Clients&FriendsMemo

Contractual Recognition of Bail-In – Are You Ready?

15 December 2015

Background

The aim of the EU Bank Recovery and Resolution Directive (the "**BRRD**")[1] is to establish a framework for the recovery and resolution of EU credit institutions and significant investment firms and to equip EU national authorities with harmonised powers and tools to tackle financial crises at such institutions and firms. These powers and tools include preparatory and preventative measures[2], early supervisory intervention[3] and resolution. One of the resolution tools is the "bail-in" tool which enables EU national authorities to recapitalise in-scope entities or reduce the principal amount of, or to convert to equity, in-scope liabilities.

To secure the effective use of the bail-in tool by EU national authorities in respect of in-scope liabilities governed by the law of a non-EU member state (a "**third country**")[4], Article 55(1) of the BRRD requires EU national authorities to require in-scope entities to include a contractual term in instruments creating such liabilities under which the counterparty recognises such liabilities may be subject to bail-in and agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation.

Article 55(3) of the BRRD requires the European Banking Authority (the "**EBA**") to develop draft regulatory technical standards ("**RTS**") in order to further determine the list of liabilities which are excluded from the requirements of Article 55(1) and the contents of the required contractual term. Although the RTS are yet to be adopted, the EBA published its final report on the draft RTS[5] earlier this year[6].

EU member states are required to implement the requirements of Article 55 into national law by 1 January 2016[7]. With the deadline fast approaching, this note sets out the scope of the requirement and some practical considerations that market participants need to consider.

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1 http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0059

2 Including the preparation of recovery and resolution plans

3 Including powers for authorities to take early action to address emerging problems

4 In respect of in-scope liabilities governed by the law of an EU member state, the application of the bail-in tool would be effective as a matter of the law of the relevant EU member state

5 https://www.eba.europa.eu/documents/10180/1132911/EBA-RTS-2015-06+RTS+on+Contractual+Recognition+of+Bail-in.pdf

6 This note proceeds on the basis that the RTS are adopted in the form proposed by the EBA in its final report

7 Some EU member states have already done so

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Which entities are in-scope?

EU credit institutions[8] and investment firms[9], their EU holding companies, their subsidiaries that are EU financial institutions and their non-EU branches are all in-scope. Non-EU institutions and their EU branches are out of scope.

What liabilities are in-scope?

The bail-in power under Article 44 of the BRRD is expressed to apply to all "liabilities" which are not expressly excluded. The exclusions relate to covered deposits, secured liabilities[10], covered bonds, client assets, client money, liabilities arising from fiduciary relationships, certain short-term[11] loans, short-term[12] liabilities owed to securities settlement systems, certain liabilities owed to employees and trade creditors and preferred tax liabilities[13]. This means that not only are bonds and other unsecured debt instruments in-scope, but guarantees, indemnities, derivatives and letters of credit (amongst others) are also potentially in-scope.

What is the relevant date of in-scope liabilities?

Liabilities will be in-scope if created after the date of implementation for the relevant EU member state[14]. Although the deadline for EU member states to adopt Article 55 is 1 January 2016, some EU member states have already implemented the requirements[15]. This means the status of the requirements in each relevant EU member state needs to be checked. The RTS also provide that a liability will be in-scope (a) regardless that it is governed by an agreement (for example, an ISDA Master Agreement) entered into before the relevant date so long as the liability is created after that date, or (b) if it is created before the date of implementation but is subject to a material amendment after that date.

What form of clause should be used?

There is no prescribed form in the BRRD. The RTS sets out the requirements for such clauses, including (a) an acknowledgement and acceptance by the counterparty that the liability may be subject to the bail-in tool; (b) a description of the powers of each relevant resolution authority; (c) an acknowledgement and acceptance by the counterparty that: (i) it is bound by the exercise of the bail-in tool; (ii) the terms of the relevant agreement may be varied to give effect to the bail-in tool; (iii) shares or other instruments may be issued as a result of the exercise of the bail-in tool. Given the nature of these requirements, care needs to be taken, on a case-by-case basis, to determine that the requirements of the RTS will be satisfied.

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8 Excluding those listed in Article 2(5) of Directive 2013/36/EU ("**CRD IV**") - central banks, certain credit unions, municipal banks, friendly societies and housing associations

9 Only those subject to the initial capital requirement laid down in Article 28(2) of CRD IV

10 But not if the obligation is not fully secured or if the obligor is not obliged to maintain the liability fully collateralised on a continuous basis. See Article 2 of the RTS

11 With a maturity of less than 7 days

12 With a maturity of less than 7 days

13 See Art 44(2) of the BRRD

14 Therefore, the relevant date will differ between EU member states

15 In the UK, Article 55 applies to debt securities of PRA regulated firms and their UK holding companies from 19 February 2015 and all other relevant liabilities from 1 January 2016. However, the PRA has issued a modification by consent of certain rules which disapplies the requirements of Article 55 in circumstances where compliance in respect of a "phase 2 liability" is impracticable. A phase 2 liability is a liability subject to Article 55 other than unsecured debt instruments, additional tier 1 instruments and tier 2 instruments. The modification is valid until the earlier of 30 June 2016, or when the relevant rules are amended or revoked.

Are legal opinions necessary?

Article 55 provides that an EU national authority may require an in-scope entity to provide a legal opinion - from counsel in the relevant non-EU jurisdiction - on the enforceability of the recognition clause. It is not clear which EU national authorities will require legal opinions. Even if it is the case that a formal legal opinion is not required from the relevant EU national authorities, market participants should consider whether legal advice is required in respect of the need to include a recognition clause and its impact on other provisions of the agreement governing the relevant liability and other local law considerations.

Practical considerations

Market participants will need to consider whether they are in-scope, what liabilities are in-scope, the form of the contractual recognition term they will use, how to negotiate with counterparties to include the required contractual clause and what legal opinions or advice may be needed. In-scope entities will also need to establish processes to ensure that their existing contracts which are amended or create new liabilities, in each case, after the relevant implementation date, are compliant.

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If you have any questions, please feel free to contact one of the following Cadwalader attorneys.

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