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Bank Recovery and Resolution Directive – Implications for Repo and Derivative Counterparties

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The Bank Recovery and Resolution Directive (BRRD)¹ introduces an EU-wide regime for recovery and resolution planning for, and for resolution action to be taken in respect of, banks and large investment firms (typically the large sell-side institutions) (FIs)². The cut-off for implementation was 31 December 2014³, except the bail-in tool (described below) which needs to be implemented by 1 January 2016.

In the US, Title II of the Dodd-Frank Act, or the Orderly Liquidation Authority, provides an alternative insolvency regime for financial companies, including bank holding companies (the resolution regime in the US is described below).

Significant Implications

BRRD gives rise to significant implications for repo and derivative counterparties^{4 5}, discussed further below⁶, including the prospect of:

- facing a new counterparty;
- facing the good bank or the bad bank in a break-up of an FI;
- trade(s) being terminated without there being a default and then valued by the resolution authorities;
- any unsecured liability of the FIs being cancelled and/or converted into equity in whole or in part without any other compensation and/or
- being temporarily prevented from exercising rights to terminate early or enforce security. Such rights may eventually be lost.

A resolution authority may take resolution action (i.e. intervene in a failing FI) upon the satisfaction of the resolution conditions. Resolution action does not *per se* constitute insolvency proceedings giving rise to termination rights⁷.

Resolution action involves the use of one or more resolution tools. In order to effectively apply the resolution tools, a resolution authority is to have various resolution powers available. The resolution authority must take all appropriate measures to ensure that resolution action is taken in accordance with the resolution principles.

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Resolution Conditions

Satisfaction that:

- the FI is failing or likely to fail;
- there is no reasonable prospect that any alternative private solution would prevent the failure within a reasonable time frame and
- a resolution action is necessary in the public interest. A resolution action will be in the public interest where it is necessary to achieve, and is proportionate to, one of the resolution objectives.

Resolution Objectives

The resolution objectives are:

- the continuation of systemically important functions;
- the avoidance of destabilisation of the financial system;
- the protection of public funds;
- the protection of certain depositors and investors and
- the protection of client funds and client assets.

Resolution action is not to be taken where winding up under normal insolvency proceedings would meet the resolution objectives to the same extent.

Resolution Tools

- *The sale of business tool* – allows the transfer, without shareholder consent, of all the shares or all or any assets, rights or liabilities of a failing FI to a purchaser.
- *The bridge institution tool* – allows the transfer, without shareholder consent, of all the shares or all or any assets, rights or liabilities of a failing FI to a bridge institution being a state entity created for the purpose, for eventual sale or orderly wind down.
- *The asset separation tool* – allows the transfer of rights or liabilities from a FI under resolution or a bridge institution to one or more asset management vehicles with a view to maximising their value through eventual sale or orderly wind down.
- *The bail-in tool*⁸ – allows the write down, write off or cancellation of share capital and the write down, write off, cancellation or conversion into share capital of certain other liabilities (including derivative liabilities), unless excluded from the scope of bail-in.

Resolution Powers

With respect to repos and derivative contracts, resolution powers available include the power:

- to close-out financial contracts or derivatives contracts⁹;

- to calculate close-out amounts where contracts are closed-out for the purposes of bail-in¹⁰;
- to cancel or modify the terms of a contract¹¹ and
- to temporarily suspend:
 - the payment and delivery obligations of the FI under resolution¹²;
 - the counterparty's right to enforce security¹³ and
 - the counterparty's contractual termination rights (the jurisdictional reach of the "stay" of termination rights is described below)¹⁴,

in each case until midnight at the end of the business day following the resolution authority's publication of a notice to take resolution action.

If a resolution authority suspends payment and delivery obligations, and a counterparty is owed a delivery of collateral, the delivery of collateral will be delayed and the counterparty will not know until the end of the suspension period whether there is a default or not.

If the resolution action has been successful, a counterparty cannot rely on its rights against the FI which was under resolution. Therefore, any rights to terminate would be lost upon a successful resolution action.

Resolution Principles

The overriding principles of BRRD include:

- the shareholders of the FI under resolution bear first losses;
- the creditors of the FI under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings, except where BRRD provides otherwise and
- no creditor should be left "worse off" in resolution than they would have been under normal insolvency proceedings.

The Bail-in Tool

Bail-in is available as a resolution tool only for very specific purposes—to recapitalize an FI by way of reducing its liabilities and/or bolstering Common Equity Tier 1 or to reduce the liabilities that are transferred under the other resolution tools. It can be used in combination with other resolution tools.

Derivative liabilities should, in principle, be available for bail-in and this can take the form of a write down or write off of the liability in question or a full or partial conversion into Common Equity Tier 1.

However, for derivative liabilities to be subject to bail-in, the FI subject to resolution action will have to have suffered serious losses. Shareholders bear the first losses and thereafter creditors in accordance with the order of priority of their claims under normal insolvency proceedings. For example, bail-in by the conversion of derivative liabilities to restore Common Equity Tier 1 capital would only kick in if the conversion of the FI's regulatory capital instruments would be insufficient to meet the minimum Common Equity Tier 1 capital ratio.

Resolution authorities may not exercise the bail-in tool with respect to secured liabilities,¹⁵ albeit liabilities in excess of the amount of security are available for bail-in by the resolution authorities. A derivative contract cannot be bailed-in until it has been terminated.

Where bail-in is to be applied, unsecured liabilities are to be bailed-in unless excluded by the resolution authority in exceptional circumstances¹⁶.

Repos will always be secured liabilities. Derivative contracts will be secured liabilities, irrespective of the party who is “in-the-money,” provided there is a security or title transfer collateral arrangement under which some collateral has been posted or delivered and is currently outstanding.

A resolution authority has the power under Article 63(1)(k) of BRRD to close-out repos and derivative contracts even where they are secured liabilities. Any resulting close-out amount payable by a FI under resolution, to the extent that it is not a secured liability, is within the scope of bail-in, even though the actual contract was a secured liability.

Some Practical Issues and Consequences

- EU branches of third-country firms can be subject to resolution, for example, a London branch of a US bank.
- Where a resolution authority transfers the transactions to another entity, the third-party entity may not satisfy the credit and due diligence requirements of the counterparty.
- Where a resolution authority exercises its power to close-out:
 - counterparties will lose their hedges, which could result in a breach of hedging requirements under other financing documents and
 - the resulting close-out amount may be payable by a counterparty creating possible liquidity issues.
- Where a resolution authority exercises its power to close-out for the purposes of bail-in, the close-out amount will be calculated by the resolution authority (rather than the non-defaulting counterparty)¹⁷.
- Derivative liabilities may be written down or written off in whole or in part without any compensation.
- If derivative liabilities are converted into Common Equity Tier 1, counterparties will have to consider whether there are any impediments in holding the equity of the FI. For example, does the size of position require regulatory approval?
- Counterparties’ rights to terminate may be suspended and eventually lost. Following a successful resolution action, counterparties will not be able to exercise their rights against the FI that was under resolution.
- Counterparties may not be able to enforce security.
- If a counterparty is regulated, there may be an impact on its regulatory capital.
- During a period of resolution action, values may become volatile and delivery of collateral may be delayed. The amount of collateral held may not reflect the risk.
- Liabilities in excess of the amount of collateral are available for bail-in.
- The days of uncollateralised trading would seem to be limited. This would be consistent with the direction of global regulatory reform. Counterparties should consider the need to negotiate or renegotiate collateral documentation.

Resolution Regime in the US

In the US, Title II of the Dodd-Frank Act, or the Orderly Liquidation Authority, provides an alternative insolvency regime for financial companies, including bank holding companies, if, among other things, the failure of the financial company and its resolution under the otherwise applicable insolvency regime would have serious adverse effects on financial stability in the US.

In order to invoke Title II, generally two-thirds of the members of the Board of Governors of the Federal Reserve System and two-thirds of the board of the Federal Deposit Insurance Company (**FDIC**) must make a recommendation

to the US Secretary of the Treasury, who makes the determination in consultation with the President of the United States.

Like BRRD, Title II is based on several overriding principles, including that:

- unsecured creditors bear losses in accordance with the priority of claim provisions, and that shareholders of the covered financial company should not receive payment until all other claims are paid in full;
- management and/or the board of directors responsible for the failed condition should be removed and
- no taxpayers shall bear losses from the exercise of authority under Title II.

If Title II is invoked, the FDIC is appointed as receiver of the covered financial company, and has certain powers, similar to those that the FDIC has for resolving banks in the US. Among these, the FDIC is empowered to:

- establish and operate a bridge financial company, and to transfer any assets or liabilities of the covered financial company to such bridge company without obtaining any approvals or consents for the transfer;
- arrange for a merger of the covered financial company with another company (subject to applicable antitrust laws) or arrange for the transfer of assets and liabilities of the covered financial company without obtaining any approvals or consents for the transfer and
- repudiate certain contracts that may be burdensome or otherwise impede the orderly liquidation of the covered financial company.

Unlike the rules under the US Bankruptcy Code, counterparties of the covered financial company are prohibited from closing-out qualified financial contracts (**QFCs**) for one business day following the FDIC's appointment as receiver, during which period the FDIC can transfer the QFCs to a bridge financial company or other financial company, provided that the FDIC transfers all the QFCs with that counterparty and its affiliates. Once a contract or QFC has been transferred to a bridge financial company or third party, it cannot be closed-out, terminated or liquidated based on the appointment of the FDIC as receiver or the insolvency or financial condition of the covered financial company.

Title II does not explicitly provide for a bail-in, but the FDIC has issued a public statement describing how it would use the powers under Title II to effect a "single point of entry" (**SPOE**) resolution of a covered financial company. Under the SPOE resolution strategy, debt holders of the top-tier holding company would be converted to equity holders in the new, resolved financial company, and old equity holders would be left behind in the receivership¹⁸.

ISDA Stay Protocol

In November 2014, the International Swaps and Derivatives Association, Inc. published a Resolution Stay Protocol (**ISDA Stay Protocol**) which extends the jurisdictional reach of certain provisions of national resolution regimes, such as the UK-implementation of BRRD, the Federal Deposit Insurance Act (**FDIA**) and Title II of the Dodd-Frank Act, which mandate stay provisions under certain swap and derivative contracts.

The ISDA Stay Protocol requires that, if an adhering party (or its parent or certain of its affiliates) becomes subject to a "special resolution regime" (**SRR**), any counterparty to such party in respect of covered master agreements and credit enhancements who also adheres to the ISDA Stay Protocol will only be permitted to exercise default rights that it would have otherwise been entitled to exercise under the SRR if the underlying agreement were governed by the laws of the jurisdiction of the SRR.

Current SRRs under the ISDA Stay Protocol include the FDIA and Title II of Dodd-Frank, along with SRRs in France, Germany, Japan, Switzerland and the UK. Therefore, entities opting into the ISDA Stay Protocol would be bound by

the UK-implementation of BRRD to the extent that their counterparties (or certain of their affiliates) become subject to the UK's BRRD implementation.

The ISDA Stay Protocol was developed in response to requests from regulators to address concerns and uncertainty where stays of termination rights under national resolution regimes were not necessarily required to be recognised in other jurisdictions. Currently, the ISDA Stay Protocol only binds parties who have elected to adhere to its provisions. The 18 major global banks (the G-18) agreed to voluntarily adhere to the ISDA Stay Protocol¹⁹, and the SRR provisions became effective between the initial adhering banks on 1 January 2015. Broader market adherence to the ISDA Stay Protocol is expected only as a result of related regulations which are expected in 2015, with effectiveness in 2016 or possibly 2017.

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- ¹ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU and Regulations (EU) No 1093/2010 and (EU) No 648/2012.
 - ² The BRRD applies to both banks and large investment firms, including the EU branches of third-country firms.
 - ³ Some member states implemented BRRD early and some member states had certain of the resolution tools and powers already available to them under national legislation.
 - ⁴ This note deals with the situation where one of the counterparties becomes subject to resolution. The impact of BRRD on derivatives is also relevant in situations where the entity subject to resolution is (not a counterparty, but) the reference entity under a CDS.
 - ⁵ This note is focused towards OTC derivatives. Additional considerations are relevant with regard to cleared derivatives. Cleared derivatives have a number of protections under BRRD.
 - ⁶ See “Some Practical Issues and Consequences”.
 - ⁷ Article 68(3) of BRRD.
 - ⁸ As noted, the bail-in tool may already be available to some EU member states but is required to be available not later than 1 January 2016.
 - ⁹ Articles 43(1) and 63(1)(k) of BRRD. Article 43(1) provides for close-out for the purpose of bailing-in derivatives liabilities. Article 63(1)(k) does not restrict close-out for the purpose of bail-in.
 - ¹⁰ Article 49(4) of BRRD.
 - ¹¹ Article 64(f) of BRRD.
 - ¹² Article 69 of BRRD.
 - ¹³ Article 70 of BRRD.
 - ¹⁴ Article 71 of BRRD.
 - ¹⁵ Article 44(2) of BRRD.
 - ¹⁶ Article 44(3) of BRRD.
 - ¹⁷ The European Banking Authority has until January 2016 to submit draft technical standards setting out the methodologies and principles for valuation by a resolution authority.
 - ¹⁸ FDIC, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (18 December 2013), available at: <http://www.gpo.gov/fdsys/pkg/FR-2013-12-18/pdf/2013-30057.pdf>.
 - ¹⁹ A complete list of the parties that have opted in to adhere can be found here: <https://www2.isda.org/functional-areas/protocol-management/protocol-adherence/20>

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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