Bank Bail-ins in International Investment Law

- Exposé -

1. Background

A financial crisis is often accompanied by a banking crisis. Any effort to constrain the adverse effects of a financial crisis on the economy will usually require government intervention. This is especially true for the financial sector, where the failure of a major financial institution (often referred to as ‘too-big-to-fail’ or ‘TBTF’) can severely affect other market participants and threaten overall financial stability.

Since insolvency is not an option for TBTF financial institutions, governments have been forced to rescue TBTF entities with taxpayer funds in order to restore their viability.¹ When governments injected billions into the financial sector in order to save ailing banks during the 2008 global financial crisis, the banks’ shareholders and creditors (especially bondholders) were generally not required to contribute and even profited from the government bailout at the expense of the taxpayer. This has encouraged financial institutions to undertake high risk and excessive leverage, and also created a moral hazard problem.²

Critical voices have since called for the participation or ‘bail-in’ of creditors in such rescue operations. A bail-in allows regulators to write off claims of creditors of a failing institution and convert debt into equity, while setting a hierarchy of claims amongst creditors. In short, bail-ins achieve the purpose of minimizing the costs of saving failing institutions for taxpayers by shifting the burden to shareholders and certain groups of creditors (e.g. bondholders). Under such a regime, even uninsured depositors may be required to bail-in. The impact on public finances is significantly reduced or even eliminated.

In this regard the Financial Stability Board has developed regulatory proposals in 2011 to provide a framework to

“make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make

¹ See Paul Melashenko, A template for recapitalizing too-big-to-fail banks, BIS Quarterly review, June 2013, p. 25.
it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation.”

Several legislative proposals providing for bail-in measures have since been made in different jurisdictions, such as the EU Bank Recovery and Resolution Directive ("BRRD") or the U.S. Dodd-Frank Act. In Austria, the government recently decided to liquidate the Bank Hypo Alpe Adria, and enacted legislation that requires the participation of the bank’s bondholders.

The 2013 Cyprus Financial Crisis can be described as the prototype of a full-scale bail-in: the government transferred selected claims and assets from Laiki Bank to Bank of Cyprus, and converted creditor claims at Bank of Cyprus into equity. This included senior unsecured debt and even deposits, which did not even receive the same debt to equity conversion rates. At least one international arbitration, initiated by a group of Greek investors against Cyprus, is already pending.

Although the concept of bail-ins is a relative novelty, it has the potential to significantly affect the legal rights of market participants under both domestic and international law.

2. Area of research

The central focus of the dissertation shall be the extent to which bail-in measures may conflict with obligations under investment treaties and whether and how they may entail State responsibility.

The dissertation will first describe the measures typically available to regulators as well as the relevant economic and legal background. Primary sources shall be past examples of government intervention, recent legislation, as well as relevant case law.

The dissertation will then analyze such measures in the context of international investment law. Specifically, the dissertation will analyze jurisdictional and procedural aspects of investment treaty claims based on bail-in measures and the investment treaty protections that may be invoked.

2.1. Jurisdiction and Admissibility:

A number of procedural questions emerge when pursuing claims against the state under international investment law. Regarding claims by bondholders or shareholders, the complexities of a global financial system pose a challenge with regard to the jurisdictional requirements of rationae personae, rationae materiae or rationae loci (e.g. bonds issued in jurisdictions other than the host state).

Since debt instruments such as bonds or loans constitute portfolio investments, the question is whether these instruments are protected under the provisions typically found in relevant BITs or FTAs and under the ICSID Convention.

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3 Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.

4 Stavros A. Zenios, Fairness and Reflexivity in the Cyprus Bail-In, p. 14.

5 Marfin Investment Group v. The Republic of Cyprus, ICSID Case No. ARB/13/27

2.2. **Standards of treatment**

Standards of treatment shall not be analyzed in the context of a particular treaty, but under the general standards commonly found in BITs.

**Expropriation**

One of the central questions with regard to bail-in measures is whether international investment law would consider such acts expropriatory or whether the state was legitimately exercising its lawful right to regulate in the public interest.\(^7\)

In the course of a bail-in of a failing institution, former shareholders are usually expropriated, whereas in other cases even depositors and bondholders can be subject to measures of expropriation. Since a bail-in does not involve a transfer of property to the state or a third party\(^8\), the question is whether it amounts to indirect expropriation or a measure tantamount to expropriation. The loss of a bondholder is incurred before a formal insolvency proceeding is initiated. Even if such acts were considered lawful, the question remains whether and to what extent the state is liable to pay compensation. Especially in the case of bail-ins, this is an important economic question for policy makers, since the *raison d’être* of a bail-in is to eliminate costs for the taxpayer.

Moreover, bail-in measures are usually guided by the principle that no creditor should be worse off than if the bank went into bankruptcy.\(^9\) This raises the question as to whether the state is required to pay compensation if the creditors and shareholders of an insolvent institution would have received little or nothing in the event of bankruptcy. With respect to the requirement of causation, it is doubtful whether it can be established that the damage was caused by the intervening state, or whether it would have occurred without the state’s intervention.\(^10\)

Many tribunals employ the discounted cash flow method\(^11\) when calculating quantum, which also raises the question how much an investor could have still expected from a failing institution. In this respect, it would be inequitable to compensate a bondholder with the face value of a bond in an ailing institution, considering that he would only have been able to obtain a fraction of its nominal value on the market.

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\(^7\) The *Saluka* tribunal ruled that a state is not liable to pay compensation when “in the normal exercise of their regulatory powers, they adopt in a non-discriminatory manner bona fide regulations that are aimed at the general welfare.”, see *Saluka Investments B.V. v. The Czech Republic*, UNCITRAL, Partial Award, 17 March 2006, para 255.


\(^10\) See also *Sapphire International Petroleum Ltd v National Iranian Oil Co*, where the arbitrator held that ‘the object of damages is to place the party […] in the same pecuniary position that they would have been in if the contract had been performed […]’, *Sapphire International Petroleum Ltd v National Iranian Oil Co* (1963) 35 ILR 136.

It is also unclear whether the ‘fair market value’ can be claimed if public interest considerations have been adequately taken into account.\textsuperscript{12} Most likely, one must distinguish between damages attributable to macro-economic causes and those attributable to conduct of the state.\textsuperscript{13}

Another question is what conduct can be expected of stakeholders of a failing institution and whether such conduct may amount to own shortcomings on the part of the investor and reduce payable compensation.\textsuperscript{14}

\textbf{Fair and equitable treatment}

Commonly, FET standards guarantee the protection of legitimate expectations and the application of a fair decision-making process.\textsuperscript{15} The latter prohibits discrimination and a lack of transparency.

Generally, the complexity of restructurings makes it difficult or impossible to treat all stakeholders equally, which provides a basis for a possible discrimination claim. In a cross-border bank restructuring process, which is almost inevitable with large financial conglomerates, the difficulties faced by a regulator will almost certainly lead to unequal treatment between different creditors and other stakeholders.\textsuperscript{16} In this respect, certain provisions in the BRRD allow for an exclusion of certain classes of creditors.\textsuperscript{17} Moreover, the BRRD provides that the Deposit Guarantee Scheme (a deposit insurance scheme financed by all market participants) may be bailed-in as well, which imposes costs of such rescues on actors not directly connected to the failing institution.\textsuperscript{18}

Bank restructurings are often implemented over a single weekend, in order to minimize the impact on the market. The question is whether such a procedure fulfills the requirements of due process and transparency commonly required under FET standards. Often, it is impossible to obtain the consent of all shareholders, let alone of all creditors of the institution in the process of a swift restructuring.

A provocative question is to what extent investors can ‘legitimately’ expect the government to intervene and bail-in an institution. In this regard it also important to analyze how legitimate expectations are influenced by recent legislative developments. There also exists a fine line between losses caused by the government and those caused by bad business judgment.\textsuperscript{19}

\begin{thebibliography}{99}
\bibitem{13} Ibid, p. 13.
\bibitem{14} See \textit{Bogdanov v Moldova}, Final Arbitral Award of 30 March 2010, para 5.2.
\bibitem{17} See Art. 44 BRRD.
\bibitem{19} See \textit{Maffezini v Spain}, Award of 13 Nov 2000, ICSID Case No. ARB/97/7, para 432.
\end{thebibliography}
National treatment

The preferential treatment of domestic institutions, which is common to bank restructuring measures, is very likely to violate standards of national treatment. In the 2008 Iceland financial crisis, the government transferred domestic depositors to new ‘good banks’, while leaving the claims of foreign depositors with the failed ‘bad bank’. This treatment is common, since governments usually protect their domestic industries and constituents, but raises serious questions of national treatment.

MFN

Although some BITs contain carve-out clauses for the financial sector, a most-favored nation clause may afford claimants better treatment if the host country has concluded other BITs without such carve-out clauses.

Protection and Security

Under one view, a state may be obliged to provide a stable legal system as part of its duties of full protection and security, which may apply to financial stability concerns as well.

3. Schedule

For planning purposes, I will divide my dissertation into two parts. Part I will deal with the historic background and the economic aspects of bailouts and bail-ins, including recent legislative developments. Part II will consist of the legal analysis. I intend to complete Part I by the end of 2015, and focus on Part II in 2016. I intend to finalize the dissertation by the end of 2016. The dissertation will be financed by myself.

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