

Bail-in Mechanism as Applied to Deposits of Individuals in Russia

The press last week resumed discussions of the possibility of launching the bail-in mechanism in Russia. What triggered the mass media's passions was a proposal by the Ministry of Finance to introduce bail-in procedures for depositors in troubled banks, whose deposits were in excess of 100 million Russian rubles each.¹

In accordance with the working papers of the Financial Stability Board (set up by the G20 countries in 2009, with representatives of their national financial institutions sitting on the Board's supervisory council), all the member countries agreed to bring their banking laws in line with the unified bank liquidation and resolution rules (bail-in procedures) in the framework of Smart Money global monetary reform project².

The concept essentially implies incorporation of the bail-in mechanism in national legislations of the member countries and exemption of the priority of the bail-out concept currently in force in Russia (whereby bank "saving" functions are in fact discharged by the state represented by DIA³, with the state's liability limit per natural person determined as being 1.4 million Russian rubles⁴). For example, the amount of an insurance claim payment in the United States is \$250,000 and in the European Union, €100,000 (under the general rule)⁵.

The bail-in mechanism implies an involuntary conversion ("seizure") of third-priority creditor claims⁶ into subordinated loans⁷ (*whereby the depositor becomes the bank's long-term creditor (for no less than five years), with no chance of early repayment*) or the bank's charter capital fund (*with the depositor becoming the bank's shareholder*).

A precedent of using a similar institute in Russia already exists – resolution of Tavrishesky Bank became possible, as two of its major clients, Lenenergo and the North-Western Interregional Distribution Grid Company, had agreed to have their assets (ca. 12.7 billion Russian rubles, in aggregate) converted into

¹ Cm.: http://www.minfin.ru/ru/press-center/?id_4=34366&area_id=4&page_id=2119&popup=Y

² http://www.fsb.org/wp-content/uploads/r_111104cc.pdf?page_moved=1

³ Deposit Insurance Agency.

⁴ Article 11, Paragraph 2, of the Federal Law "On Insurance of Deposits of Natural Persons in the Banks of the Russian Federation."

⁵ In the European Union, the bail-in mechanism has been in effect since 01 January 2016. The mechanism will be operational in relation to banks and major investment firms accepting deposits from private individuals. The procedure implies the writing off of obligations to shareholders and subsequent conversion into equity capital of obligations to bondholders and holders of major deposits worth over €100,000 each. Smaller deposits are guaranteed by the government. The government will only get involved in resolution of banks following involvement therein of their shareholders and creditors.

⁶ According to Article 189.92, Paragraph 6, of Federal Law No. 127-FZ "On Insolvency (Bankruptcy)," dated 26 October 2002, claims of natural persons, who are deemed to be the creditors of a lending institution under bank deposit contracts and/or bank account contracts concluded therewith, to be compensated for losses resulting from foregone benefit and financial sanctions shall be treated as creditors' claims satisfied as a matter of third priority.

⁷ According to Article 25.1 of Federal Law No. 395-1 "On Banks and Banking Activity," dated 02 December 1990, a *subordinated credit* (deposit, loan, bonded loan) shall be understood to mean that credit (deposit, loan, bonded loan) which at all times meets all of the following requirements: (a) it has been issued/made for an indefinite term or for a term of no less than 5 years; (b) the creditor shall have the right to require repayment of the credit and payment of interest and to terminate the contract prematurely; (c) the bank shall have the right to refuse unilaterally to pay interest ([provided that] such right is expressly referred to in the contract [with the bank]); and (d) the debt may be converted into or exchanged for the bank's common shares ([provided that] such right is expressly referred to in the contract [with the bank]).

subordinated loans for a term of 20 years⁸. It ought to be noted here that this was not a fully-fledged bail-in procedure as seen by the FSB and yet it is so far the only precedent in Russian practice.

Russian legislation offers no tools for the use of bail-in procedures. For example, there is no concept of "bridge bank" (to which the problem bank transfers its assets for the period of bank resolution) and no legislative procedure for conversion of deposits into securities.

However, conversion of claims under subordinated loans into bank shares in the event of the bank's resolution is currently accessible under the condition that such a possibility has been incorporated in an agreement with the bank⁹. The rule will not apply automatically and forcefully, as is characteristic of bail-in.

Dividends received by an organization on banks' common shares acquired as a result of such permutation or conversion shall not be treated as incomes in determining the tax base for the purposes of profit tax (Article 251, Clause 52, of the Tax Code of the Russian Federation). Nor is any similar provision prescribed at the present time by the Tax Code of the Russian Federation in respect of incomes subject to personal income tax.¹⁰

Considering that no draft amendments to relevant legislative acts have been published as yet, legal risks for depositors can hardly be objectively assessed. Even so, one can safely presume that those depositors who have been forcefully turned into shareholders will be held liable for the obligations of their banks in distress, having not been involved in the making of their decisions which led to adverse financial consequences, if no special exemptions in this field are put firmly in place. The emerging tendency observed in 2015 was inherent in the upgrading of penalties imposed on participants / shareholders for the business activities of their respective organizations (the most prominent cases in this respect being Case No. A40-119763/10¹¹ of "former senator S.V. Pugachev," as well as Case No. A07-20425/2012¹²).

At a conference of the International Association of Deposit Insurers in October 2012, the head of the Bank of England described the position of the UK Central Bank, according to which, *"given that a banking group may be operating across lots of regions and jurisdictions, the national authorities will coordinate parallel bail-ins for parts of the banking group."*¹³

This means that the depositors of any international bank in Russia bear the risks of losing their uninsured deposits if the bail-in mechanism is launched, for example, in the primary bank in the UK. In any such case, the restructuring of the bank's balance sheets in the UK will involve the assets of such bank in Russia placed into correspondent accounts, which will be converted into bank-to-bank credits (loans) and debt securities of the "parent" institutions of such bank in the UK. If the restructuring of

⁸ <http://www.banki.ru/news/lenta/?id=7803538>

⁹ Article 25.1 of Federal Law No. 395-1 "On Banks and Banking Activity," dated 02 December 1990.

¹⁰ Which is an indirect indication of the fact that the applicable law provisions are geared to legal persons.

¹¹ See: <http://kad.arbitr.ru/Card/5df88f77-b521-492e-aea6-6be11b422f0c>

¹² <http://kad.arbitr.ru/Card/39aab072-0369-48ed-936e-c8b05acb7216>

¹³ See: "From Bail-outs to Bail-ins: Risks and Ramifications," page 9, Goldcore Limited

http://cdn2.hubspot.net/hub/233034/file-425589122-pdf/Ebook_PDF_Uploads_2013/From_Bail_Outs_To_Bail_Ins_Risks_and_Ramifications_International_Edition.pdf?t=1393502290000&submissionGuid=2ee45ca5-68bf-451e-9220-b37a587b5440

the foreign “parent” bank results in substantial losses of the Russian “subsidiary” bank, the Bank of Russia will have to resort to resolution measures, something that may lead to conversion of uninsured deposits of Russian depositors into the shares of the Russian subsidiary bank.

The most glaring and resonating example of using the bail-in mechanism was posed by measures taken in the framework of the financial crisis which broke out in Cyprus in March 2013 to put the country's banking system on the verge of default.

On 22 March 2013, the Parliament of Cyprus promulgated Law 17(1)/2013, which laid grounds for decrees on debiting funds from deposit accounts.

Following the implementation of the decrees on debiting funds from deposit accounts, about 4,000 depositors in Laiki Bank and the Bank of Cyprus filed applications with the Supreme Court, asking for reversal of the aforesaid decrees, above all, because of their unconstitutional and discriminating nature, the lack of the appropriate situation analysis by the Central Bank of Cyprus and the Republic [of Cyprus], and on other grounds.

At its plenary session in the summer of 2013, the Supreme Court of Cyprus, by a majority vote (of 7 to 2), turned down the appeals as unacceptable on grounds that the debiting of funds from deposit accounts was a matter falling within the competence of private law, rather than public law. The Court referred to the fact that since the matter in question was about the banks' contractual obligations to their respective depositors, the latter should file civil law suits on their own with district courts of Cyprus first against the banks and then against the Republic of Cyprus. Such position was virtually upheld by the European Court in relation to the Eurogroup.

As a result, tens of thousands of deposit holders in Laiki Bank and the Bank of Cyprus, including a large number of Russians, received bank shares of all sorts in exchange for part of funds on their deposit accounts. In particular, the Cypriot authorities forcefully exchanged 47.5% of deposits in excess of € 100,000 each into bank shares.

In the UK, the bail-in mechanism was introduced in 2013 by the Financial Services (Banking Reform) Act 2013¹⁴. Nevertheless, the UK Government admits that the mechanism should be perpetually improved and that subordinate legislation should be amended accordingly on the basis of international experience¹⁵.

The United States in 2010 adopted the Dodd-Frank law prescribing the rules for resolving lending institutions in reliance on bail-in. One of the major tasks the law is expected to cope with is to avert the threat posed by companies which are too big to go bankrupt (commonly referred to as “companies too big to fail,” which the government has to save in a crisis anyway in order to preclude catastrophic consequences for the country's economy)¹⁶.

¹⁴ <http://www.legislation.gov.uk/ukpga/2013/33/introduction/enacted>

¹⁵ <https://www.gov.uk/government/consultations/bail-in-powers-implementation-including-draft-secondary-legislation/bail-in-powers-implementation>

¹⁶ <https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412somm.pdf>



According to different estimates, the introduction of the bail-in mechanism may occur no sooner than the second half of 2017.