 20 7888 0326

Credit Strategy- Europe

William Porter	Managing Director	(44) 20 7888 1207

Quantitative Credit Strategy

Helen Haworth, CFA	Vice President	(44) 20 7888 0757
Christian Schwarz	Vice President	(44) 20 7888 3161
Chiraag Somaia	Associate	(44) 20 7888 2776

CREDIT SUISSE

Disclosure Appendix

Analyst Certification

Pieter Fyfer, Stephane Suchet and Atif Ali each certify, with respect to the companies or securities that he or she analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Important Disclosures

Credit Suisse's policy is only to publish investment research that is impartial, independent, clear, fair and not misleading. For more detail, please refer to Credit Suisse's Policies for Managing Conflicts of Interest in connection with Investment Research: http://www.csfb.com/research-and-analytics/disclaimer/managing_conflicts_disclaimer.html

Credit Suisse's policy is to publish research reports as it deems appropriate, based on developments with the subject issuer, the sector or the market that may have a material impact on the research views or opinions stated herein.

The analyst(s) involved in the preparation of this research report received compensation that is based upon various factors, including Credit Suisse's total revenues, a portion of which are generated by Credit Suisse's Investment Banking and Fixed Income Divisions.

Credit Suisse may trade as principal in the securities or derivatives of the issuers that are the subject of this report.

At any point in time, Credit Suisse is likely to have significant holdings in the securities mentioned in this report.

As at the date of this report, Credit Suisse acts as a market maker or liquidity provider in the debt securities of the subject issuer(s) mentioned in this report.

For important disclosure information on securities recommended in this report, please visit the website at https://firesearchdisclosure.credit-suisse.com or call +1-212-538-7625.

For the history of any relative value trade ideas suggested by the Fixed Income research department as well as fundamental recommendations provided by the Emerging Markets Sovereign Strategy Group over the previous 12 months, please view the document at http://research-and-analytics.csfb.com/docpopup.asp?ctbdocid=330703_1_en. Credit Suisse clients with access to the Locus website may refer to http://www.credit-suisse.com/locus.

For the history of recommendations provided by Technical Analysis, please visit the website at http://www.credit-suisse.com/techanalysis.

Credit Suisse does not provide any tax advice. Any statement herein regarding any US federal tax is not intended or written to be used, and cannot be used, by any taxpayer for the purposes of avoiding any penalties.

Emerging Markets Bond Recommendation Definitions

Buy: Indicates a recommended buy on our expectation that the issue will deliver a return higher than the risk-free rate.
Sell: Indicates a recommended sell on our expectation that the issue will deliver a return lower than the risk-free rate.

Corporate Bond Fundamental Recommendation Definitions

Buy: Indicates a recommended buy on our expectation that the issue will be a top performer in its sector.
Outperform: Indicates an above-average total return performer within its sector. Bonds in this category have stable or improving credit profiles and are undervalued, or they may be weaker credits that, we believe, are cheap relative to the sector and are expected to outperform on a total-return basis. These bonds may possess price risk in a volatile environment.
Market Perform: Indicates a bond that is expected to return average performance in its sector.
Underperform: Indicates a below-average total-return performer within its sector. Bonds in this category have weak or worsening credit trends, or they may be stable credits that, we believe, are overvalued or rich relative to the sector.
Sell: Indicates a recommended sell on the expectation that the issue will be among the poor performers in its sector.
Restricted: In certain circumstances, Credit Suisse policy and/or applicable law and regulations preclude certain types of communications, including an investment recommendation, during the course of Credit Suisse's engagement in an investment banking transaction and in certain other circumstances.
Not Rated: Credit Suisse Global Credit Research or Global Leveraged Finance Research covers the issuer but currently does not offer an investment view on the subject issue.
Not Covered: Neither Credit Suisse Global Credit Research nor Global Leveraged Finance Research covers the issuer or offers an investment view on the issuer or any securities related to it. Any communication from Research on securities or companies that Credit Suisse does not cover is factual or a reasonable, non-material deduction based on an analysis of publicly available information.

Corporate Bond Risk Category Definitions

In addition to the recommendation, each issue may have a risk category indicating that it is an appropriate holding for an "average" high yield investor, designated as **Market**, or that it has a higher or lower risk profile, designated as **Speculative** and **Conservative**, respectively.

Credit Suisse Credit Rating Definitions

Credit Suisse may assign rating opinions to investment-grade and crossover issuers. Ratings are based on our assessment of a company's creditworthiness and are not recommendations to buy or sell a security. The ratings scale (AAA, AA, A, BBB, BB, B) is dependent on our assessment of an issuer's ability to meet its financial commitments in a timely manner. Within each category, creditworthiness is further detailed with a scale of High, Mid, or Low – with High being the strongest sub-category rating: **High AAA, Mid AAA, Low AAA** – obligor's capacity to meet its financial commitments is extremely strong; **High AA, Mid AA, Low AA** – obligor's capacity to meet its financial commitments is very strong; **High A, Mid A, Low A** – obligor's capacity to meet its financial commitments is strong; **High BBB, Mid BBB, Low BBB** – obligor's capacity to meet its financial commitments is adequate, but adverse economic/operating/financial circumstances are more likely to lead to a weakened capacity to meet its obligations; **High BB, Mid BB, Low BB** – obligations have speculative characteristics and are subject to substantial credit risk; **High B, Mid B, Low B** – obligor's capacity to meet its financial commitments is very weak and highly vulnerable to adverse economic, operating, and financial circumstances; **High CCC, Mid CCC, Low CCC** – obligor's capacity to meet its financial commitments is extremely weak and is dependent on favorable economic, operating, and financial circumstances. Credit Suisse's rating opinions do not necessarily correlate with those of the rating agencies.

CREDIT SUISSE

Credit Suisse's Distribution of Global Credit Research Recommendations* (and Banking Clients)

	Global Recommendation Distribution**	
Buy	3%	(of which 100% are banking clients)
Outperform	37%	(of which 96% are banking clients)
Market Perform	31%	(of which 95% are banking clients)
Underperform	27%	(of which 96% are banking clients)
Sell	2%	(of which 95% are banking clients)

*Data are as at the end of the previous calendar quarter.
**Percentages do not include securities on the firm's Restricted List and might not total 100% as a result of rounding.

References in this report to Credit Suisse include all of the subsidiaries and affiliates of Credit Suisse AG operating under its investment banking division. For more information on our structure, please use the following link: https://www.credit-suisse.com/who_we_are/en/.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Credit Suisse AG or its affiliates ("CS") to any registration or licensing requirement within such jurisdiction. All material presented in this report, unless specifically indicated otherwise, is under copyright to CS. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior express written permission of CS. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of CS or its affiliates.

The information, tools and material presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. CS may not have taken any steps to ensure that the securities referred to in this report are suitable for any particular investor. CS will not treat recipients of this report as its customers by virtue of their receiving this report. The investments and services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about such investments or investment services. Nothing in this report constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal recommendation to you. CS does not advise on the tax consequences of investments and you are advised to contact an independent tax adviser. Please note in particular that the bases and levels of taxation may change.

Information and opinions presented in this report have been obtained or derived from sources believed by CS to be reliable, but CS makes no representation as to their accuracy or completeness. CS accepts no liability for loss arising from the use of the material presented in this report, except that this exclusion of liability does not apply to the extent that such liability arises under specific statutes or regulations applicable to CS. This report is not to be relied upon in substitution for the exercise of independent judgment. CS may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and CS is under no obligation to ensure that such other reports are brought to the attention of any recipient of this report.

CS may, to the extent permitted by law, participate or invest in financing transactions with the issuer(s) of the securities referred to in this report, perform services for or solicit business from such issuers, and/or have a position or holding, or other material interest, or effect transactions, in such securities or options thereon, or other investments related thereto. In addition, it may make markets in the securities mentioned in the material presented in this report. CS may have, within the last three years, served as manager or co-manager of a public offering of securities for, or currently may make a primary market in issues of, any or all of the entities mentioned in this report or may be providing, or have provided within the previous 12 months, significant advice or investment services in relation to the investment concerned or a related investment. Additional information is, subject to duties of confidentiality, available on request. Some investments referred to in this report will be offered solely by a single entity and in the case of some investments solely by CS, or an associate of CS or CS may be the only market maker in such investments.

Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information, opinions and estimates contained in this report reflect a judgement at its original date of publication by CS and are subject to change without notice. The price, value of and income from any of the securities or financial instruments mentioned in this report can fall as well as rise. The value of securities and financial instruments is subject to exchange rate fluctuation that may have a positive or adverse effect on the price or income of such securities or financial instruments. Investors in securities such as ADR's, the values of which are influenced by currency volatility, effectively assume this risk.

Structured securities are complex instruments, typically involve a high degree of risk and are intended for sale only to sophisticated investors who are capable of understanding and assuming the risks involved. The market value of any structured security may be affected by changes in economic, financial and political factors (including, but not limited to, spot and forward interest and exchange rates), time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Any investor interested in purchasing a structured product should conduct their own investigation and analysis of the product and consult with their own professional advisers as to the risks involved in making such a purchase.

Some investments discussed in this report may have a high level of volatility. High volatility investments may experience sudden and large falls in their value causing losses when that investment is realised. Those losses may equal your original investment. Indeed, in the case of some investments the potential losses may exceed the amount of initial investment and, in such circumstances, you may be required to pay more money to support those losses. Income yields from investments may fluctuate and, in consequence, initial capital paid to make the investment may be used as part of that income yield. Some investments may not be readily realisable and it may be difficult to sell or realise those investments, similarly it may prove difficult for you to obtain reliable information about the value, or risks, to which such an investment is exposed.

This report may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the report refers to website material of CS, CS has not reviewed any such site and takes no responsibility for the content contained therein. Such address or hyperlink (including addresses or hyperlinks to CS's own website material) is provided solely for your convenience and information and the content of any such website does not in any way form part of this document. Accessing such website or following such link through this report or CS's website shall be at your own risk.

This report is issued and distributed in Europe (except Switzerland) by Credit Suisse Securities (Europe) Limited, One Cabot Square, London E14 4QJ, England, which is regulated in the United Kingdom by The Financial Services Authority ("FSA"). This report is being distributed in Germany by Credit Suisse Securities (Europe) Limited Niederlassung Frankfurt am Main regulated by the Bundesanstalt fuer Finanzdienstleistungsaufsicht ("BaFin"). This report is being distributed in the United States and Canada by Credit Suisse Securities (USA) LLC; in Switzerland by Credit Suisse AG; in Brazil by Banco de Investimentos Credit Suisse (Brasil) S.A; in Mexico by Banco Credit Suisse (México), S.A. (transactions related to the securities mentioned in this report will only be effected in compliance with applicable regulation); in Japan by Credit Suisse Securities (Japan) Limited, Financial Instruments Firm, Director-General of Kanto Local Finance Bureau (*Kinsho*) No. 66, a member of Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Securities Investment Advisers Association; elsewhere in Asia/ Pacific by whichever of the following is the appropriately authorised entity in the relevant jurisdiction: Credit Suisse (Hong Kong) Limited, Credit Suisse Equities (Australia) Limited, Credit Suisse Securities (Thailand) Limited, Credit Suisse Securities (Malaysia) Sdn Bhd, Credit Suisse AG, Singapore Branch, and elsewhere in the world by the relevant authorised affiliate of the above. Research on Taiwanese securities produced by Credit Suisse AG, Taipei Branch has been prepared by a registered Senior Business Person. Research provided to residents of Malaysia is authorised by the Head of Research for Credit Suisse Securities (Malaysia) Sdn Bhd, to whom they should direct any queries on +603 2723 2020. This research may not conform to Canadian disclosure requirements.

In jurisdictions where CS is not already registered or licensed to trade in securities, transactions will only be effected in accordance with applicable securities legislation, which will vary from jurisdiction to jurisdiction and may require that the trade be made in accordance with applicable exemptions from registration or licensing requirements. Non-U.S. customers wishing to effect a transaction should contact a CS entity in their local jurisdiction unless governing law permits otherwise. U.S. customers wishing to effect a transaction should do so only by contacting a representative at Credit Suisse Securities (USA) LLC in the U.S.

This material is not for distribution to retail clients and is directed exclusively at Credit Suisse's market professional and institutional clients. Recipients who are not market professional or institutional investor clients of CS should seek the advice of their independent financial advisor prior to taking any investment decision based on this report or for any necessary explanation of its contents. This research may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA or in respect of which the protections of the FSA for private customers and/or the UK compensation scheme may not be available, and further details as to where this may be the case are available upon request in respect of this report.

CS may provide various services to US municipal entities or obligated persons ("municipalities"), including suggesting individual transactions or trades and entering into such transactions. Any services CS provides to municipalities are not viewed as "advice" within the meaning of Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. CS is providing any such services and related information solely on an arm's length basis and not as an advisor or fiduciary to the municipality. In connection with the provision of the any such services, there is no agreement, direct or indirect, between any municipality (including the officials, management, employees or agents thereof) and CS for CS to provide advice to the municipality. Municipalities should consult with their financial, accounting and legal advisors regarding any such services provided by CS. In addition, CS is not acting for direct or indirect compensation to solicit the municipality on behalf of an unaffiliated broker, dealer, municipal securities dealer, municipal advisor, or investment adviser for the purpose of obtaining or retaining an engagement by the municipality for or in connection with Municipal Financial Products, the issuance of municipal securities, or of an investment adviser to provide investment advisory services to or on behalf of the municipality.

Copyright © 2011 CREDIT SUISSE GROUP AG and/or its affiliates. All rights reserved.

Investment principal on bonds can be eroded depending on sale price or market price. In addition, there are bonds on which investment principal can be eroded due to changes in redemption amounts. Care is required when investing in such instruments.

When you purchase non-listed Japanese fixed income securities (Japanese government bonds, Japanese municipal bonds, Japanese government guaranteed bonds, Japanese corporate bonds) from CS as a seller, you will be requested to pay purchase price only.