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# Topical issues
## Bail-in without borders

### EU contractual recognition provisions

Article 55 of the 2014 Bank Recovery and Resolution Directive (BRRD) imposes rules on banks and most investment firms to insert contractual recognition of bail-in language into their non-EEA law governed contracts. It is extremely broad in scope. So much so, that in its response to the European Commission's Call for Evidence on the EU Regulatory Framework for Financial Services published on 1 February, the Bank of England states that Article 55 needs to be reassessed to ensure that it achieves its objective in providing loss absorption capacity in resolution, while being proportionate in its reach.

In this guide, we explain more fully what Article 55 requires, some of the difficulties in its application to the loan market and offer practical guidance on the appropriate approach to be taken by firms.

### Bail-in as a resolution tool

The BRRD provides a framework for the recovery and resolution of European banks and most investment firms. It enables national resolution authorities – including the Bank of England in the UK – to restore the balance sheet of financial institutions through use of a "bail-in" tool.

Bail-in was developed as a response to the financial crisis. Its aim is to reduce the likelihood that future governments/taxpayers will need to "bail-out" a failing firm by instead requiring shareholders and creditors to bear the costs of failure. Broadly, bail-in operates by enabling the write-down of liabilities and/or their conversion into equity. At its heart, it enables the absorption of losses and subsequent recapitalisation of troubled financial institutions.

### The problem of international recognition

The effectiveness of statutory bail-in powers is ensured throughout the EEA (which includes the 28 EU member states and also Iceland, Liechtenstein and Norway) by the mutual recognition requirements of the BRRD. If the Bank of England were to bail-in the German law liabilities of a UK bank, such action would broadly be recognised and take effect in Germany.

However, this is not the position where a European resolution authority wants to bail-in a non-EEA law governed liability. The mutual recognition requirements in the BRRD do not apply because they do not extend beyond the borders of the EEA and there may not be any other international framework in place. This gives rise to a potential problem for resolution authorities across Europe who need to have confidence that the exercise of a bail-in measure will be legally enforceable. If the bail-in of a non-EEA law liability is not effective under that law, creditors may bring claims before the courts in that non-EEA jurisdiction irrespective of any purported write-down or conversion. The issue will be particularly acute if a financial institution has significant non-EEA law liabilities and the success of the resolution could be threatened if their bail-in does not work.

### Article 55 BRRD: a contractual solution

Article 55 BRRD is aimed at closing the gap between the automatic effectiveness of EU bail-in action within the EEA and its uncertain effect elsewhere – to achieve bail-in without borders. As a result of Article 55, EEA banks and most investment firms (as well as certain affiliates) must incorporate contractual recognition of bail-in language into their non-EEA law governed agreements, unless a specific exemption applies. Bail-in language should ensure that the counterparty (i.e. the one owed the liability by the financial institution) recognises that the liability may be subject to write-down and conversion. The aim is that this should prevent litigation in the relevant non-EEA jurisdiction, with its courts holding the counterparty to its contractual agreement. The problem with the Article 55 requirement, however, is its broad scope which, as the Bank of England notes in its response to the Commission's Call for Evidence referred to above, could lead to legal uncertainty. In particular, it is not limited to debt instruments or particular categories of liabilities and does not have a materiality or minimum threshold.

The EBA has published "final" draft Regulatory Technical Standards on the Article 55 requirement which specify the mandatory features of any bail-in language. The Commission is expected shortly to adopt these final draft RTS. While offering some clarification on its scope, the final draft RTS do little to ease the burden of the Article 55 requirement. The trigger for the requirement to insert bail-in language is that the liability is:

> not otherwise excluded from bail-in;

> not a covered or protected deposit;

> governed by non-EEA law; and

> issued or entered into after 1 January 2016 or the agreement creating it is materially amended after that date.

The exemption from the Article 55 requirement which excludes certain liabilities from bail-in is not relevant to loan market documents.

In the UK, the Article 55 requirement has been implemented in the PRA and FCA rulebooks. The final draft RTS were published after the relevant PRA and FCA rules implementing the Article 55 requirement were made. As such, the UK rules will need to be brought into line with the RTS (as amended by the Commission when adopted), although that may now be subsumed in a more general re-write during the six month waiver period referred to below.

The precise scope of application of the Article 55 requirement is left to the implementing national regulator. In the UK, broadly, the PRA rules apply to UK credit institutions (i.e. deposit taking banks), PRA regulated investment firms and certain UK holding companies of such firms. The FCA rules, again broadly, apply to most investment firms and certain holding companies. However, the rules regarding which entities are caught are complex and should be looked at on a case by case basis.

### Agreements entered into before 1 January 2016: material amendments and grandfathering

Where a pre 1 January 2016 non-EEA law governed agreement is materially amended, the final draft RTS provide that it will also need to be amended to include bail-in language. It is the materiality of the *amendment* and not the liability which is relevant, so a material change to an immaterial liability would be caught by the Article 55 requirement. Although the final draft RTS do not clarify what constitutes a "material" amendment, it confirms that an amendment not otherwise affecting the substantive rights and obligations of a party will not be material. The final draft RTS give as examples of non-material amendments: a change to the contact details or service provisions, correction of a typo or an automatic increase in the interest rate. These examples do not provide any real guidance as to where the line is drawn but suggest that any amendment affecting substantive rights would be considered material for these purposes.

Article 55 applies to liabilities "issued or entered into" after 1 January 2016. This suggests that there is a grandfathering of liabilities issued or entered into on or before that date. However, the PRA rules implementing Article 55 – but not the FCA rules – also refer to liabilities "arising" after 1 January 2016.

This has led to some suggestions that, in effect, many non-EEA law governed contracts entered into by European financial institutions before 1 January 2016 (unless otherwise exempt) will need to be amended to include bail-in language if they could give rise to a liability after that date.

However, this interpretation would seem to overlook the intention of both the BRRD and the final draft RTS generally to provide for the grandfathering of pre 1 January 2016 agreements. In particular, the final draft RTS state that the Article 55 requirement shall apply to "liabilities created after [1 January 2016], regardless of whether they are created under relevant agreements entered into before that date". The use of the word "created" supports the argument in favour of grandfathering.

The final draft RTS give as an example of the type of liability this wording is intended to capture, trades executed under master or framework agreements. This ensures that new trades are not excluded from the Article 55 requirement simply because they are executed pursuant to a master agreement which predates 1 January 2016. The RTS example does not, however, seek to capture a pre 1 January 2016 trade even if a liability might arise under it after 1 January 2016.

### Relevance of materiality of liabilities?

Many concerns have been expressed about the wide scope of Article 55, including by the Bank of England in its response to the Commission's Call for Evidence as noted above. The Article 55 requirement would seem to catch almost all non-EEA law governed agreements entered into by European financial institutions after 1 January 2016. Article 55 does not identify in-scope liabilities by reference to any materiality or minimum threshold, nor do the final draft RTS. The breadth of this requirement would suggest a practicable approach is needed to identify which agreements to focus on to insert bail-in language, but until the waivers referred to below were introduced this was not possible.

### PRA and FCA publish temporary waivers from complying with Article 55

Both the PRA and FCA have now introduced a waiver from the Article 55 requirement where compliance would be "impracticable", although these waivers will expire on 30 June 2016 or when the PRA/FCA rules are amended. Absent further clarification on what this means, each firm will need to determine whether compliance is impracticable. However, the introduction of a waiver recognises that compliance with the UK rules in their current state may, to some extent, be impracticable.

The Bank of England's response to the Commission's Call for Evidence referred to above highlights that the broad scope of Article 55 can pose a burden that is disproportionate to the additional loss-absorption capacity achieved. It remains to be seen whether the amount of time and resource a firm should spend on incorporating bail-in language into liabilities which are unlikely to affect a firm's resolvability will be considered relevant to the question of impracticability. However, arguably, proportionality should be a relevant factor in what is impracticable.

### Application to the loan market

The Article 55 requirement potentially applies to a wide range of non-EEA law governed liabilities under syndicated and bi-lateral lending documentation – including, present and future and actual and contingent liabilities. Facility agreements, commitment letters, security agreements, intercreditor agreements and secondary loan trading documents are all likely to contain liabilities which, on a literal reading, are caught by Article 55. The liabilities that arise might broadly be categorised as follows:

> there will be agreements which require the insertion of bail-in language because they contain clear intended liabilities with a requirement to pay. For example, lending commitments, payment obligations, liabilities under letters of credit and guarantees and underwriting agreements; or

> there will also be agreements where it is less obvious that bail-in language should be inserted because they are low value or no liability is expected to arise or the liability is merely administrative. These might include, for example, typical loan related indemnities (e.g. to the security/facility agent), turnover obligations, notification/provision of information obligations or administrative obligations (e.g. under NDAs). Such liabilities would be unlikely to affect the resolvability of an institution and it might be considered disproportionate to negotiate the inclusion of bail-in language bearing in mind possible time and cost implications. As suggested above, it is possible that these factors should be relevant to a consideration of whether compliance with the Article 55 requirement would be impracticable.

Of course, as counterparties become more familiar with bail-in language and the Article 55 requirement, there may be less concern about including bail-in language. Early signs of market practice indicate that bail-in language will be included in non-EEA law security agreements, for example, even though any possible liability of an institution (e.g. as security agent or as beneficiary) is not likely to impact on its resolvability.

### Form of bail-in language

A number of industry bodies have produced bail-in language for use in non-EEA law governed agreements, including AFME, ICMA and ISDA. In relation to loan market documentation, both the LMA and LSTA have produced forms of bail-in language. Both variants take the form of a standalone clause, related definitions and refer to a schedule defining the bail-in legislation and powers relevant to each EEA member state. However, due to differences in terminology, structure and governing law, the LMA and LSTA bail-in language is not exactly the same. The LSTA has also produced a version of its language for inclusion in its form of secondary market documents.

The LMA bail-in language is for use in non-EEA law governed loan documents, although the LSTA variant should be used for loan documents governed by New York law or any other U.S. jurisdiction.

Although the Article 55 requirement will not apply to a non-EEA bank or an EEA branch of a non-EEA bank, it may be prudent for such firms to consider whether to include appropriate bail-in language in their non-EEA law finance documents. This approach has at least three benefits:

> it facilitates syndication to EEA firms that are within scope of the Article 55 requirement;

> it will make it easier for such in-scope EEA firms to trade in the secondary loan market, as they will not need to amend the agreement when making a trade (which could otherwise involve having to seek the agreement of a large number of parties); and

> it will allow transfers within the group to be made to in-scope EEA firms, as well as to those not caught by the Article 55 requirement.

### Practical considerations

European financial institutions will need to consider the application of Article 55 and whether they require an internal policy as to the circumstances in which they should ensure that bail-in language is included. In particular, the following considerations will need to be addressed:

> **impracticability**: as identified above, an assessment as to whether the resolvability of the financial institution would be adversely impacted by an inability to bail-in the relevant liability may be a relevant factor as to whether compliance with the Article 55 requirement is impracticable, as would the possible time and resource spent on negotiating the inclusion of bail-in language into agreements below a certain value threshold;

> **internal escalation**: who will make the decision whether to continue to enter into a non-EEA law governed agreement where bail-in language will not be included? Are they sufficiently senior?;

> **choice of language**: for loan documentation, the LMA form of bail-in language should be used, unless the non-EEA law is one of the U.S. jurisdictions in which case the LSTA variant should be used;

> **where to insert**: appropriate bail-in language could simply be included in each relevant non-EEA law agreement. Alternatively, it may be possible to incorporate appropriate bail-in language by reference (e.g. to apply across all Finance Documents), although the effectiveness of this approach should be checked in each relevant non-EEA jurisdiction. Bail-in language will need to be included in an agreement to which all relevant entities are a party. Market practice may eventually determine the approach, including whether, for example, to include language in the facility agreement or intercreditor agreement;

> **future proofing**: even where the contractual entity is not caught by the Article 55 requirement, it may be sensible to include bail-in language anyway to facilitate syndication or secondary trades; and

> **evidence of decisions**: ensure decisions not to include bail-in language are documented.

By having a considered internal policy, European financial institutions can limit the risks of non-compliance with the rules on Article 55, although it may not be possible to eliminate them completely.

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