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# Implications for Bank Creditors: the Latest EU Banking Reform Proposals

The European Commission recently announced an extensive package of banking reform proposals. Of particular interest to bank creditors, proposed amendments to the Bank Recovery and Resolution Directive aim to amend the creditor hierarchy in European bank resolution and insolvency proceedings. The Commission is also proposing changes to the onerous requirement that banks procure third party agreements to the recognition of bail-in for contracts governed by the laws of a third country. The timing of these proposals is significant because in both areas national rulemakers in different EU Member States are currently implementing, or planning to implement, differing requirements. This note discusses the Commission's proposals in the context of the bail-in tool with a particular focus on the implications for creditors.

## Introduction

On 23 November 2016, the European Commission published legislative proposals outlining far-reaching amendments to the Bank Recovery and Resolution Directive ("BRRD")[1] and other key pieces of EU banking legislation.[2] Under the BRRD, resolution authorities have the power, among other things, to write down or convert into equity certain debt liabilities of an EU firm in resolution ("Bail-In").

### Bail-In Clauses

Bail-In is one of the resolution measures available to EU resolution authorities which is given cross-border recognition throughout the EU. This means that any Bail-In with regard to contracts governed by the laws of an EU Member State should be construed as a valid administrative act under the governing law of the contract. We would not expect Bail-In measures to exclude liabilities under contracts which are governed by the laws of a third-country (i.e., non-EU law governed contracts). However, due to concerns as to the effectiveness of a Bail-In under the governing law of the contract, there is a requirement in BRRD to procure contractual agreement to Bail-In under such contracts. Without such language, under a contract governed by New York law for instance, a creditor might argue in the US courts that a write-down or conversion into equity was not valid to modify the parties' obligations under the contract and that the EU firm is in default of a payment obligation, notwithstanding the resolution action.

1 The Bank Recovery and Resolution Directive 2014/59/EU.

2 The proposals also covered the Capital Requirements Regulation 575/2013 (CRR) and Capital Requirements Directive 2013/36/EU (CRD IV). The changes to the BRRD are mirrored in the Single Resolution Mechanism Regulation 809/2014. The proposals amending CRD IV are available here and the proposals amending CRR are available here. Those amending the BRRD on ranking of unsecured debt instruments in the insolvency hierarchy are available here and on loss-absorbing and recapitalisation capacity of credit institutions and investment firms here. The proposals amending Single Resolution Mechanism Regulation are available here.

BRRD requires EU firms to include in their non-EU law governed contracts a clause by which “a creditor or party to the agreement” recognises and agrees that liabilities may become subject to Bail-In (the “Bail-in Clause”). As currently drafted, the scope of the Bail-in Clause requirement is very broad. Beyond certain limited exceptions, it appears to be triggered by any type of liability regardless of the circumstances.[3]

**Sequence of Bail-In**

When applying the Bail-In tool under BRRD, resolution authorities must respect the following order of loss-absorbency in terms of creditor hierarchy (from last to first): regulatory capital (namely Common Equity Tier 1, then Additional Tier 1 and Tier 2), other subordinated debt and, last, senior debt. Within the categories of non-regulatory required subordinated debt and senior debt, any Bail-In must follow the hierarchy of claims in normal insolvency proceedings as stipulated in the relevant national insolvency law. One exception to this principle applies for deposit-takers: protected (typically consumer) deposits are outside the scope of the Bail-In tool. BRRD also requires EU Member States to ensure that any deposits of natural persons and SMEs that are not covered by depositor protection rank higher than other (non-preferred) senior debt.

**Loss-Absorbing Capital**

To ensure that EU firms have at all times sufficient liabilities that are eligible for a Bail-In, BRRD introduced a minimum requirement for own funds and eligible liabilities (“MREL”). Resolution authorities must set an individual MREL for each EU firm which will depend on, amongst other things, their resolution strategy. MREL serves a similar purpose to the total loss absorbing capital (“TLAC”) standard established by the Financial Stability Board for global systemically important banks (“G-SIBs”), but the two concepts differ in a number of details, particularly the subordination criterion.[4] BRRD does not include a formal requirement for subordination but resolution authorities may require a specific EU firm’s MREL (or part thereof) to be met with subordinated instruments. By contrast, subject to certain exemptions, the TLAC standard includes a subordination requirement.

**Diverging Approaches of EU Member States to the Ranking of Senior Unsecured Bonds**

EU Member States have taken very different approaches to help local banks comply with the subordination requirement of the TLAC standard and the broader MREL requirements.

The UK favours a structural subordination approach under which major banks issue senior unsecured bonds from holding companies that do not have operational liabilities. This approach ensures that liabilities of operational entities are not impacted by any Bail-In at the level of the non-operating holding company. However, many of the largest continental banks have an operating top-level entity. Bailing-in senior unsecured bonds which have the same rank as large deposits, liabilities arising from derivative contracts and other operational liabilities may entail significant legal risks and render a Bail-In less effective. To address this, some EU Member States have favoured an approach based on either contractual or statutory subordination. The latter is the

[3] Further detail on the scope of the Bail-In Clause requirements is available in our client note, “BRRD: Contractual Recognition of Bail-in and Resolution Stays,” available here.

[4] The European Commission’s proposals to amend the BRRD and CRR include proposals to amend the EU MREL to introduce the TLAC standards for EU G-SIBs. Those proposals are not discussed in this note. The Commission suggests that, in light of the similar purpose of MREL and TLAC, an integrated approach is best so as to avoid undue complexity.

current German and Italian approach, whereas France and Spain plan to follow an approach based on contractual subordination.

## New Non-Preferred Senior Debt Instruments

To address the legal patchwork arising from diverging national approaches, the Commission is proposing to harmonize legislation in this area by introducing a separate tier within the category of senior debt. The new non-preferred senior debt instruments would rank junior to all other senior liabilities but would be senior to the subordinated debt. Much like the French approach, the Commission proposes that these instruments, when issued, must explicitly refer to the 'non-preferred' ranking in their terms and conditions. The status as non-preferred senior debt would mean that, in case of a Bail-In that breaks within the senior debt, losses could be allocated to the holders of such instruments ahead of the creditors of other senior liabilities. Through the establishment of a statutory basis for the issuance of non-preferred senior debt instruments, combined with explicit contractual subordination arrangements, legal certainty around the ability of resolution authorities to resolve failing EU firms is expected to increase significantly. The proposed harmonised approach should also help the holders of ordinary senior unsecured bonds (i.e., those issued without reference to the new regime) and the creditors of other senior liabilities (such as large deposits, liabilities arising from derivatives contracts and other operational liabilities) with the assessment of their Bail-In risk. From their perspective, a new layer of non-preferred senior debt would function as an extra safety cushion, making it less likely that they get bailed-in themselves.

### Timing

These proposed amendments are intended to be transposed throughout the EU by June 2017 and to apply from July 2017. However, the ultimate timing will depend on how long the EU legislative process takes. Unlike under the German approach, the Commission does not intend to apply the provisions retroactively, which means that any instruments issued before the date of application of the revised BRRD provisions would remain subject to national insolvency regimes. To the extent that any of the existing national approaches adopted by EU Member States conflict with the final text, they will need to amended or adjusted accordingly.

## New Waiver to Bail-In Clause Requirement

The Commission is also proposing a new right of resolution authorities to waive the Bail-In Clause requirement under certain circumstances.[5] The intention is to remove the practical and legal issues that EU firms and, in particular, those operating branches in third countries, have faced in complying with the Bail-In Clause requirement, and will help them avoid having to discontinue business lines. Some third-country counterparties have persistently declined to include the Bail-In Clause in contracts with EU firms. In other instances, third-country regulators have even prohibited agreement to such clauses. Due to the many difficulties faced by EU firms in complying with the Bail-In Clause requirement, the banking industry has lobbied for a more flexible implementation and enforcement approach. This has led some of the EU national regulators, in particular those in the UK and Germany, to give guidance on their supervisory practice to mitigate some of the challenges. For example, UK firms may decline to include a Bail-In term for unsecured liabilities which are not debt instruments

5 The bail-in tool is a separate resolution mechanism to that of the resolution stay. You may like to view our client note, BRRD: Contractual Recognition of Bail-in and Resolution Stays, available here.

where it would be "impracticable" to do so.[6] The UK Prudential Regulation Authority ("PRA") has provided some examples of where firms might assess that their compliance is impracticable, such as where it would be illegal to include the language in a contract governed by a particular country's laws or where the liability is contingent on a breach of the relevant contract. However, the PRA will not allow the rule to be used where a bail-in clause is merely inconvenient or leads to loss of competitiveness or profitability. In light of diverging approaches at national level and the limited leeway in BRRD, amendments to the text of BRRD itself will be broadly welcomed.

Building on the UK approach, the Commission proposes to give resolution authorities discretion to grant a waiver from compliance with the Bail-In Clause requirement where:

- it is determined that it would be "legally, contractually or economically impracticable" for a EU firm to include a Bail-In Clause;
- the waiver would not impede the resolvability of the EU firm; and
- the liabilities or instrument can be subject to the Bail-In powers of an EU resolution authority according to the laws of the relevant third country.

The European Banking Authority ("EBA") would be charged with preparing draft technical standards on the conditions under which it would be legally, contractually or economically impracticable for an EU firm to include a Bail-In Clause in certain liabilities and the conditions under which a waiver would not impede the resolvability of an EU firm. The waiver would only be available for liabilities that are not unsecured debt instruments, Additional Tier 1 instruments or Tier 2 instruments and for liabilities that would be senior to any MREL liabilities. If a waiver is granted, the liabilities would not count towards the EU firm's MREL.

If the Commission's amendments go ahead as currently drafted, a waiver could only be given if all three of the conditions are met. This may be difficult to achieve and, with regard to the third condition, also depend on the analysis of the relevant third-country law. With regard to the details, much will depend on the EBA's technical standards. The Commission intends the revisions to be transposed by EU Member States within 12 months after the date of entry into force of the revised BRRD and to apply within six months after that transposition date. Those national regulators that have already adopted supervisory practices, such as the UK's PRA, will need to assess whether the final text will require an alteration to their existing practices.

6 The Prudential Regulation Authority's rules are available here and the PRA's Supervisory Statement, "The contractual recognition of bail-in: impracticability," is available here.

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