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August 29, 2016

Bail-In and Contractual Recognition: The Impact on US and Other Non-EU Counterparties and the Potential Impact of Brexit

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Background

Following the 2008 banking crisis, governments around the world found themselves having to bail out large financial institutions by injecting capital to help those institutions continue to service their debts. In Europe, the most high profile of these bail outs were those in Greece, Portugal and Iceland. The UK also was affected with many of the UK's best known banks being included in a bank rescue package totalling some £500 billion (approximately $850 billion at the time, closer to $650 billion now). As banking institutions were bailed out by the government, it was, of course, the taxpayer who footed the bill and, as a result, Lloyds Bank PLC and The Royal Bank of Scotland PLC remain partly owned by UK PLC even now.

What this meant in practice was that the creditors of those bailed out institutions—the depositors, bondholders and so on—were spared at the expense of the taxpayer.

The European Union (together with many taxpayers) considered this to be unjust, and sought to ensure that such mass quasi-nationalisation of financial institutions would not need to happen again. The process began in earnest in 2009 when the European Commission published a consultative communication that outlined the beginnings of a new framework for crisis management arrangements in the banking sector. Following further consultation the legislative framework began to form and in 2013 the *Bank Recovery and Resolution Directive (2014/59/EU)*[1] (BRRD) was approved by the European Parliament and Council. Member states had until December 2014 to implement the BRRD into national legislation and until January 2015 to apply its provisions (January 2016 in respect of bail-in).

In the UK this was done by way of statutory instruments extensively revising the Banking Act 2009 ("Banking Act"), and by amending the Financial Services and Markets Act 2000 to give the Bank of England, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) new powers. The revisions also made extensive changes to the UK special resolution regime[2] (SRR) introduced by the Banking Act. The SRR applies to banks, building societies, certain investment firms, central counterparties and banking holding companies. The aim of SRR is to provide a mechanism for ensuring that financial institutions can fail without undue disruption to the financial systems, without interruption to the economy and (perhaps most crucially) without it being at the taxpayers' expense.

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[1] http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32014L0059

[2] http://www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf

The SSR is composed of five stabilisation options:

1. transfer to the private sector;
2. transfer to a bridge bank;
3. transfer to an asset management vehicle;
4. bail-in; and
5. transfer to temporary public sector ownership.

What is Bail-In?

The aim of bail-in is to absorb losses and recapitalise a financial institution by using that institution's own resources. The central banks of EU-member states have powers to make special bail-in provisions that write down or convert the claims of shareholders and unsecured creditors into equity. In this way, ordinary taxpayers, who otherwise have no connection and no previous liability to the failing institution, do not find themselves exposed to the cost of saving it.

Bail-in is already happening in practice. In April 2016 the Austrian Financial Market Authority (FMA) became the first EU-member state to use the new law to shore up an €8 billion ($9.1 billion) hole in the balance sheet of Heta Asset Resolution AG (the "bad bank" residual asset of Hypo Alpe-Adria-Bank International AG). The FMA did this by (amongst other things) insisting on a 53.98 percent bail-in for all eligible preferential liabilities, cutting Heta's senior liabilities by 54 percent and extending the maturities of all eligible debt to the end of 2023.

What is the Contractual Recognition of Bail-In Powers?

Financial institutions established in EU-member states are bound by the BRRD and its provisions by virtue of the obligation of member states to implement the directive into national legislation.

Outside the EU, however, the BRRD does not automatically apply and there is a risk that a counterparty may challenge (and the courts may fail to give effect to) a subsequent bail-in. In order to avoid this, Article 55 of the BRRD has, since 1 January 2016, required financial institutions established in EU-member states to include terms, in any agreements governed by non-EU laws, that specify that the payment and other liabilities in those agreements may be subject to bail-in under the BRRD. The type of liabilities caught may be quite broad, may include contractual and non-contractual liabilities, and may extend to loan agreements, hedging arrangements, guarantees, intercreditor arrangements and security documents amongst others.

So far as the loan markets are concerned, both the Loan Markets Association (LMA)[3] and the Loan Syndications and Trading Association (LSTA)[4] have published suggested bail-in clauses in respect of loan documentation and these are gradually being accepted by the market as standard. The Association for Financial Markets in Europe (AFME) has produced a similar model clause for use in the capital markets (although for the moment this is limited to use by UK financial institutions for debt securities governed by New York law) and the International Securities Lending Association (ISLA), International Capital Markets Association (ICMA), and the International Swaps and Derivatives Association (ISDA) are considering protocols for securities lending, repo and derivatives.

The penalties for the failure by a financial institution to comply with article 55 depend on the law of that institution's jurisdiction. In England and Wales, the PRA has the ability to take disciplinary action against financial institutions "in accordance with standard PRA policy"[5] for any breach of PRA rules, which include the obligation to include contractual recognition provisions in relevant contracts[6]. Because of this, the ability of counterparties to negotiate the contractual recognition provisions or indeed to strike them out altogether is limited.

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3 http://www.lma.eu.com/documents-guidelines/documents/category/bailin-clause

4 http://lsta.org/news-and-resources/news/the-lsta-publishes-a-form-of-eu-bail-in-contractual-recognition-provision

5 http://www.bankofengland.co.uk/pra/Documents/publications/ss/2015/ss4215.pdf

6 See http://www.bankofengland.co.uk/publications/Documents/other/pra/approachenforcement.pdf and http://www.bankofengland.co.uk/pra/Documents/publications/sop/2016/approachenforcementupdate.pdf for details of the PRA's approach to deciding whether action should be taken and, if so, its approach to setting the level of penalty applicable. Factors include the "seriousness of the breach," the "size and financial position of the firm," and "the effect or potential effect of the breach on the advancement of the PRA's statutory objectives".

Counterparties have, understandably, begun to challenge the provisions; most recently a US borrower client successfully seeking to reserve the right to contest both a bail-in and the applicability of bail-in provisions before the US Federal Court. But the main LMA and LSTA template clauses are swiftly becoming market standard and financial institutions are resisting changes.

The Impact of Brexit

On 23 June 2016 the UK electorate voted to leave the EU. Brexit itself is likely to take some time, with commentators now of the opinion that the relevant notice under Article 50 of the Lisbon Treaty, formally commencing the exit process, may not be delivered by the UK until Q2 2017 at the earliest, which means that formal dissolution of the UK's membership of the EU will not take place until at least 2019.

Before then there is likely to be considerable negotiation in respect of the UK's relationship with the EU and its individual member states, as well as the negotiation of trade agreements globally. A large part of the exit process will need to be devoted to the many EU regulations that currently apply to the UK and that will, once the two-year exit timetable envisaged by the Article 50 process comes to an end, no longer be binding. In addition, there are a number of EU directives that require national implementation and have been implemented, and one of those is, of course, the BRRD.

The UK is currently an EU-member state and the financial institutions established in the UK are therefore institutions to which the BRRD applies. The position post-Brexit is uncertain and may change. Stabilisation requirements of some sort are likely to continue, but whether it will be by way of a formal implementation of BRRD (that is, the effective continuation of the BRRD requirements as transposed into national laws and the SRR) or an altered, "home-grown" version is subject to debate. While the impact of BRRD is likely to continue to be felt in the UK (once the BRRD no longer applies, entities in the UK that enter into contracts with EU financial institutions are likely to be required to accept contractual recognition provisions), whether contracts between non-EU parties and UK financial institutions will be subject to contractual recognition provisions post-Brexit is an entirely different matter.

Conclusion

Following the implementation into national legislation of the BRRD and of bail-in obligations as of 1 January 2016, financial institutions established in an EU-member state would be wise to ensure that any non-EU law governed contracts (most obviously, finance documents, for example where an EU established lender is granting banking facilities to a US borrower subject to New York law) that impose payment or other liabilities contain contractual recognition of bail-in provisions substantially in the form of the LMA or LSTA suggested bail-in clause.

Counterparties may find that some minor negotiation is possible, but expectations should be managed. The likelihood of substantive changes to the increasingly market standard LMA/LSTA bail-in clauses is slim. Counterparties should therefore seek advice on the impact of effectively agreeing to be bailed-in.

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