**Association for Financial Markets in Europe**

# Article 55 of the BRRD

## Why it matters, and why changes are needed

June 2017


**Executive Summary**

- There are a number of significant practical challenges with the current requirement under Article 55 BRRD.

- The Commission proposal seeks to reduce these by introducing a power to waive the requirement in certain circumstances.

- We propose a simple, clear scope of application to all liabilities eligible for MREL and any others required to ensure resolvability. This would provide a clear, proportionate approach while achieving the objective of resolvability.

- We also suggest a number of amendments required to the proposed waiver regime to make it effective.


### Introduction

This paper explains the background to the requirements for the contractual recognition of bail-in under Article 55 of the Bank Recovery and Resolution Directive (BRRD), the practical difficulties which the Commission's proposed changes seek to address, and AFME's[1] proposals for a workable framework that ensures resolvability in a cross-border context while minimising the practical challenges for implementation.

### What is 'Article 55' and why does it matter?

Following the financial crisis, the European Union introduced the BRRD to protect taxpayers from future bank failures. This legislation put in place an effective framework for the recovery and resolution of banks, for the purpose of avoiding publicly funded 'bail-outs', and broader economic disruption. One of the tools under the BRRD is the "bail-in" tool which allows resolution authorities to pass losses to a bank's creditors through the write-down or conversion of liabilities to absorb losses and recapitalise the bank, enabling its critical economic functions to continue.

Article 55 supports the bail-in tool by requiring banks to include clauses in contracts governed by third country law to ensure that liabilities under these contracts can be effectively written down or converted if necessary. This is known as "contractual recognition of bail-in" and plays an important role in ensuring resolvability, at least until a statutory framework for cross-border recognition is put in place in all key jurisdictions.[2] The need for contractual terms recognising bail-in and other resolution actions arises from the

[1] The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is listed on the EU Transparency Register, registration number 65110063986-76.

[2] As the Financial Stability Board has acknowledged, a statutory recognition framework should be the preferred goal. See FSB 'Consultative Document on cross-border recognition of resolution action' – 29 September 2014 - http://www.fsb.org/wp-content/uploads/c_140929.pdf


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lack of statutory cross-border recognition frameworks between the EU and other key jurisdictions and efforts should continue to put these in place.

Article 55 of the BRRD requires the inclusion of a contractual recognition clause in a very broad scope of agreements governed by non-EU law. The scope includes new contracts that create liabilities that are not excluded from bail-in[3] or are retail deposits, and existing contracts (again not including those contracts excluded from bail-in) to the extent that they give rise to new liabilities.

As such, Article 55 is an important part of the framework to ensure bail-in works on a cross-border basis until statutory cross-border recognition is achieved. Many EU banks issue debt instruments governed by the law of a third country. If a challenge to the bail-in of debt instruments issued by an EU bank governed by New York law, for example, were upheld – because a New York court refused to recognise the actions of an EU resolution authority in respect of the New York law governed liabilities – then this may lead to an unequal treatment to holders of similar instruments here in the EU. As a result of this the EU needs a clear and harmonised requirement for such contractual recognition.

The importance of ensuring the effectiveness of bail-in for liabilities eligible for the loss absorbing capacity requirements (the "Minimum Requirement for own funds and Eligible Liabilities" or "MREL") is also recognised in Article 45 (5) of the BRRD. This gives resolution authorities the power to require institutions to demonstrate that the resolution authority can give effect to a write-down or conversion of the applicable liability where it is governed by third-country law. If the resolution authority is not satisfied of this, the liability shall not be eligible for MREL. However, the scope of Article 55 goes significantly beyond MREL to include a broad range of other liabilities, including those, which in practice, are extremely unlikely to ever be bailed-in under any circumstances. Moreover, as discussed below, despite very substantial efforts by the industry to implement Article 55, a number of practical difficulties have arisen from the current requirements under Article 55. These have been recognised by many resolution authorities, Member States, the EBA and the European Commission.

### How has Article 55 been implemented to date?

The requirement under Article 55 came into effect on 1 January 2016. Individual firms and industry associations have undertaken an extensive exercise to ensure that firms comply with its requirements, for the purpose of enhancing resolvability. AFME has developed model clauses for debt instruments and 'other liabilities' to help banks meet the requirement[4]; and ISDA has developed a protocol to which banks and their counterparties may adhere to in order to amend their respective Master Agreements to include cross-border recognition of resolution (however, the accession rate by banks' counterparties to this protocol is not as high as the banks had expected). Much resource has gone into ensuring the requirements are met wherever

[3] **Article 44 of the BRRD sets out the exclusions to bail-in.** Liabilities excluded from the bail-in tool include covered deposits, secured liabilities including covered bonds (as well as liabilities in the form of financial instruments used for hedging purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to covered bonds). Also excluded are client assets and client money held on behalf of Undertakings for Collective Investment in Transferable Securities (UCITS) or Alternative Investment Funds (AIFs), provided that such a client is protected under the applicable insolvency law. Any liability that arises by virtue of a fiduciary relationship between the institution and another person (as beneficiary) provided that such a beneficiary is protected under the applicable insolvency or civil law is also excluded from bail-in. Liabilities to institutions with an original maturity of less than seven days (not including entities that are part of the same group) are excluded, as are such liabilities owed to payment systems, operators of payment systems, or their participants arising from the participation in such a system. Various other liabilities are excluded, including some liabilities to employees, commercial or trade creditors (i.e. in so far as they provide goods and services that are critical to the daily functioning of the firm's operations), tax and social security authorities, and deposit guarantee schemes.

[4] **AFME** https://www.afme.eu/globalassets/downloads/standard-forms-and-documents/afme-model-clauses-for-contractual-recognition-of-bail-in.pdf

practicable. However, as evidenced by the different experiences of firms in trying to apply the contractual terms, more needs to be done to provide for a proportionate and clear requirement.

As discussed further below, a number of significant challenges have become clear that have led to different approaches being taken across the EU as Member States and resolution authorities have recognised a number of challenges with the implementation of Article 55. As Directives are not directly applicable and require transposition in Member States' national laws, implementing the requirement as currently set out in the BRRD has led to some confusion with regards to its exact scope, waivers by some authorities on the grounds of impracticability, and a far from harmonised approach across the EU.

These differences in approach, combined with the fact that the exact scope of Article 55 is unclear, has led some overseas counterparties to infer, incorrectly, that the proposed inclusion of a contractual clause in an agreement setting out a given bank's liabilities suggests that those liabilities are more likely to be bailed in in the event of a resolution than liabilities of a similar nature of a different bank. It has proven difficult to explain, in practice, the differences in scope of bail-in, Article 55, and MREL to global counterparties. This has a knock-on-effect for wider EU competitiveness globally and in some cases may limit the ability for EU firms to conduct certain business activities or provide certain services without being in breach of the requirement.

The European Banking Authority (EBA) in their interim report on the implementation of the requirements under the BRRD[5] highlighted Article 55 as an area that requires further attention:

*"The EBA's provisional view is that some reduction of the burden of compliance with third country recognition requirements is necessary. This could be achieved by narrowing the scope of the requirement while maintaining the effectiveness of contractual recognition for MREL liabilities".*

In France, the Sapin II Law, containing, among other measures, an amendment to the French transposition of Article 55 in the French Code Monétaire et Financier was published on 12 December 2016. This brought the French transposition of Article 55 in line with Article 55 of the BRRD by removing certain drafting issues in the original text, and more importantly introduced the requirement that (i) a proportionate approach should be taken by a resolution authority in applying the contractual recognition requirements under Article 55, and (ii) the resolution authority may suggest a timetable for the application of the requirement to various liabilities.

The Federal Agency for Financial Market Stabilisation (FMSA) in Germany has also published a 'Common understanding'[6] related to the obligations under Article 55. Within this the FMSA point to criteria that could be used to help prioritise the implementation of contractual recognition clauses, including whether the instruments in question would be eligible for the purposes of MREL, given the difficulties acknowledged in meeting the requirement. A number of other jurisdictions have adopted similar arrangements.

The Prudential Regulation Authority (PRA) in the UK, has modified the requirement for contractual recognition of bail-in[7], by allowing banks to determine that bail-in language should be excluded on the grounds

[5] **EBA** 'Interim report on MREL, report on implementation and design of the MREL framework' – 19 July 2016 - https://www.eba.europa.eu/documents/10180/1360107/EBA+Interim+report+on+MREL

[6] **FMSA** 'Common understanding on the implementation of the obligations under Article 55 and 60a German Recovery and Resolution Act' – 1 February 2016 - https://www.fmsa.de/export/sites/standard/downloads/sonstige/FMSA-DK-Gemeinsames-Verstaendnis-19-02-2016-AnlageBdB-Info.pdf

[7] **PRA** 'modification by consent of contractual recognition of bail-in rules 1.2 & 2.1' – 29 June 2016 - http://www.bankofengland.co.uk/pra/Documents/authorisations/waiverscrr/modbyconbailin20160629.pdf
Also see PRA Policy Statement 1/15 http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps115.pdf

of impracticability for certain classes of liabilities. Such liabilities include liabilities to financial market infrastructures, trade finance, and cases of illegality. This has since been established on a more permanent basis in the PRA rules such that an application for a waiver is no longer required[8]. This issue was also highlighted by HM Treasury in their response to the European Commission's Call for Evidence[9].

**What have been the practical difficulties in implementing Article 55?**

In taking forward the requirement as it currently applies in the existing BRRD, firms have encountered several problems. These relate to the ability of the firm to agree with counterparties the necessary changes to contractual terms that provides formal recognition from the counterparty that the liability that the contract concerns may be written-down and/or converted to common equity in the event of a resolution.

In some cases the contract is not bilaterally negotiated and cannot therefore be amended, for example trade finance instruments (letters of credit, performance guarantees etc.) are invariably issued subject to globally recognised rules that are in practice non-negotiable because they are accepted without amendments the world over. Another example includes contracts surrounding a firm's membership of financial market infrastructure.

Agreements that are subject to standard terms and conditions that the bank would not be permitted to change and may not provide any meaningful or material sum to facilitate a bail-in, such as hotel room bookings, are also within scope of Article 55.

In addition to this there may also be cases where particular challenges are faced where local regulatory authorities are resistant to any change in contractual terms along the lines required by Article 55. One such example being uninsured corporate deposits of a branch of a bank outside the EEA where such deposits are governed by local law. Other examples are the inclusion of relevant contractual provisions in agreements relating to liabilities owed to governmental entities, and where the inclusion of such a contractual clause would be deemed illegal under local law or render the provision or contract void.

In other cases the liability is not specifically excluded in the BRRD but is not something that could be bailed-in due to the lack of a monetizable value, for example contingent liabilities that only exist once a pre-determined event occurs, such as a breach of contract. Contingent liabilities are common in trade finance activities as many instruments are provided to assure a beneficiary of an independent irrevocable promise to pay. A bail-in clause undermines confidence in this promise and creates a perception that payment is uncertain, which will have an undesirable impact on international trade. Other examples of non-monetizable liabilities outside of trade finance include guarantees or indemnity provisions in placement agreements.

These few examples highlight the problems with the existing requirement in the broad scope of application, the lack of consideration to the materiality of contracts, and the absence of waivers where firms are unable to amend the contractual documentation. Together these comprise what is often referred to as the impracticability of the existing requirement.

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[8] **PRA** PRA Rulebook: CRR Firms and Non-Authorised Persons: "Contractual Recognition of Bail-In Instrument 2015 9PRA 2015/5) - http://www.prarulebook.co.uk/rulebook/Content/Part/211722/31-05-2017

[9] **HM Treasury** 'Response to the EU Commission: Call for evidence on EU regulatory framework for financial services' – February 2016 - https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/496887/PU1903_HMT_response_to_EU_consultation.pdf (see page 41)

**What can be done to address the problems with Article 55?**

The majority of the issues discussed above arise from the current scope of Article 55. At present the article only excludes certain liabilities from its requirement, with no regard to the applicability or appropriateness of bail-in with respect to the relevant liability. This produces situations in which the application of Article 55 is either impossible or illogical, and in which banks must devote significant resources to understanding and implementing the requirement with little to no benefit to resolvability. For example, should a hotel room booked in Hong Kong need to have its own contractual clause inserted into any terms and conditions to acknowledge that the cost of a booking beyond the point of cancellation may need to be bailed-in were a resolution to occur?

To address this, and as the EBA has stated, our preference would be to narrow the scope of the requirement to 'MREL' liabilities – i.e. liabilities deemed eligible to count towards an institution's Minimum Requirement for own funds and Eligible Liabilities (the amount of liabilities authorities will require institutions to hold in order to give effect to the resolution of an institution). Authorities would retain discretion under Article 17 of the BRRD to require contractual recognition clauses to be included in agreements for other specific liabilities on a case by case basis if that is necessary to ensure resolvability. This would provide greater clarity to banks as to the liabilities that must include contractual recognition clauses, as well as providing greater transparency to creditors. Limiting the scope to these instruments would ensure effective resolution can take place with regard to non-EU law governed liabilities that are eligible to meet the BRRD's own criteria of what a bank must hold to make sure that an effective resolution can take place.

A benefit of this approach is that it provides a clear and consistent scope for Article 55 and does not limit the possibility for further instruments to be required to include contractual recognition of bail-in. The reason for this is that resolution authorities already have the power (under Article 17) to require such recognition in agreements where they feel it is necessary to fulfil the resolution objectives, and where not including such contractual recognition is an impediment to the resolvability of the bank (for example to ensure that the 'no creditor worse off than in liquidation' principle can be adhered to in case of a resolution). Therefore, what the EBA suggests does not restrict the ability of resolution authorities to go beyond such an amended scope of Article 55, and so would not detrimentally impact the resolvability of the relevant institutions.

Were Article 55 to be amended such that the scope were limited to MREL eligible liabilities issued under third-country law, notwithstanding the ability for this scope to be expanded where resolution authorities require it, banks across the EU would have a clear, proportionate, practicable and unambiguous requirement to comply with[10].

In doing so, the burden for complying with the obligations under Article 55 will be reduced, as firms would not have to focus resources on investigating whether certain contracts require amendment, and on including bail-in language in tens of thousands of contracts that will have limited or no effect on resolvability. The full roll-out of contractual recognition could be achieved sooner as a result of having a clearer and more easily communicated requirement that non-EU counterparties are more likely to accept. The global competitiveness of EU firms, and the confidence of global counterparties in EU firms and resolution authorities, would be protected.

[10] Amendments reflecting this approach are available in the attached annex 1.

Critically, banks would continue to be required to hold enough liabilities that can be bailed-in to give effect to a resolution that meets the resolution objectives. By amending Article 55 such that its scope includes only MREL eligible liabilities and those liabilities where the resolution authority deems it necessary to ensure there are no impediments to the resolvability of the firm, this outcome is not undermined; in fact, it is strengthened. If Article 55 were to be amended as we propose, EU banks would have the clarity they require as to their obligations under the article, whilst creditors will also have increased transparency as to their risks in case of an insolvency or resolution event.

**What has the Commission proposed?**

Having observed the need for Article 55 of the BRRD to be amended, in light of the difficulties with the current requirements, the Commission has proposed changes to Article 55[11]. The proposed amendments provide resolution authorities across the EU with a power to waive the requirement in limited circumstances where the application is deemed legally, contractually, or economically impracticable.

However, the Commission's proposal does not solve the problems outlined above, and introduces further conditionality on any waiver being permitted that makes the application of waivers difficult and compromises the effectiveness of this solution in cases where it is most needed.

Looking further into the three conditions that must all be met before a waiver can apply we can see this solution is unworkable and itself impractical. The conditions are: (a) the need for statutory cross-border recognition to already be in place; (b) that it is 'legally, contractually or economically impracticable' for the contractual clause to be included; and (c) that the provision of the waiver does not impede resolvability. In addition to these conditions the liabilities must also be senior to MREL liabilities in order for a waiver to be applied. A further notable restriction is that the broad category of 'debt instruments which are unsecured liabilities' has been precluded from receiving a waiver.

Taking first the requirement that statutory cross-border recognition be in place; these agreements are not in place, meaning that waivers would not be available until they are put in place. Whilst these agreements should be the ultimate end-goal (as previously shown from the FSB's view on the topic) they are not currently there to be relied upon and it appears unlikely that they will be reached in the short to medium term. This condition is in stark contrast to the objective of the amendments to Article 55, as it nullifies any potential benefits of the amendments to Article 55 in the short to medium term.

In the second, where the insertion of the clause needs to be deemed impracticable, this is welcome. However, the terms 'legally, contractually or economically' are not defined and would be the subject of Regulatory Technical Standards, to be drafted by the EBA. It is unclear what purpose such qualification serves. If the qualification remains it would be important to ensure that the RTS defines concepts sufficiently broadly so as to mitigate the challenges discussed above, but also with sufficient certainty so as to limit differing approaches across the EU.

[11] **European Commission** proposal amending Directive 2014/59/EU – November 23 2016 – (page 40 to 42): http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0852&from=EN

The requirement that the application of the waiver not impede the resolvability of a firm is understood and welcomed. We do not advocate for a solution that would otherwise impede resolvability, and support this as a condition should an approach involving waivers be taken forward.

Where the liabilities need to be senior to MREL liabilities, we see that this is overly restrictive for many European institutions, the reason being that MREL liabilities are not in all cases required to be subordinated in the creditor hierarchy to other liabilities that may need to benefit from a waiver. This restriction would prevent the application of a waiver to any senior liabilities where a bank has any eligible liabilities that are not fully subordinated. As such, the liabilities that have proved impracticable to amend under the current Article 55 will not be subject to a waiver and the existing issues will not be resolved.

The proposal also seeks to exclude the application of waivers to 'debt instruments which are unsecured liabilities'. We do not believe that it is necessary or appropriate to restrict resolution authorities from applying the waiver to debt instruments that are unsecured liabilities. The definition of debt instruments is very broad and this restriction in applying the waiver would be overly burdensome. The scope of the definition does not only apply to bonds, but also includes instruments acknowledging a debt. In certain jurisdictions, the inclusion of contractual recognition clauses in debt instrument agreements has been just as impracticable as for other types of contracts. If debt instruments are excluded, and thus the necessary waivers cannot be granted, in order for the firm to be compliant with the requirements under the BRRD its branches would have to end parts or all of its local business in certain jurisdictions as local funding (often attracted through various forms of unsecured funding transactions, with limited or no alternatives) can no longer be relied upon. Whilst it is welcome that the Commission has acknowledged the current problems with Article 55, this solution of partially waiving the requirement in cases of impracticability, as it stands, is not workable and may have other knock-on effects that need to be considered.

One of these may be the different application of waivers from different resolution authorities in different ways. To ensure a level playing field for all EU firms subject to this requirement, it would be preferable to pursue an approach as discussed above – applying a common scope enveloping only MREL eligible liabilities and those where the resolution authority deems it necessary to ensure there are no impediments to the resolvability of the firm. This will ensure an equal basis from which every firm can work from, and leaves open the possibility of the requirement to be applied further where necessary for the effective application of a resolution strategy.

**Improving on a waiver-based approach**

Considering the approach that has been proposed by the Commission, we are mindful that in the absence of any move to reduce the scope of liabilities (as preferred), the very least that should be taken forward are amendments that ensure appropriate conditions are attached to the proposed waivers to ensure that they are workable and address the practical issues discussed above. This should be with a view to ensuring that:

i) impracticability is suitably accommodated for – to effectively address the existing problems that have been identified with the application of the existing Article 55 requirements;

ii) waivers are easy to apply and approve where relevant conditions are met – to minimise the administrative burdens on both firms applying any waiver and for the relevant authorities approving the use of them. A general permission to provide waivers could be applied for and, where approved, granted to firms to make sure that there is no delay that could affect the provision of services and therefore the competitiveness of EU banks; and,

iii) the conditionality criteria are proportionate and in line with the wider MREL framework – to ensure that banks are not penalised or treated differently with respect to their size or the specifics of their MREL requirement.

As such AFME's specific proposed amendments to achieve these objectives are included at the end of the attached annex 2. These address the key concerns with the proposal as set out previously, in addition to more technical concerns.

Beyond the current proposed text, efforts should also be made to ensure key principles are upheld, specifically the application of waivers in an equal manner to ensure a level playing field for firms that are subject to the requirement. This means that the applicability of any waivers should not be determined by, for example, the size of the firm – i.e. banks that operate cross-border, or are themselves deemed a Globally Systemic Important Institution (GSII), should not be excluded from any waivers, as they are the very institutions that are most likely to be facing the difficulties highlighted.

The form in which firms are required to meet their MREL should also not exclude them from applying waivers – i.e. where subordination of MREL is not required waivers should still be permissible on liabilities that are *pari passu* to MREL liabilities. Moreover, provided that this does not impede the objective of resolvability, we believe the broad category of 'debt instruments that are unsecured liabilities' should not be generally excluded. Otherwise this excludes any remedy to the current problems for many firms.

If it is decided not to limit the scope of Article 55 as we propose, it will be important to ensure that changes to the proposed waiver are made in order to provide a workable solution.

**Concluding remarks**

The issues that institutions have faced in applying the requirements under Article 55 are widely acknowledged. The potential impacts of not having a workable requirement under Article 55 are far reaching; not only impacting on the effective application of cross-border resolution actions, but also the competitiveness of EU banks globally. It is important that their ability to provide the services that facilitate job creation and economic growth are not hampered by unnecessary or disproportionate requirements. It is therefore paramount that a sensible, proportionate, and workable solution is delivered to support resolution authorities in having certainty in their ability to write-down and convert cross-border liabilities in a way that minimises the impact on the operation of affected institutions. To this end we have provided two sets of amendments in the attached annexes setting out the necessary changes to bring about our preferred approach, and also those amendments that would help improve the approach set out in the Commission's proposal.

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**Notes:**

1. AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu.
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