Association for Financial Markets in Europe

Contractual recognition of bail-in: article 55 BRRD

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Executive summary

AFME continues to be very concerned about the impact of article 55 of the Bank Recovery and Resolution Directive ("BRRD") which requires banks to insert contractual provisions giving effect to bail-in in a very broad range of liabilities governed by third country law.

We consider that statutory recognition of resolution is the preferred approach to ensure legal certainty and a level playing field for banks internationally. While we support the objective of article 55, which provides an interim solution to cross-border recognition, the current scope creates a number of significant issues which need to be resolved.

The scope of article 55 is very broad and includes liabilities that are highly unlikely to be bailed-in and where there will be very significant challenges to including contractual recognition provisions (e.g. liabilities of an operational nature, contingent liabilities and liabilities to financial markets infrastructure). To date there has been no substantive impact analysis in relation to article 55.

This note highlights our concerns and proposes a solution which would provide the authorities with the necessary comfort that contractual recognition will be applied where necessary to ensure that a bank is resolvable.

We propose that the scope of article 55 is revised as part of the review of the minimum requirement for eligible liabilities and own funds ("MREL") under the BRRD to align it with the guidance of the Financial Stability Board ("FSB"). This would ensure that contractual recognition provisions would be included in all liabilities that are eligible for MREL (and in due course TLAC), all other debt instruments and any additional liabilities identified by the resolution authority to ensure that the bank is resolvable.

In the meantime, as discussed further below, a pragmatic approach should be adopted as to how article 55 will be applied in practice and where waivers may be appropriate. Absent these changes, we fear that article 55 could have an adverse impact on the ability of European banks to compete in global markets and be applied differently between member states.

Background and the international context

AFME supports the objective of ensuring that bail-in is effective in relation to liabilities governed by foreign law. We are very supportive of the work of the FSB in this area to develop guidance on the cross-border recognition of resolution action.[1] A global approach is required to this global issue. This is particularly

[1] FSB Consultative Document "Cross-border recognition of resolution action", 27 September 2014.

important in relation to contractual recognition requirements where inconsistencies in approach could severely impact the competitiveness of banks in global markets.

As proposed by the FSB, the preferred approach to ensuring cross-border recognition of resolution actions should be through the implementation of statutory recognition and support mechanisms as required by the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions ("Key Attributes") or cross-border agreements. The G7 has also recently reiterated the need for enhanced cross-border cooperation in resolution.[2] Until such mechanisms are put in place, contractual solutions to recognition in debt instruments can be helpful.[3]

The industry is committed to achieving the objective of credible cross-border resolution and has, for example, worked with the FSB in developing the ISDA Resolution Stay Protocol. AFME is also developing model clauses which could be included in debt instruments to give contractual recognition to bail-in. Nevertheless, acknowledging that this is an interim solution, we consider that a proportionate approach with careful cost/benefit analysis is required.

Scope of contractual recognition requirements

Article 55 BRRD requires European firms to include provisions in agreements creating liabilities governed by the law of a jurisdiction outside the EU to give contractual recognition to the application of the bail-in tool. The requirement applies from 1 January 2016 at the latest, although some Member States have implemented it earlier. The requirement applies to all liabilities other than:

a) liabilities that are expressly excluded from bail-in under article 44(2) BRRD or are deposits held by individuals or SMEs that are specified in article 108(a) BRRD; and
b) liabilities issued or entered into before the requirement is implemented.

The scope of article 55 is significantly broader than the proposed FSB guidance that contractual recognition requirements should apply to "debt instruments" and be evaluated through the resolvability assessment process. This extended scope beyond that proposed at the international level has a significant impact on European banks, which is considered below.

Impact of article 55 requirements

Article 55 requires European banks to include contractual recognition provisions in a broad scope of contracts, including those relating to:

- operational liabilities such as supplier agreements of minimal value;
- contingent liabilities eg letters of credit, guarantees and indemnities; and
- membership of clearing and settlement systems outside the EU[4].

Banks are unable to unilaterally impose contractual terms in relation to many of these categories of liabilities and face significant difficulties in complying with article 55 by 1 January 2016. Counterparties often lack the ability to amend contracts or their standard terms of business, for example due to fiduciary duties not to accept such amendments. These difficulties were seen in the challenges with obtaining buy-side adherence to the ISDA

[2] See G7 Summit Leaders Declaration, 7-8 June 2015: https://www.g7germany.de/Content/EN/_Anlagen/G7/2015-06-08-g7-abschluss-eng_en.pdf?__blob=publicationFile&v=1

[3] See the joint GFMA and IIF response to the FSB Consultation Paper, available at http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=12152.

[4] Article 44(2)(f) only excludes liabilities to systems or operators of systems designated under Directive 98/26/EC (Settlement Finality Directive).

Resolution Stay Protocol. However, they are even more challenging in relation to article 55 where European requirements depart from the international standard and a globally consistent approach is required.

It is highly unlikely that financial markets infrastructure (FMI) outside the EU will agree to rewrite their rules to accommodate the contractual recognition requirement, at least without regulatory support in the FMI's host jurisdiction. However, the absence of contractual recognition should not create an obstacle to the firm's resolvability. Indeed, in practice liabilities to an FMI are highly likely to be excluded from bail-in to ensure that the bank maintains its critical functions.

Difficulties also arise in the context of other types of contracts governing operational liabilities which cannot be readily negotiated. These could include contracts with foreign public authorities and those which are governed by standard terms under local law (eg local purchases of land, leases, purchases and rental of equipment or supplies, car rental, flights, hotel rooms, utilities etc.).

Compliance is particularly challenging in relation to liabilities which are connected to the financing of international trade, such as letters of credit, bank guarantees and performance bonds. The terms governing trade finance are often not between the bank and the beneficiary to whom the liability will be owed and the beneficiary is not the client of the bank. Contingent liabilities - for example under letters of credit - are generally not recorded as liabilities on the balance sheet or viewed as part of the loss absorbing capacity of the institution. Including contingent trade obligations within the scope of article 55 could cause disruption in the financing of cross-border trade transactions. In practice, contingent liabilities are unlikely to be bailed in because of their contingent nature and their uncertain value.

Challenges also arise in relation to liabilities that are documented through SWIFT messages, are agreed verbally (such as spot currency payment vs delivery obligations) or arise under market conventions which would be difficult to amend.

Many other counterparties lack the incentive or the understanding to agree to revised terms, particularly in jurisdictions which are unfamiliar with the concept of bail-in and where non-EU banks operating in the jurisdiction do not require such provisions.

Finally, there are also aspects of article 55 which are contrary to the principle set out in the Key Attributes[5] that creditors should be treated equally regardless of their nationality, for example the exclusions from bail-in for liabilities to EU FMIs which do not apply to FMIs outside the EU.

To conclude, the scope of the requirements raises a number of significant practical and legal issues which are likely to adversely impact the ability of European banks to access markets and do business outside the EU. For example it could restrict European banks from participating in clearing, payment and settlement systems in third countries.

AFME's members are therefore very concerned about the impact of these requirements to include contractual recognition provisions in such a broad range of contracts governed by non-EU law, materially departing from the internationally agreed approach and without any proportionality requirement or impact assessment.

This is a significant problem in terms of its importance and its scope. A sample of just 6 banks identified a total of 230 branches of EU institutions located in 47 different non-EU jurisdictions. Customers of these branches are likely to be affected as their contracts will, most likely, be governed by local law. The number of jurisdictions to be addressed is indicative of the scale of the issues and in addition to business conducted through branches, EU institutions have significant other contracts governed by non-EU law which will also have to be considered.

To date there has been no substantive analysis of the impact of the requirements under article 55. Neither the Commission's proposal for the BRRD nor the EBA's draft Regulatory Technical Standards under article 55(3) were accompanied by substantive impact analysis, despite the responses of stakeholders summarised in the

[5] See Key Attribute 7.4.

Commission's BRRD impact assessment highlighting "major concerns over the practicality of this measure" and that international agreement on recognition would be "more effective".[6]

Achieving the right balance

It should be recognised that the preference, as stated by the FSB, should be for a statutory or cross-border cooperation agreement solution to cross-border recognition and that a contractual approach, while helpful, should be balanced in its application.

We suggest that the focus of contractual recognition requirements should be to ensure the credibility and feasibility of the resolution plan. Liabilities governed by non-EU law which are likely to bear losses should be considered in the context of the resolvability assessment rather than a blanket requirement applicable to every liability that could theoretically be bailed in. We propose that this could be achieved by aligning the requirement under article 55 with the FSB's proposed scope, namely debt instruments.

This proposal would mean that the scope would include (save where the resolution authority is satisfied that recognition can be achieved under the law of the third country or a binding agreement):

a) all liabilities that are eligible for MREL (or TLAC once implemented) which are governed by non-EU law;
b) all debt instruments which are governed by non-EU law; and
c) any additional liabilities identified by the resolution authority where the absence of contractual recognition requirements creates an impediment to resolvability.

This approach would enable resolution authorities to be satisfied that all firms are resolvable without imposing an undue burden on them and bring the EU in line with global standards.

We appreciate that implementing the above proposal would involve amendments to the BRRD. We propose that this is considered as part of the review of MREL under article 45. In the meantime, we suggest that a pragmatic approach is adopted to the application of article 55 such that it is viewed as part of the resolvability assessment process and that compliance should be focused on ensuring that any absence of contractual recognition provisions does not create a substantive impediment to resolvability. Appropriate waivers should be provided where necessary to support this approach.

Continuing to pursue statutory recognition

The EU, FSB and national authorities should encourage other jurisdictions to introduce powers to recognise and give effect to EU resolution in those jurisdictions, similar to the power to recognise and enforce third country resolution proceedings under article 94 of the BRRD or through cross-border agreements as contemplated in article 93 BRRD. These efforts should support the implementation of the Key Attributes. This is important to support a global approach to resolution and cross border cooperation and the implementation of recognition powers in the major jurisdictions would go a long way towards solving these issues.

[6] European Commission Impact Assessment, 6 June 2012, Annex XVIII, page 246, available at: http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_assessment_final_en.pdf