
Bank Recovery and Resolution Directive Requirements for the contractual recognition of bail-in

17 April 2014

Introduction

This note sets out AFME's views on the important issue of the requirements under Article 50¹ of the Bank Recovery and Resolution Directive ("BRRD") for contracts governing certain liabilities to contain contractual provisions giving effect to bail-in.

We understand the objective of ensuring that bail-in is effective in writing down or converting eligible liabilities and could not be successfully challenged in a foreign court. This will increase the credibility of bail-in and reduce NCWOL issues that could arise from some creditors within a class not being converted or written down. We support the requirement in Article 39(2a) to ensure that in order to be eligible to count towards the minimum requirement for own funds and liabilities ("MREL"), the resolution authority must be satisfied that bail-in would be effective in respect of any liabilities governed by third country law ("Third Country Liabilities"). This reflects the fact that a key characteristic of MREL is to be loss absorbing.

However, the application of Article 50 beyond MREL requires careful consideration as it gives rise to a number of practical and legal difficulties. A balance needs to be struck between the objective of ensuring that bail-in will be effective in respect of all Third Country Liabilities and the difficulties with achieving this objective. The need to exclude certain liabilities from the requirements of Article 50 is recognized in the level 1 text and the technical standards under Article 50 should address the scope of the necessary exclusions. Absent appropriate exclusions, the ability of European banks to conduct business and compete in third countries could be adversely affected. For example it could restrict the ability of European banks from participating in clearing, payment and settlement systems in third countries.

It should also be kept in mind that the exclusion of Third Country Liabilities from the requirements of Article 50 does not mean that bail-in will necessarily be ineffective in respect of those liabilities. Recognition of bail-in can also be achieved through mutual recognition procedures as required by the FSB Key Attributes.² This could involve the statutory or common law recognition of the EU resolution and/or the use of equivalent local resolution powers to support the resolution and achieve the same effect.

Uncertainties in the scope of Article 50

The scope of Article 50 excludes liabilities which are excluded from bail-in under Article 38(2)³ and deposits of natural persons and SMEs which are eligible for EU deposit insurance or would be eligible but for being made

¹ Article 55 of the renumbered text post the jurist linguist process.

² Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, Key Attribute 7.5.

³ Article 44(2) of the renumbered text post the jurist linguist process.

through a branch outside the EU. The precise scope of these exclusions is unclear in some respects and should be clarified under the RTS. For example:

- It is unclear precisely which contracts fall within the scope of the exemption under Article 38(2)(f)(ii) for the provision of goods or services that are critical to the daily functioning of operations.
- It is unclear whether some of the exclusions under Article 38(2) apply to certain liabilities in third countries by virtue of the definitions used. For example the exclusions of short-term liabilities to institutions and payments systems may not include institutions and systems in third countries. We note that any distinction between creditors on national grounds goes against the FSB Key Attributes and could create obstacles to cross-border cooperation.

The obligation to include contractual recognition provisions is also limited to liabilities that are “issued or entered into after the date of entry into force of bail-in”. This should be clarified to confirm the treatment of, for example new deposits on existing accounts, new transactions under a master agreement, revolving credit facilities etc where additional liabilities might be created under pre-existing contractual arrangements.

The cut-off date for new liabilities under Article 50(1)(d) should also be clarified to confirm that it applies to contracts issued or entered into after the date from which the relevant Member State applies the provisions adopted to implement Section 5 of Chapter III of Title IV of the BRRD and that the reference to “entry into force” as opposed to transposition/implementation should not be interpreted as being a reference to any other date.

Obstacles to the inclusion of contractual recognition provisions

A number of further difficulties arise in respect of certain Third Country Liabilities where it might be impossible or impracticable for banks to require contractual recognition provisions to be introduced. For example:

- Contracts for membership of clearing, payment, settlement and trading systems in third countries whose rules are governed by local law and are not capable of negotiation. In practice this has the perverse incentive for European banks to trade bilaterally as they will be unable to access all central markets.
- Some types of contracts cannot be readily negotiated. These could include contracts with foreign public authorities and contracts which are governed by standard terms under local law, eg local purchases of land, leases, purchases and rental of equipment or supplies, car rental, hotel rooms, utilities etc. While some of these would be likely to be excluded under Article 38(2), the lack of certainty could require banks to insert such terms as a matter of caution.

The requirements of Article 50 could therefore restrict European banks from providing certain functions in third countries.

Finally, it should be confirmed that Article 50 does not apply to Third Country Liabilities which do not arise from a contract, such as liabilities arising from statute or tort. Clearly as there are no contractual provisions governing such liabilities, banks are unable to insert contractual recognition provisions to govern them.

Achieving the right balance

Absent appropriate exclusions, the ability of European banks to conduct business and compete in third countries could be adversely affected. It should be recognized that Europe is more advanced than some other

countries in the implementation of its resolution regime. The markets in some third countries are also less developed in their understanding of bail-in and contractual provisions may take time to be accepted in these markets. Accordingly there will be a period of time where the requirements under Article 50 are likely to lead to EU banks being disadvantaged in comparison to their peers in third countries. This is an issue that could be addressed by aligning Europe's implementation timeline for compliance with Article 50 with other G20 countries. This could be done by narrowing the scope of the exclusions from Article 50 over time, for example starting by applying Article 50 to liabilities to be included in MREL and phasing in the requirements for other liabilities.

The scope of the exclusions should address the difficulties outlined above. We suggest that this could be done through a combination of the following in the RTS:

- a) clarifying, to the extent possible, the scope of the exclusions under Article 50(1)(a);
- b) clarifying how the limitation to "new" liabilities should be applied;
- c) excluding contracts with public authorities;
- d) excluding contracts on standard terms which are not set by the bank, or at least qualifying the obligation on the bank to include such terms. For example the bank could be required to use its reasonable endeavours to include the contractual provision in such contracts;
- e) introducing a materiality threshold or at least a *de minimus* value on the liability so that the requirement would only apply to substantial liabilities eg those in excess of €5,000;
- f) clarifying that non-contractual liabilities are excluded from the scope of Article 50; and
- g) phasing in the requirements to start with broader exclusions and narrowing the exclusions over time.

As recognized in the level 1 text, the scope of Article 50 should also reflect progress in achieving international agreements and mutual recognition procedures to give statutory recognition of resolution in third countries. For key jurisdictions this could be dealt with under bilateral agreements and included in institution-specific cross-border cooperation agreements and group resolution plans.

The EU and national authorities should encourage other jurisdictions to introduce powers to recognize and give effect to EU resolution in those jurisdictions, similar to the power to recognize and enforce third country resolution proceedings under Article 85 of the BRRD. These efforts should build upon the progress made in the recognition of cross-border insolvency proceedings and the doctrine of comity. This is important to support a global approach to resolution and cross border cooperation. Contractual recognition provisions will only ever go so far – both in terms of some liabilities having to be excluded and in the scope of those provisions being limited to giving effect only to the write down or conversion and not necessarily other resolution actions or, for example the stay on termination. It is also unclear whether law firms in all third countries would be able to provide sufficiently certain legal opinions on the enforceability of the contractual provisions. They are not therefore a substitute for international recognition.

Wording of contractual recognition provisions

We note that the EBA is also tasked with producing the wording of the contractual provision to be included pursuant to Article 50. We suggest that while it should be possible to develop key elements of a template clause, any provision will need to be tailored to the particular contract to ensure that it is effective under the applicable governing law. Therefore while some guidance would be welcome, we do not expect that it will be possible to develop a "one size fits all" provision that would be effective in all jurisdictions.