

THE BANK RECOVERY AND RESOLUTION DIRECTIVE AND THE SINGLE RESOLUTION MECHANISM

PREADVIEZEN / REPORTS 2014

SASKIA M.C. NUIJTEN, BART P.M. JOOSEN & PATRICK CLANCY



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International Insolvency Law **(NACIIL)**

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SERIES EDITORS

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LEGAL PROTECTION AGAINST ACTIONS UNDER THE SINGLE RESOLUTION MECHANISM – OR THE LACK OF IT

Saskia M.C. Nuijten

1 INTRODUCTION

During the 2007-2013 financial crisis it became apparent that some banks were “too big to fail”, meaning that the failure of one bank led to a systemic risk for the financial sector as a whole. This systemic risk was caused by cross-shareholdings in the banking world and the interconnectedness between public finance and banks. To prevent systemic failures, national governments have rescued banks through financial aid measures and even their acquisition and expropriation.

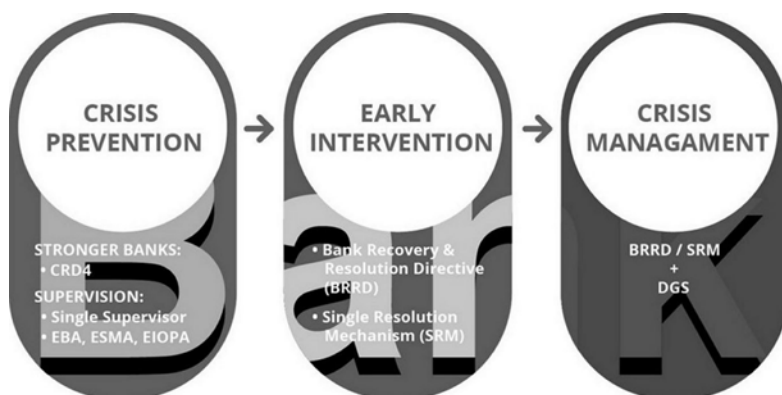
For the European Economic and Monetary Union (EMU) this problem was exacerbated by the fact that systemic risks are not confined to single countries but affect all EMU countries. At the time of the EMU’s introduction, there was no political union between its member countries, each of which had its own budgetary policy. Therefore, the consequences of the crisis in Greece, for example, were felt throughout the EMU. Furthermore, banking supervision – unlike the banks themselves – was bound by national borders, which limited the possibilities for a European monetary policy. The supervision was directed towards individual undertakings and did not offer a solution for the systemic risks. The public rescue costs for banks in distress, incurred to prevent systemic crises, were unprecedented.¹

The first step in addressing this problem was the introduction of the European System for Financial Supervision (ESFS) on 1 January 2011. The ESFS consists of the European Systemic Risk Board (ESRB) and three European Supervisory Authorities (ESA): the European Insurance and Occupational Pensions Authority (EIOPA), the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA). The ESFS is an integrated network of national and European supervisory authorities, created

¹ According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 are close to €1 trillion or 8% of the EU GDP. Between October 2008 and December 2012, the Commission approved €591.9 billion or 4.6% of EU 2012 GDP in state aid measures in the form of recapitalisation and asset relief measures.

to provide the necessary links between the macro and micro prudential levels, leaving day-to-day supervision to the national level.

The introduction of the banking union was the second phase in addressing the systemic risk problem. The banking union consists of three pillars: the Single Rule Book, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The European Commission (EC) illustrates the relationship between the Single Rule Book, the SSM and the SRM as follows:²



The Single Rule Book contains common rules intended to prevent bank crises. These rules, which are aimed at turning banks that are “too big to fail” into banks that are “too safe to fail”, have been incorporated mainly in the Capital Requirements Directive³ (CRD)⁴ and Capital Requirements Regulation⁵ (CRR). The Bank Recovery and Resolution Directive⁶ (BRRD) sets out a common framework for the procedures to be followed if a bank does end up in difficulty, including a means to wind it down in an orderly way. The third part of the common rules are the rules regarding the deposit guarantee scheme (DGS).

² http://europa.eu/rapid/press-release_MEMO-14-294_nl.htm.

³ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRDIV).

⁴ The law implementing this directive in the Netherlands has come into effect on 1 August 2014.

⁵ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

⁶ 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, of the European Parliament and of the Council. This Directive should be implemented before 1 January 2015.

The BRRD had to be implemented before 1 January 2015.⁷ It is aimed at preparing banks for the possibility of failure and giving national authorities a broad range of powers and tools to ensure that any failing bank can be restructured and resolved in a way that preserves financial stability and protects taxpayers. The BRRD also provides for cooperation among resolution authorities in different member states when dealing with the failure of cross-border banks. Among other things, the BRRD constitutes a harmonised rulebook for allocating the costs of a bank failure – starting with shareholders and creditors – and backed by financial support from resolution funds sourced from the banking sector and not taxpayers. Deposits below EUR 100,000 will be covered by the DGS, and deposits of natural persons and small- and medium-sized enterprises above EUR 100,000 will benefit from preferential treatment ensuring that they do not suffer any loss before all other secured creditors' claims are absorbed. The bail-in tool applies as from 1 January 2016. The Dutch Central Bank (DNB) has been appointed as the Dutch resolution authority.⁸ Within DNB, this function is separated from banking supervision to comply with the BRRD, which demands that structural arrangements are in place to ensure operational independence and to avoid conflicts of interest between the functions of supervision and resolution.

The Single Rule Book, however, establishes minimum harmonisation rules and does not lead to centralisation of decision-making. The BRRD leaves discretion to national authorities in the use of resolution tools and powers, and in the use of national financing arrangements in support of resolution procedures. The banking union eliminates this discretion in several supervision areas. The banking union introduces a SSM for centralised, uniform supervision of compliance with the Single Rule Book. Under the SSM, the supervision of banks is elevated to the European level: the ECB will be the main supervisor of all 6000 banks in the Euro area in the framework of the SSM as of November 2014.⁹

Furthermore, the banking union introduces a centralised uniform resolution mechanism – the SRM. Under the SRM, bank resolution is managed by a European Single Resolution Board (SRB) and a European Single Resolution Fund (SRF).¹⁰ Its structure reflects the division of tasks under the SSM. The SRB will be the resolution authority for significant and cross-border groups and will exercise the powers under the BRRD. DNB will have to implement decisions by the SRB and will be the resolution authority for other

7 The Dutch consultation was closed on 19 December 2014. The legislative proposal is expected to be submitted shortly.

8 *Kamerstukken II* 32013, nr. 77, p. 4-5.

9 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

10 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

banks under the SRB's supervision, except where a resolution scheme foresees the use of the SRF.

Upon notification from the ECB that a bank is failing or likely to fail, the SRB will adopt a resolution scheme including relevant resolution tools and any use of the SRF. The EC and the Council can object to the resolution scheme within 24 hours. If approved, the resolution scheme will be executed by the SRB with assistance from the national resolution authority. If not approved, the SRB must adapt its decision within 8 hours.

The banking union was created without any amendments to the treaties of the European Union. Supervision under the SSM is assigned to an already existing European institution, the ECB. The authorities needed for European supervision are based on existing authorities that were established by separate regulations.¹¹ The SRM was created by Regulation 806/2014. This regulation is based on Article 114 of the Treaty of the Functioning of the European Union (TFEU), which allows the adoption of measures for the approximation of national provisions aiming at the establishment and functioning of the internal market. This legal basis has led to several questions regarding the admissibility of the delegation of authorities laid down in the regulation.

In this paper, I will first describe the functioning of the SRM, because the legal protection of the SRM can only be described per phase and action under the SRM since there is no general legal protection procedure applicable to every action under the SRM. After this description I will discuss the possibilities for legal protection against these actions and the uncertainties the SRM has created for involved parties.

2 WHY AN SRM?

Resolution occurs when the authorities determine that a bank is failing or likely to fail, that there is no other private sector intervention that can restore the entity back to viability within a short time frame – a standard “insolvency situation”.

In normal solvency procedures, the primary objective is to maximise the value of assets of the failed firm in the interest of creditors. This may take many years for complex entities and therefore leads to uncertainty. This uncertainty in case a bank would fail is incompatible with the character of banks. Banks operate on the basis of public trust. The loss of confidence by depositors and creditors might lead to a bank run, which could lead to the failure of the bank. Briefly summarised, this means that the possibility of failure and regular insolvency procedures itself might be the trigger of this failure.

Another problem is that the failure of a large bank may undermine the confidence in other banks, affect their finances and create instability across the financial system as a

11 The ESRB was established by Regulation 1092/2010, EBA was established by Regulation 1093/2010, the EIOPA was established by Regulation 1094/2010 and ESMA was established by Regulation 1095/2010.

whole. Through this “contagion effect”, the value and viability of many or all banks can be rapidly eroded, and the entire financial system could be destabilised in case of the failure of one bank.

To prevent these consequences, the primary objective of bank resolution is to respond in a rapid and decisive manner to a bank in financial distress to maintain financial stability and minimise losses for society, in particular in relation to taxpayers, while ensuring similar results to those of normal insolvency proceedings in terms of allocation of losses to shareholders and creditors. Resolution thus aims to protect certain critical stakeholders and functions of the failing bank (such as depositors and payment systems). Other parts, which are not considered key to financial stability, may be allowed to fail in the normal way.

Because divergences between national resolution rules have an impact on the perceived credit risk, financial soundness and solvency, these differences created an unlevel playing field. This undermines public confidence in the banking sector and obstructs the exercise of the freedom of establishment and the free provision of services within the internal market because financing costs would be lower without such differences.¹² That is the reason for the introduction of a European resolution mechanism. Moreover, because the high national rescue costs lead to unilateral ring-fencing activities and the imposition of higher national liquidity and capital requirements by national supervisors to prevent financial risks, it was also necessary to establish a European fund in conjunction with the resolution mechanism.

The financial crisis in Cyprus highlighted the need for an SRM. The resolution decisions taken in that case became a blueprint for the SRM. This crisis showed that only swift and decisive action backed by EU-level funding arrangements could avoid a disproportionate impact on the real economy, curb uncertainty and prevent bank runs and contagion of other parts of the Euro area and the Single Market.

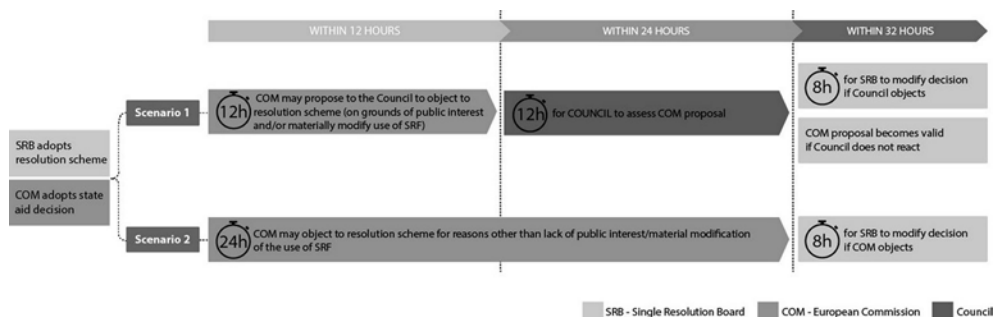
3 FUNCTIONING OF SRM

“Resolution” means the restructuring of a bank by a resolution authority, through the use of resolution tools, to ensure the continuity of its critical functions, preservation of financial stability and restoration of the viability of all or part of that entity, while the remaining parts are put into normal insolvency proceedings.

The working of the resolution procedure is illustrated by the EC¹³ as follows:

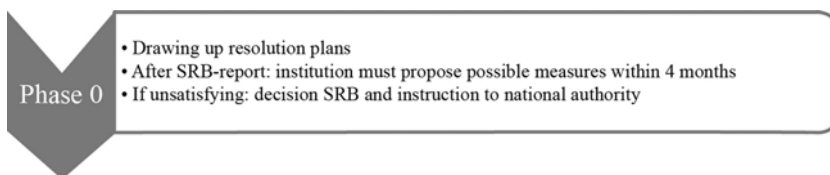
¹² Recital 3 Regulation 806/2014.

¹³ http://europa.eu/rapid/press-release_MEMO-14-294_nl.htm.



This resolution procedure will apply to

1. significant banks in accordance with Article 6(4) of Regulation (EU) No 1024/2013 that are not a group;
2. not-significant banks in relation to which the ECB has decided to exercise directly all of the relevant powers in accordance with Article 6(5)(b) of Regulation (EU) No 1024/2013;
3. other cross-border groups;
4. the resolution of banks where the resolution action requires the use of the SRF;
5. resolution after a decision by the SRB to exercise directly all of the relevant powers in accordance with Article 7(4)(b) of the Regulation; and
6. resolution after a decision by a participating Member State that the SRB will exercise all of the resolution powers in relation to entities established in that Member State's territory in accordance with Article 7(5) of the Regulation.¹⁴

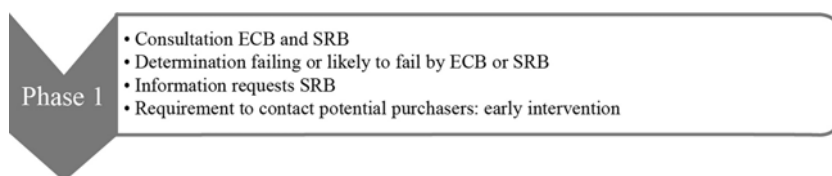


The preliminary phase of recovery under the SRM for a significant bank is the drawing up of resolution plans for all banks under the responsibility of the SRB. This resolution plan must set out the options for applying the resolution tools and exercising resolution powers.¹⁵ These plans will be reviewed at least annually and after material changes. If the SRB, after consultation with the ECB, determines that there are substantive impediments to the resolvability of that entity or group, the Board of the SRB must prepare a report and

¹⁴ Article 7 Regulation (EU) No 806/2014.

¹⁵ Article 8(5) Regulation (EU) No 806/2014.

send it to the entity.¹⁶ The entity must propose possible measures to address or remove the substantive impediments within 4 months.¹⁷ The SRB assesses the proposal and can decide that it does not effectively reduce or remove the impediments and in this decision instruct the national resolution authority to require the entity to take any of the measures mentioned in Article 10 (11).¹⁸ The national resolution authority is obliged to follow this instruction.



The first phase of recovery under the SRM is the determination of whether an entity is failing or likely to fail. This determination is the competence of the ECB.¹⁹ If the ECB, after consultation with the SRB, concludes that this criterion is met, the ECB will notify the SRB and the EC. However, the SRB is authorised to inform the ECB about its own intention to make this determination. If the ECB does not make the determination within 3 days after the SRB notice, the SRB has the power to do so.²⁰

The SRB may request any information from the ECB to be able to make such a determination. The ECB also has the right to request information, but this right is not based on the provisions regarding the SRM but on the provisions regarding the SSM. The SRB remains ultimately responsible to determine whether resolution action is necessary in the public interest.

The recovery process can also be triggered by certain supervisory measures. Article 13 of the Regulation summarises measures that the SRB must be informed about by the ECB or the national authority. Based on this information, the SRB is authorised to prepare for the resolution of the entity involved. In this case, the SRB must have the power to require the entity to contact potential purchasers in order to prepare for the resolution of the entity.²¹ These measures are called “early intervention”. Given that use of the SRF is to be minimised, the SRM can be expected to focus on preparations and readiness for resolutions and, if necessary, early intervention measures.

16 Article 10(7) Regulation (EU) No 806/2014.

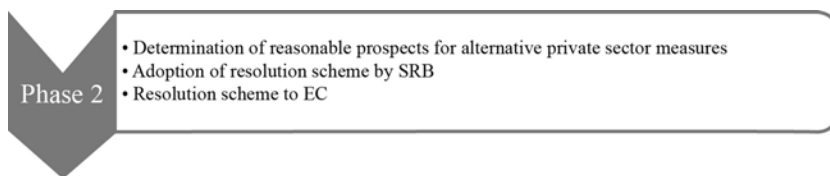
17 Article 10(9) Regulation (EU) No 806/2014.

18 Article 10(10) Regulation (EU) No 806/2014.

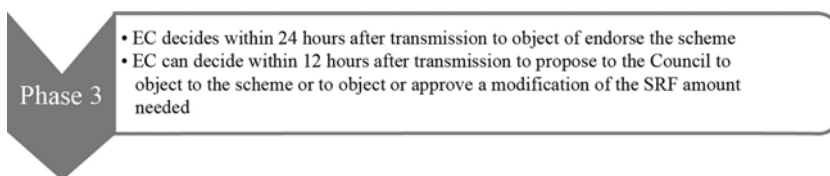
19 Article 18(1) Regulation (EU) No 806/2014.

20 Article 18(1) Regulation (EU) No 806/2014.

21 Article 13(3) Regulation (EU) No 806/2014.



The second phase is the determination of whether or not there are prospects for alternative private sector solutions. This determination is made by the SRB, in close cooperation with the ECB.²² The ECB may inform the Board that this second condition for resolution is met. If the SRB concludes that resolution action is necessary in the public interest, it adopts a resolution scheme, including relevant resolution tools and any use of the SRF, after consultation with the ECB or the relevant national resolution authorities.²³ Immediately after adoption, the SRB transmits the resolution scheme to the EC.²⁴ Depending on the total amount needed from the SRF in the course of 1 year, the SRB will convene a meeting of its plenary or executive session.



In the third phase, within 24 hours after transmission by the SRB, the EC must either endorse the resolution scheme or object to it. The EC's decision is directed to the SRB. The decision to object must state the grounds. In the same third phase, within 12 hours after transmission by the SRB, the EC may propose to the Council to object, within 12 hours after receiving the proposal, to the resolution scheme or to approve or object to a material modification of the amount of Fund provided for in the resolution scheme. The Council must provide reasons for the exercise of its power of objection.

The objection by the Council can only be based on the judgment that resolution is not necessary in the public interest. In that case, the entity is orderly wound up in accordance with the applicable national law.²⁵ The objection by the EC can be based on all other discretionary aspects of the resolution scheme.²⁶

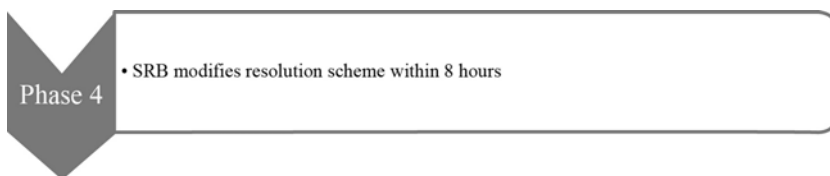
22 Article 18(1) Regulation (EU) No 806/2014.

23 Article 18(6) Regulation (EU) No 806/2014.

24 Article 18(7) Regulation (EU) No 806/2014.

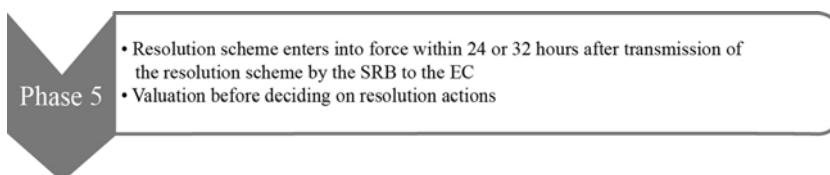
25 Article 18(8) Regulation (EU) No 806/2014.

26 Article 18(7) Regulation (EU) No 806/2014.



The fourth phase only takes place after objections by the EC and/or the approval by the Council of material modifications of the amount of Fund that should be provided in the resolution scheme. In this phase, the SRB will modify the resolution scheme in accordance with the reasons expressed by the EC or the Council within 8 hours.²⁷

The SRB has the authority to amend and update the resolution scheme after it enters into force if this is appropriate in light of the circumstances of the case.²⁸



After the modification or after the third phase if there are no objections, the resolution scheme may enter into force. This is the fifth phase. The purpose of these very tight deadlines, in a total of 32 hours, is to allow a bank to be resolved over the weekend.

The resolution scheme is addressed to the national resolution authorities and instructs these authorities to take all necessary national measures to implement it using their resolution powers in line with national company and insolvency law.²⁹

The SRB must ensure a “fair, prudent and realistic” valuation of the assets and liabilities of the entity under resolution before deciding on resolution action or the exercise to write down or convert relevant capital instruments. The valuation must be carried out by an independent person.³⁰ The valuation is an integral part of the decision on the application of a resolution tool or on the exercise of a resolution power or the decision on the exercise of the write-down or conversion power of capital instruments.³¹ Valuations must be updated if necessary and possible.³²

27 Article 18(7) Regulation (EU) No 806/2014.

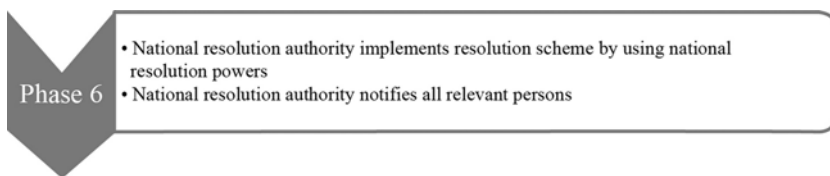
28 Articles 23 and 28(3) Regulation (EU) No 806/2014.

29 Article 18(9) Regulation (EU) No 806/2014.

30 Article 20(1) Regulation (EU) No 806/2014.

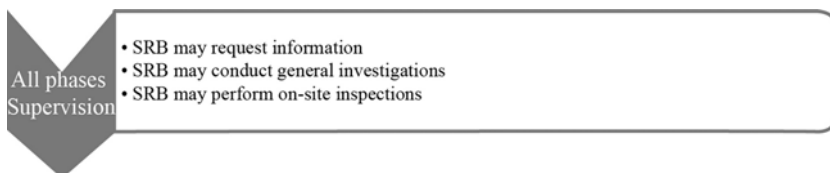
31 Article 20(15) Regulation (EU) No 806/2014.

32 Article 20(14) Regulation (EU) No 806/2014.



The national resolution authorities must comply with the applicable procedural obligations based on Article 83 of the BRRD.³³ This means that they must notify the institution under resolution and several authorities in a prescribed order by sending a copy of any order or instrument by which the relevant powers are exercised and an indication of the date by which the resolution action or actions will be effective. The authority will publish a copy of the order or instrument.³⁴

The SRB monitors the execution by the national resolution authorities of its decisions at the national level. The SRB may give instructions to the national resolution authorities as to any aspect of the execution of the resolution scheme³⁵ and, should a national resolution authority not comply with its decision, can directly address executive orders to the bank in resolution.³⁶ These measures are published by the SRB.



The SRB has the power to obtain any information necessary for it to prepare and decide upon a resolution action from the involved entity, its employees and third parties to whom the entities have outsourced functions or activities. These persons have an obligation to comply with the request.³⁷ The information request must be based on a decision.³⁸

The SRB may also conduct investigations of the same parties: the involved entity, employees and third parties. This authority means that the SRB may require the submission of documents, examine and take copies of books and records, obtain explanations and interview persons. Such an investigation must be based on a decision of the SRB.³⁹

33 Article 29(5) Regulation (EU) No 806/2014.

34 Article 83 Directive 2014/59/EU.

35 Article 28(2) Regulation (EU) No. 806/2014.

36 Article 29(2) Resolution (EU) No. 806/2014.

37 Article 34(2) Regulation (EU) No. 806/2014.

38 Article 39(1) Regulation (EU) No. 806/2014.

39 Article 35 Regulation (EU) No. 806/2014.

The SRB may also perform on-site inspections at the business premises of the involved entity and third parties. The SRB must give a prior notification of the inspection to the person or persons involved unless the proper conduct and efficiency of the inspection require otherwise. An on-site inspection must be based on a decision of the SRB.⁴⁰

All phases
Sanctions

- SRB may impose a fine
- SRB may recommend national resolution authorities to take enforcement action
- SRB may impose periodic penalty payments
- SRB publishes fines and periodic penalty payments

The SRB may impose an administrative fine on companies under the scope of the Regulation in cases where

- a person does not supply information requested by the SRB;
- a person does not submit to general investigations or on-site inspections by the SRB;
or
- a person does not comply with a decision regarding instructions based on the resolution scheme addressed to him by the SRB.⁴¹

The basic amount of the fine is a percentage between 0.05% and 0.5% of the total annual net turnover of the fined person. These amounts can be adjusted by applying mitigating and aggravating coefficients in situations described in the Regulation, but the fine may not exceed 1% of the entity's annual turnover.

For infringements other than the ones that can be fined, the SRB may recommend that the national resolution authorities take enforcement action in accordance with Articles 110 and 114 of Directive 2014/59/EU and any relevant national legislation.⁴²

The SRB may impose a periodic penalty payment to compel the entity or person to

- comply with an information request by the SRB;
- submit to general investigations or on-site inspections.

The amount of a periodic penalty payment will be 0.1% of the average daily turnover, but that amount can be adapted to make sure the sanction is effective and proportionate. A periodic penalty payment will be imposed on a daily basis until the relevant decision has been complied with but may not be imposed for a period longer than 6 months.⁴³

⁴⁰ Article 36 Regulation (EU) No. 806/2014.

⁴¹ Article 38(2) Regulation (EU) No. 806/2014.

⁴² Article 38(8) Regulation (EU) No. 806/2014.

⁴³ Article 39 Regulation (EU) No. 806/2014.

Before a decision is taken to impose a fine or periodic payment penalty, the addressee will be able to express its views. The addressee will have access to the SRB's file, subject to the legitimate interest of other persons in the protection of their business secrets and with the exception of confidential information and internal preparatory documents of the Board of SRB.⁴⁴ In principle, the decisions imposing fines or periodic penalty payments will be published.⁴⁵ Enforcement of fines and periodic payments is governed by the applicable national procedural rules.

4 LEGAL BASIS

The SRM Regulation is based on Article 114 TFEU. The SRB is an EU agency and has legal personality.⁴⁶

It has been questioned whether this legal basis suffices for the powers of the SRB under the SRM. Therefore, although the decision to adopt a resolution scheme will be prepared and endorsed by the SRB, either in its plenary or executive session, the discretionary parts of the decision will be adopted by the EC and/or the Council as Treaty-based institutions. The reason for this is that it was concluded from case law that there can be no conferral of discretionary powers on EU agencies.⁴⁷ Furthermore, an additional legal basis for the SRF was decided upon in December 2013, namely an intergovernmental agreement.⁴⁸

In the meantime, the EU Court of Justice has rendered an important judgment in this regard. The UK sought the annulment of an Article of a Regulation that confers on an EU agency, namely ESMA, the power to intervene, by way of legally binding acts, in Member State financial markets in the event of a "threat to the orderly functioning and integrity of financial markets or to the stability of the whole or part of the financial system in the Union".⁴⁹

The main findings of the judgment of the Court of Justice are as follows:

1. The Union legislature may, in an area that requires the deployment of specific technical and professional expertise, confer discretionary implementing powers upon a Union agency if these powers are clearly defined and limited by various conditions and criteria;
2. Article 114 TFEU serves as a legal basis for the establishment of a mechanism that would enable measures to be adopted throughout the EU, which may take the form, where necessary, of decisions directed at certain participants in financial markets.

44 Article 40 Regulation (EU) No. 806/2014.

45 Article 41 Regulation (EU) No. 806/2014.

46 Article 42 Regulation (EU) No. 806/2014.

47 Case 9/56 *Meroni v High Authority* (1957 and 1958) ECR 133.

48 Recital 19 Regulation (EU) No. 806/2014.

49 Court of Justice 22 January 2014, Case C-270/12, *United Kingdom v Council and European Parliament*.

This judgment has implications for the assessment of the legal basis of the SRM. The Court of Justice made it clear in this judgment that measures that are needed for the orderly functioning and integrity of the financial markets or the stability of the financial system in the EU serve the functioning of the internal market under Article 114 TFEU, in particular where consistency between Member States is of importance and the continuing application of divergent measures by Member States may create obstacles to the internal market.

In fields with complex technical features and that require highly technical and specialist analyses – which is the case with banking resolution – Article 114 TFEU does provide a legal basis for establishing Union agencies and for conferring the necessary implementing powers upon those agencies even though these powers may be discretionary.

The Court has set⁵⁰ certain conditions for the referral as follows:

- The conferred powers have to be clearly defined by the empowering act with respect to substantive and procedural requirements;
- The conferred powers have to be effectively controlled by the delegating authority (political control);
- The conferred powers have to be subject to a legal review (legal control);
- Political responsibility cannot be conferred upon executive bodies.

The ESMA judgment is important for the legal protection under the SRM. Before this judgment it was questioned whether the conferring of powers on the SRB met the criteria for this under the EU treaties. If not, a resolution decision of the SRB, with far-reaching consequences, could be annulled by the Court of Justice. This would create legal uncertainty. This legal uncertainty has been substantially reduced by the ESMA judgment.

This paper analyses the legal protection from the powers conferred on SRB under the SRM. The main basis for legal protection is an action for annulment before the Court of Justice. This right was extended to – among others – agencies of the Union by the Lisbon Treaty.⁵¹

50 Court of Justice 22 January 2014, Case C-270/12, *United Kingdom v Council and European Parliament* and 13 June 1958, Case C-9/56, *Meroni v High Authority*.

51 Article 263(1) TFEU.

5 LEGAL PROTECTION

5.1 *Articles 85 and 86 Regulation*

The Regulation contains two articles on legal protection: Article 85 and Article 86. I will discuss these articles before discussing the legal protection for the actions and decisions described above.

Any natural or legal person, including resolution authorities, may appeal with the Appeal Panel against the following decisions by the SRB addressed to that person, or decisions that are of direct and individual concern to that person:

- a decision indicating that the measures proposed by the entity do not effectively reduce or remove the impediments to resolvability, and instructing the national resolutions authorities to require the entity to take any of the measures listed in Article 10(11) of the Regulation;
- a decision to apply simplified obligations in relation to the drafting of resolution plans based on Article 11 of the Regulation;
- a decision regarding the minimum requirement for own funds and eligible liabilities based on Article 12(1) of the Regulation;
- a decision to impose a fine or a periodic penalty payment;
- a decision setting or increasing the contributions owed by an entity to the SRB based on Article 65(3) of the Regulation;
- a decision on extraordinary ex-post contributions to the SRF;
- a decision on confirmatory applications – i.e. applications filed after failure by the entity to reply within the prescribed time limit – for access to a document.⁵²

The appeal must be filed within 6 weeks of the date of notification of the decision and will be decided within 1 month. The appeal has no suspensive effect, but the Appeal Panel may suspend the application of the contested decision.⁵³

Recital 120 of the Regulation relates to the competence of the Court of Justice:

[...] The Court of Justice has jurisdiction to review the legality of decisions adopted by the Board, the Council and the Commission, in accordance with Article 263 TFEU, as well as for determining their non-contractual liability. Furthermore, the Court of Justice has, in accordance with Article 267 TFEU, competence to give preliminary rulings upon request of national judicial authorities on the validity and interpretation of acts of the institutions, bodies

⁵² Article 85 Regulation (EU) No. 806/2014.

⁵³ Article 85 Regulation (EU) No. 806/2014.

or agencies of the Union. National judicial authorities should be competent, in accordance with their national law, to review the legality of decisions adopted by the resolution authorities of the participating Member States in the exercise of the powers conferred on them by this Regulation, as well as to determine their non-contractual liability.

This recital has led to Article 86 of the Regulation on actions before the Court of Justice. The Court of Justice may review a decision by the Appeal Panel or, if there is no right of appeal, by the Board in accordance with Article 263 TFEU. Member States, Union institutions, as well as any natural or legal person may institute proceedings against decisions of the Board in accordance with Article 263 TFEU.

Furthermore, Article 86 provides that proceedings for failure to act may be brought before the Court of Justice in accordance with Article 265 TFEU in the event that the SRB has an obligation to act and fails to take a decision.

5.2 *Article 263 TFEU*

The Court of Justice is competent only in the cases determined by the EU treaties. Article 274 TFEU explicitly provides that disputes to which the Union is a party must not on that ground be excluded from the jurisdiction of the courts or tribunals of the Member State, save where jurisdiction is conferred on the Court of Justice by the Treaties. If the Court of Justice is competent, the competence is exclusive.⁵⁴ The most important Article that confers jurisdiction on the Court of Justice for appeals by legal or natural persons is Article 263 TFEU.⁵⁵

Article 263 TFEU is not limited to “decisions” but gives the Court of Justice authority to review “acts” of agencies. The difference, however, is not as big as it seems because, according to case law, only acts that produce legal effects that are binding on and capable of affecting the interests of the individual fall within the scope of judicial review based on Article 263 TFEU. Confirmatory measures and implementing measures, mere recommendations and opinions and, in principle, internal instructions do not meet this criterion.⁵⁶ In other cases several acts were considered to have binding, legal effects: the rejection of a complaint, a letter detailing the reasons for not following up on a complaint, the decision to grant or refuse a third-party access to a file, the refusal to hear interested parties. Furthermore, to be challengeable, an act must be definitive. A preparatory act that only constitutes one of the steps towards a legal decision cannot be challenged on the basis of

54 Court of Justice 9 October 2001, Case C-214/08, *Guigard v. Commission*.

55 R. Barents, *EU-procesrecht*, Deventer, 2010, p. 65.

56 Court of Justice 12 September 2006, Case C/242/04, *Reynolds Tobacco/Commission*.

Article 263 TFEU.⁵⁷ If a decision from an agency leaves some leeway to the national authority to determine the content of the final measure, the decision of the agency cannot be regarded as directly affecting the legal situation of the person concerned and therefore cannot be challenged before the Court of Justice.⁵⁸ In that case the matter can be raised only before the national court having jurisdiction. The national court may, if necessary, raise questions concerning the validity of the decision concerned and submit these for a preliminary ruling to the Court of Justice.⁵⁹

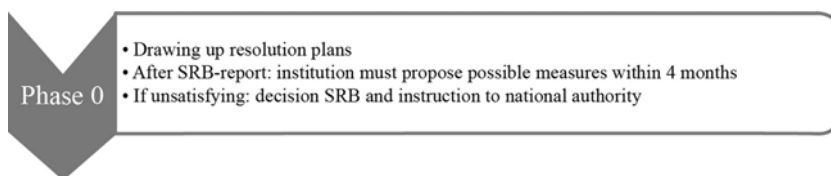
Proceedings based on Article 263 TFEU must be instituted within 2 months after the publication of the action. If an action was eligible for proceedings, but no proceedings were filed (timely), the action becomes definitive, and the illegality can no longer be plead.

5.3 *Article 265 TFEU*

Article 265 TFEU gives the right to a natural or legal person to complain to the Court of Justice that an institution, body, office or agency of the Union has failed to address to that person any act other than a recommendation or an opinion. This right is limited to the supposed addressees. And this right is furthermore limited to the same actions that are subject to an appeal based on Article 263 TFEU. Therefore, it is limited to actions that – if they were taken – have legal effect.

5.4 *Legal Protection in Resolution Phases*

It seems almost impossible to discuss the legal protection against any possible action under the SRM. Below, the most important ones will be discussed phase by phase.



In the preliminary phase, resolution plans are drawn up and reviewed periodically. The SRB may decide, based on this plan, that there are substantive impediments to the resolvability of that entity. This opinion will be in writing (in a report), addressed to the entity.

⁵⁷ Court of First Instance 6 May 2003, Case T-45/02, DOW Agrosociencias v. Parliament and Council.

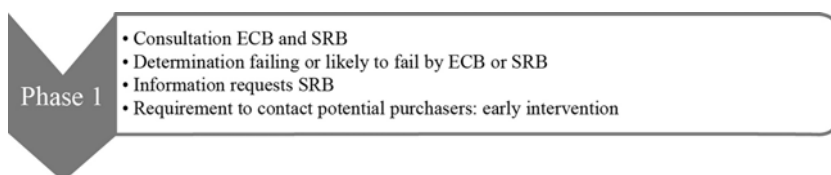
⁵⁸ Court of First Instance 12 December 2007, Case T-109/06, Vodafone España and Vodafone Group v Commission.

⁵⁹ Court of Justice 16 March 1987, Case 123/77, UNICME and Others v Council.

The report contains recommendations on the necessary measures. The entity must propose possible measures to the SRB within 4 months.

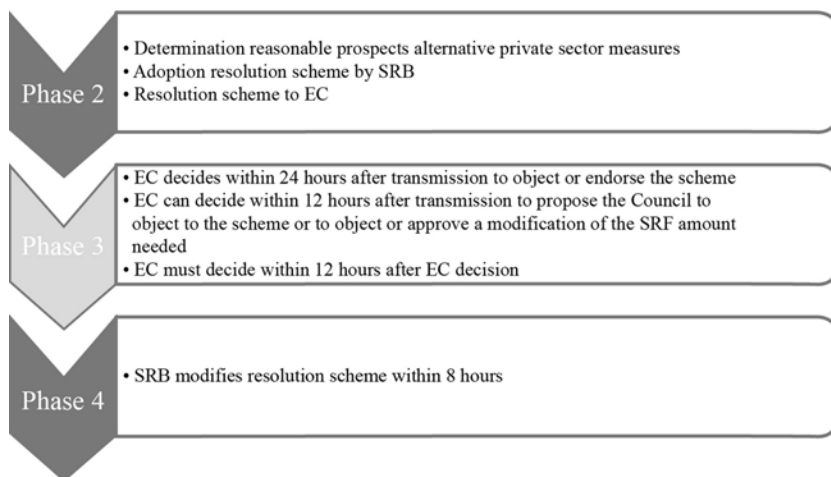
In the Regulation this report is not qualified as a decision. And Article 10(7) and (8) Regulation are not mentioned in the list of decisions open for appeal to the Board of Appeal in Article 85(3) Regulation. Because the SRB gives recommendations instead of instructions, I believe the report will not be considered to have legal effect, and therefore it will not be possible to request the annulment of the report by the Court of Justice based on Article 263 TFEU.

If the SRB decides that the proposal does not effectively reduce or remove the impediments, it gives a decision. This decision contains an instruction to the national resolution authority to require the entity to take any of the measures mentioned in Article 10(11). The national resolution authority is obliged to follow this instruction. This decision is specified in Article 85(3) Regulation as a decision open for appeal to the Board of Appeal. Because the instruction is addressed to the national resolution authority, the national resolution authority can appeal. The question is whether the involved entity can also appeal the decision. An appeal can be lodged only by a person for whom the decision is of “direct and individual” concern. Since the decision must be implemented by measures to be taken by the national resolution authority and this authority has a discretionary authority in choosing the resolution measures to be used, it is questionable whether the entity will be able to appeal the decision.



The actions in the first phase are based on Articles 18 or 13 Regulation. Decisions based on these Articles are not mentioned in Article 85 Regulation and therefore not open to appeal at the Board of Appeal.

The early intervention measures from Article 13 Resolution give the SRB the authority to require certain actions from the entity. If the entity does not meet the requirement, the SRB does not have the authority to impose a fine or periodic penalty payment. Therefore, it is not likely that an action from the SRB based on Article 13 Resolution will be considered to have legal consequences.



Phases 1, 2, 3 and 4 consist of many consecutive decisions that ultimately lead to the adoption of the resolution plan. The ultimate decision is made by the Commission or the Council by endorsing the scheme or not objecting to it. The resolution plan places the entity under resolution when it enters into force. This might be considered to be a legal consequence, although the consequences for the entity will depend on the resolution measures to be taken based on the resolution scheme. The resolution scheme is addressed to the national resolution authorities and instructs these authorities to take all necessary national measures to implement it using its resolution powers in line with national company and insolvency law.⁶⁰ The national authorities will have some discretionary power by implementing the resolution scheme. Therefore, it is not likely that the adoption and entry into force of the resolution scheme will be considered to have direct legal consequences for the involved entity. Furthermore, since the adoption of a resolution scheme based on Article 18(1) Resolution is not mentioned as a decision subject to appeal, it is likely that this decision is not meant to be considered to have direct legal consequences for the entity involved. This might be problematic, because it is likely that the fact that an entity is placed under resolution will at least have several contractual consequences. Furthermore, with the adoption of the resolution scheme, the contribution from the SRF is determined. It is important to have clarity on the legal protection against the adoption of a resolution scheme as soon as possible. And it is also important to choose a legal protection procedure that is able to decide on an appeal in a very short period of time.

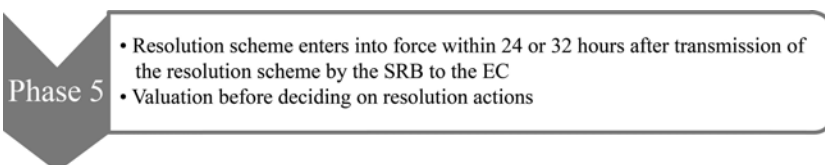
If it is not possible to request annulment to the Court of Justice based on Article 263 TFEU, it might be possible to address the national court, and the national court can ask a preliminary ruling by the Court of Justice. In the Netherlands, this could be the adminis-

⁶⁰ Article 18(9) Regulation (EU) No 806/2014.

trative court or the civil court. In the legal history of the General Administrative Law Act (Awb), it was explicitly mentioned that decisions from institutions from the EU based on EU regulations cannot be reviewed by the national administrative court.⁶¹ Therefore, the only competent judge could be the civil court if Article 263 TFEU does not apply to the adoption of a resolution scheme by the SRB. If the annulment of the decision to adopt a resolution scheme cannot be requested to the Court of Justice based on Article 263 TFEU, the failure to adopt a resolution scheme cannot be the subject of an Article 265 TFEU procedure. Since the Regulation does not determine a time limit for the drawing up of a resolution scheme, this might lead to a deficit in legal protection.

Article 42(2) Regulation prescribes that the SRB must enjoy the most extensive legal capacity accorded to legal persons under national law and explicitly mentions that the SRB may be a party to legal proceedings. However, the final decision will be made by the Commission or the Council. Since the authority of the Commission and the Council is based on the assumption that discretionary implementing powers can only be conferred on an EU institution, and apparently the power to adopt a resolution scheme is considered to be (partly) a discretionary power, I believe the decision to be challenged should be the decision by the Commission or the Council.

The SRB has the authority to amend and update the resolution scheme after entering into force if this is appropriate in light of the circumstances of the case.⁶² Decisions to do so can be reviewed only by the Court of Justice if the adoption of the scheme can be reviewed. If not, the amendments can be reviewed only by the national – in the Netherlands probably civil – court.



The possibility to challenge the entry into force of a resolution scheme is discussed above.

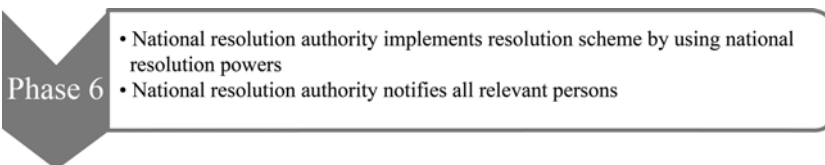
The SRB must ensure a “fair, prudent and realistic” valuation of the assets and liabilities of the entity under resolution before deciding on resolution action or the exercise to write down or convert relevant capital instruments.⁶³ The legal basis for the validation is Article 20 Regulation, which is not mentioned in the list of decisions subject to appeal. Article 20(15) Regulation provides that the validation is an integral part of the decision on the application of a resolution tool or on the exercise of a resolution power or the decision on

61 *Kamerstukken II* 1988/89, 21 221, nr. 3, p. 29.

62 Articles 23 and 28(3) Regulation (EU) No 806/2014.

63 Article 20(1) Regulation (EU) No 806/2014.

the exercise of the write-down or conversion power of capital instruments. Therefore, the validation can only be appealed in an appeal to the decisions based on the regulation scheme, addressed to the involved entity. These decisions are usually taken by national authorities as described in phase 6.



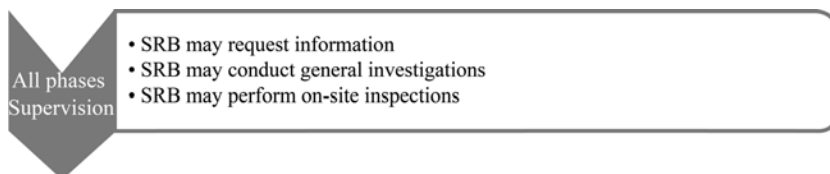
The resolution scheme instructs the national resolution authority to implement the resolution scheme by using resolution powers. The national legislator will have to provide adequate legal protection to these decisions by the national resolution authority. In the Netherlands, most of these decisions can be reviewed by the administrative court since they are decisions pursuant to the Awb.

The national authority will not only send the implementing decision to the involved entity, but will also notify several authorities and will publish a copy of the order or instrument. These actions will be subject to legal protection according to national law. In the Netherlands the publication of a decision is usually considered not to have legal consequences and therefore cannot be reviewed by an administrative court but only by the civil court. In the Netherlands an exception to this rule has been made by law for the publication of several enforcement measures pursuant to the Financial Law Act. Furthermore, non-financial supervisors that publish enforcement measures base the authority to do so on the Government Information (Public Access) Act (Wob), and according to recent jurisprudence, this kind of publication can also be reviewed by the administrative court.⁶⁴ The Wob, however, is not applicable to DNB when exercising authorities based on the Wft. DNB is the resolution authority, and the resolution powers and measures are part of the Wft. Therefore, the Wob will probably not be considered applicable to the publication of resolution measures. This means only the civil court will be competent to judge the publication of resolution measures.

The SRB monitors the execution by the national resolution authorities of its decisions at the national level. The SRB may give instructions to the national resolution authorities as to any aspect of the execution of the resolution scheme. These instructions have to be carried out by the national authority before they have legal consequences for the involved entity. Therefore, the involved entity will probably not be able to request the Court of Justice to judge an instruction by the SRB to the national resolution authority.

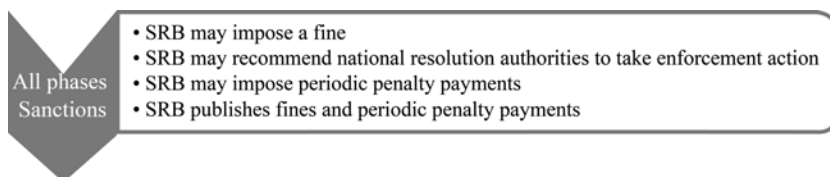
⁶⁴ P.e. ABRS 7 September 2011, AB 2011, 324.

Should a national resolution authority not comply with the instruction by the SRB, the SRB can directly address executive orders to the bank in resolution. These measures are published by the SRB. These measures have legal consequences for the involved entity and can therefore probably be reviewed by the Court of Justice. According to Article 85 Regulation, these measures are not subject to appeal to the Appeal Panel.



Information requests, general investigations and on-site inspections are based on a decision.⁶⁵ According to Article 85 Regulation, these decisions are not subject to appeal to the Appeal Panel. They may only be brought before the Court of Justice. Since non-compliance with any of these decisions can be sanctioned by a fine or a periodic penalty payment, these decisions can be regarded as actions as described in Article 263 TFEU.

In the Netherlands, decisions containing an information request or decisions to perform general investigations or on-site inspections are not considered to be decisions pursuant to the Awb.⁶⁶ Therefore, they can be reviewed only by the national civil court. And the civil court judges exercise restraint in judging these decisions because the administrative court will be able to judge these decisions at a later moment indirectly by judging the decision based on the findings of these requests, investigations and inspections.⁶⁷



The SRB can impose an administrative fine or a periodic penalty payment on entities and on legal persons. Before the decision is made, the SRB is obliged to give the involved person the opportunity to be heard on the findings of the SRB that will be the basis for imposing a fine or a periodic penalty payment. And the SRB must base its decision to impose a fine or periodic penalty payment only on findings on which the person subject to the proceed-

⁶⁵ Articles 39(1), 35, 36 Regulation (EU) No. 806/2014.

⁶⁶ Pe CBb 21 July 1998, AB 1998, 437.

⁶⁷ Pe CBb 28 August 2008, AB 2008, 344.

ings has had the opportunity to comment. A fine or a periodic penalty payment is always imposed by a decision, and this decision is subject to appeal before the Appeal Panel. The decision of the Appeal Panel can be contested before the Court of Justice.

Enforcement of fines and periodic payments imposed by the SRB is governed by the applicable national procedural rules. The courts of Member States have jurisdiction over complaints that enforcement is being carried out in an irregular manner, but only the Court of Justice can suspend enforcement.⁶⁸

For infringements other than the ones that can be fined, the SRB may recommend the national resolution authorities to take enforcement action in accordance with Article 110 and 114 of Directive 2014/59/EU and any relevant national legislation. This recommendation has no legal effect for the entity involved because a discretionary decision from the national resolution authority is necessary to implement the recommendation.

6 CONCLUSION

By November 2016, EBA has published 39 Guidelines, Recommendations and Technical Standards that give more material legal certainty to the involved entities and persons. In this paper the focus is on procedural certainty for the involved entities and persons. It is concluded that in some cases the legal protection appears to be at least unclear. It is important to reduce these uncertainties as soon as possible. Furthermore, there appears to be little protection from actions by the SRB. Most actions from the SRB will result in decisions from the national resolution authority with legal protection according to the national rules. The decisions of the SRB can be judged in these proceedings by preliminary rulings from the Court of Justice. The consequence of this system is that many important actions and decisions cannot be contested in an early phase because they are not intended to have “legal effect”. However, these early actions and decisions are very likely to have contractual consequences for the involved entity before the national resolution authority can or will take a decision based on the actions or decisions by the SRB. Therefore, the question will be whether the legal protection will be available before passing a “point of no return” in the resolution of an entity.

68 Article 41(3) Regulation (EU) No. 806/2014.

BAIL-IN MECHANISMS IN THE BANK RECOVERY AND RESOLUTION DIRECTIVE

*Bart P.M. Joosen**

1 INTRODUCTION

Avoidance of the need for bail-out operations financed by governments has been one of the most important motives for introduction of the “bail-in” mechanisms for banks that are facing difficulties to continue operations (going concern). The concept of this bail-in mechanism has been introduced in a time where it became clear that very significant rescue operations for banks were needed in order to avoid further development of turmoil in the financial markets. At the occasion of the rescue operations being put in place, it became evident that bank regulatory capital requirements fell short of obligating investors in bank’s capital to join in the burden-sharing when difficulties with banks arose.

In this working paper,¹ I will briefly comment on the bail-in mechanisms set forth in the Bank Recovery and Resolution Directive² (BRRD). I am not discussing all the features of the bail-in mechanism in the whole context of the BRRD. For instance, I will only briefly touch upon the concept of banks being “beyond the point of non-viability” as being an important trigger for the bail-in mechanisms to be put in motion. But for a thorough discussion about the instance and circumstances where bank recovery and resolution mechanism come into force, reference is made to specialised literature and other contributions to the Annual Conference of the Netherlands Association for Comparative and International Insolvency Law held on 6 November 2014.

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- 1 Most of the text of this working paper is taken from Bart P.M. Joosen, ‘Regulatory capital requirements and bail in mechanisms’, Chapter 9 in: the Research Handbook on “Crisis Management in the Banking Sector”, edited by Matthias Haentjens and Bob Wessels, Edward Elgar Publishers (2015) published.
- 2 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, of the European Parliament and of the Council, OJEU L. 173 of 12 June 2014, pp. 190-348.

2 BACKGROUND OF BAIL-IN MECHANISM IN THE INTERNATIONAL CONTEXT

The Basel Committee on Banking Supervision (BCBS) published in August 2010 a Consultative Paper³ introducing the concept of so-called “contingent capital instruments”. As a result of these instruments, private investors and creditors of banks are to be required to contribute to the rescue of banks that are facing difficulties. BCBS proposed the mechanism in which providers of regulatory capital should be denied the right to reclaim the principal sums invested in a bank, by means of a conversion of the debt obligations of the bank to equity or by means of write-off of such principal. The BCBS motivated this recommended new mechanism in bank regulatory capital regulations as follows:

During the recent financial crisis a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital. This had the effect of supporting not only depositors but also the investors in regulatory capital instruments. Consequently, Tier 2 capital instruments (mainly subordinated debt), and in some cases non-common Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support.⁴

The BCBS identified three potential solutions to address this issue: (i) introduce resolution mechanisms that permit the taking of measures against creditors of banks that have contributed to the regulatory capital of banks, (ii) prohibit the use of certain regulatory capital instruments by internationally operating banks (particularly the use of Tier 2 instruments being perceived to provide weak loss-absorbing features) and (iii) require that regulatory capital instruments contain a contractual mechanism that ensures loss absorbency at a “point of non-viability” of the bank.

The BCBS consultation paper discusses particularly the latter mechanism, where it concludes that there is a need for alteration of the regulatory framework for regulatory capital instruments. This change should introduce an additional contingent capital mechanism for the so-called “hybrid capital instruments” (these are usually perpetual subordinated debt obligations containing contractual features to the effect that the holder of the debt instrument can exercise rights and obligations as if he participates in the equity capital of the bank) and the so-called “Tier 2” capital instruments. Tier 2 capital instruments are the lowest quality regulatory capital that banks may use, subject to certain limitations.

3 BCBS, ‘Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability’, August 2010, to be consulted at www.bis.org.

4 BCBS, *op cit*, p. 1.

Tier 2 capital instruments are often shaped as subordinated medium-term bonds that contain mechanisms to be repaid to the creditors within a time horizon of 5-7 years.

The BCBS concluded that there was a need for a fundamental change in dealing with the loss-absorbing ability of regulatory capital instruments. These instruments absorb losses in any event, once a bank enters into liquidation or insolvency. Under the applicable frameworks for bank regulatory capital as they had been introduced decades ago, it is beyond doubt that once a bank is being liquidated or is being declared insolvent, the investors and creditors holding bank regulatory capital instruments – whether they participate in the core equity instruments (so-called Core Equity Tier 1 instruments, usually the share capital of the bank (CET1), or in hybrid instruments or in Tier 2 instruments) – lose their claim to be repaid principal, dividend and interest coupon. This is related to the fact that bank regulatory capital instruments are subordinated in the event a bank is being liquidated or being declared insolvent.

The financial crisis learned, however, that governments and regulatory authorities attempted to rescue banks in circumstances where liquidation or insolvency of the bank was to be avoided. If such liquidation or insolvency would be enacted, certain unwanted effects would arise in the financial markets, disrupting also the continuation of operations of other banks that did not face financial difficulties or the operation of financial markets. A problem with one bank would result into undesirable cascade effects with other banks or in the financial markets as a whole. Rescue operations were often directed at avoiding such “systemic risks” occurring.

Particularly in circumstances where the bank concerned was not yet in a state that liquidation or insolvency could not be avoided, but where the financial difficulties or other problems were too serious to continue operating the bank without measures, intervention of governments by bailing out the bank with capital injections or other financing operations was the choice made in many cases. In these circumstances, creditors providing ordinary bank regulatory capital escaped the discipline of the market, as the customary trigger events contained in the contractual terms and conditions of the bank regulatory capital instruments did not include loss-absorbing mechanisms in such circumstances. The BCBS notes in this respect:

The Basel Committee is of the view that all regulatory capital instruments must be capable of absorbing a loss at least in gone-concern situations. Furthermore, it believes that a public sector injection of capital needed to avoid the failure of a bank should not protect investors in regulatory capital instruments from absorbing the loss that they would have incurred had the public sector not chosen to rescue the bank.

To achieve this objective, the Basel Committee has developed a proposal that would ensure all regulatory capital instruments are able to absorb losses in the event that a bank is unable to support itself in the private market including situations when the public sector steps in to recapitalise a bank that would otherwise have failed. Under this proposal gone-concern loss absorbency would continue to work through subordination in liquidation for failed banks when the authorities allow them to enter liquidation. However, if the authorities choose to rescue a bank, then the proposal would give the regulatory authorities the option to require regulatory capital instruments (other than common shares) to be written-off or converted into common shares.⁵

The BCBS recommendations have been followed up, by introducing in the Basel III capital accord of 2010⁶ qualitative requirements for bank regulatory capital criteria that require banks to include so-called “contingent capital mechanisms” in terms and conditions of capital instruments. These mechanisms require creditors to accept, once the “point of non-viability” of the bank is reached, that debt obligations of the bank are either converted in equity capital or that the debt instruments are wholly or partly written off.⁷ The point of non-viability, however, has been defined as a measure in which reference is made to the decrease of the bank’s regulatory capital levels at a certain percentage interest. In this respect, the European Capital Requirements Regulation (CRR) of 2013⁸ determines that the contingent capital mechanism should be incorporated in the terms and conditions of so-called Additional Tier 1 capital instruments (AT1) only.⁹

The provisions of the CRR for AT1 capital instruments require a bank to invoke the contingent capital mechanism at least if a so-called “trigger event” occurs when the CET1 capital ratio of the bank falls below 5.125%. Banks, however, may include in the terms and conditions of the AT1 capital instruments higher triggers related to a higher percentage of the CET1 capital or other triggers.¹⁰ The specification of the triggers in the CRR and

5 BCBS, *op cit*, pp. 3 and 4.

6 ‘Basel III: A global regulatory framework for more resilient banks and banking systems’, December 2010, revised version of June 2011, reflecting the changes to the section on Credit Valuation Adjustment, document to be consulted on www.bis.org and the provisions on contingent capital have been supplemented early 2011 by the BCBS in its further document ‘Minimum requirements to ensure loss absorbency at the point of non-viability’, Press Release 11 January 2011, Ref no: 03/2011, www.bis.org.

7 See for these criteria developed by the BCBS: Basel III, *op cit*, p. 15 *et seq.*

8 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJEU L. 176 of 27 June 2013, pp. 1-348 as this text has been subject to a complete corrigendum published in OJEU L. 321 of 30 November 2013.

9 See for a further and elaborate discussion of this topic my contribution ‘Regulatory capital requirements and bail in mechanisms’, Chapter 9 in: *Research Handbook on Crisis Management in the Banking Sector*, Edited by Matthias Haentjens and Bob Wessels, Edward Elgar Publishing (2015), pp. 175-234.

10 See: Article 54, paragraph 1(a) and (b) CRR.

the mechanisms of contingent capital instruments are based on the generic qualitative requirement of the CRR, which determines:

the provisions governing the instruments require that, upon the occurrence of a trigger event, the principal amount of the instruments be written down on a permanent or temporary basis or the instruments be converted to Common Tier 1 instruments;¹¹

The write-down mechanism or the conversion of AT1 capital instruments to CET1 instruments (which mainly ends up creditors being forced to participate in lower ranking share capital) are also the two methods to effectuate the bail-in mechanism of the BRRD. As I will discuss in the further paragraphs that, although there is similarity of the chosen methods for effectuating the bail-in mechanism, there are principally differences with respect to the triggers causing the bail-in mechanism to be effectuated.

3 BAIL-IN PURSUANT TO THE BRRD AS BURDEN-SHARING INSTRUMENT OR AS PENALISATION OF CREDITORS?

The motives set out in many studies and reports on the subject matter of bail-in are reiterated to a great extent in the background recitals of the BRRD. In recital (67):

An effective resolution regime should minimise the costs of the resolution of a failing institution borne by the taxpayers. It should ensure that systemic institutions can be resolved without jeopardising financial stability. The bail-in tool achieves that objective by ensuring that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution. The bail-in tool will therefore give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances and meets the Financial Stability Board recommendation that statutory debt-write down and conversion powers be included in a framework for resolution, as an additional option in conjunction with other resolution tools.

The language used in the BRRD is sharper in its nature, where it is suggested that shareholders and creditors should “suffer appropriate losses”. This deviates from the background motives as set out in the BCBS documents from which we provided citations here, and it

11 See: Article 52, paragraph 1(n) CRR.

also deviates from the CRR language used to address this subject matter. In the BRRD, the bail-in mechanism is placed in the context of penalisation of creditors and shareholders, rather than a burden-sharing mechanism that was the original concept of the international authorities advocating the contingent capital mechanism. The BRRD language also over-estimates the influence that shareholders and creditors may have in monitoring the financial health of European banks in going concern situations. Investors in regulatory capital have little influence on the course of affairs of banks and must accept rather strict reduction of rights exercisable towards the bank when purchasing regulatory capital instruments.

Coffee, however, notes the following:

This potential wealth transfer [after conversion holders of debt take a significant position as holder of equity capital and dilute existing (common) shareholders, *add. author*], is intended to deter the equity from approaching the trigger points at which conversion would occur – and thus disincentivize them from increasing risk and leverage.¹²

These remarks must be placed, in my view, in the context of the corporate governance environment of banks regulated and active in the United States of America. As is often the case with certain concepts developed in view of the specific requirements and issues relevant for the US markets, the rationale to introduce certain principles for these markets is not always applicable or justified for markets in other jurisdictions where other mechanisms and other legal principles apply.

Without debating this topic in too much detail, my view is that the consequences of shareholders' activism and the influence of shareholders on the management of banks must be seen in another perspective if it concerns banks subject to the corporate laws adopted in Europe. The European Commission, however, has projected the discussions held to address constraints occurring in the US markets to the European situation as well. It is with this in mind that the consideration of the Commission cited earlier must be read.

12 John C. Coffee, Jr., 'Bail-ins versus Bail-outs: Using Contingent Capital to Mitigate Systemic Risk', The Centre for Law and Economic Studies, Columbia University School of Law, Working Paper No. 380, 22 October 2010, p. 35.

4 BAIL-IN GOING CONCERN AND GONE CONCERN

The BRRD provides for numerous scenarios that may apply to a bank¹³ that is facing difficulties to continue its operations. The bail-in mechanism requiring shareholders and creditors to cooperate with a reduction of their rights may also be applied in numerous circumstances. Where the original concepts of the contingent capital mechanism had been, that such mechanisms should in principle be applied when the “point of non-viability” of a bank was reached and the bank’s business must be considered gone concern, numerous references in the BRRD for application of the bail-in mechanisms in a partial or whole “going concern” situation can be found too. The BRRD bail-in mechanism can therefore play a role in going concern as well as in gone concern situations. In recital (68) of the BRRD, this is expressed as follows:

In order to ensure that resolution authorities have the necessary flexibility to allocate losses to creditors in a range of circumstances, it is appropriate that those authorities be able to apply the bail-in tool both where the objective is to resolve the failing institution as a going concern if there is a realistic prospect that the institution’s viability may be restored, and where systemically important services are transferred to a bridge institution and the residual part of the institution ceases to operate and is wound up.

From this recital, it clearly appears that the BRRD bail-in mechanisms may be applied in a wider range of circumstances than the original concepts as developed by the BCBS intended to achieve. The overarching mechanism as laid out by the BCBS is to force shareholders and creditors of a bank that is made subject to a rescue operation requiring tax payer monies to be made available for the capitalisation of the bank, to participate in the loss absorption to the fullest extent and in an irrevocable manner. With the application of this principle, the legislator wishes to avoid that claims of shareholders or creditors of a rescued bank revive after the rescue operation would be performed and the bank would successfully return to become a viable business.

The BRRD has made the circumstances where the bail-in mechanism may be applied much broader and, therefore, deviates from the internationally agreed-upon background

13 It must be noted that the BRRD provisions also apply to certain “investment firms”, being investment firms that are subject to the highest minimum capital requirements as set out in Article 28(2) of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, *Pb.EUL* 176, p. 338 and further (so-called “CRD IV-Directive”). This paper does not discuss this type of financial undertaking further.

and motives for contingent capital mechanisms applicable to banks. The purposes of the bail-in tool are set forth in Article 43, paragraph 2 of the BRRD as follows:

Member States shall ensure that resolution authorities may apply the bail-in tool to meet the resolution objectives specified in Article 31, in accordance with the resolution principles specified in Article 34 for any of the following purposes:

- (a) to recapitalise an institution or an entity referred to in point (b), (c) or (d) of Article 1(1) of this Directive that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation (to the extent that those conditions apply to the entity) and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU, where the entity is authorised under those Directives, and to sustain sufficient market confidence in the institution or entity;
- (b) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred:
 - (i) to a bridge institution with a view to providing capital for that bridge institution; or
 - (ii) under the sale of business tool or the asset separation tool.

The resolution objectives of Article 31 BRRD are not necessarily restricted to the avoidance of development of systemic risk in the financial markets, but may also relate to other objectives. The avoidance of system risk, as noted earlier, is one of the main (if not the exclusive) driver for the introduction of the bail-in mechanisms as suggested by the BCBS in August 2010. However, the resolution objectives under the BRRD may also relate to the protection of rights of depositors having claims on the bank, with the exception of depositors not protected by the deposit guarantee scheme of Directive 2014/49/EU¹⁴ or investors protected by the investor compensation scheme of Directive 97/9/EC.¹⁵ Another resolution objective is to “ensure the continuity of critical functions”. This may be relevant for banks that are not systemically important, but whose insolvency may nevertheless cause significant issues in the markets or in the provision of services to customers. One could, for instance, think of a bank that fulfils an important role in the payments system in a certain member state of the EU.¹⁶

14 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, Pb.EU L. 173 of 12 June 2014, pp. 149-178.

15 Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes, OJEC L. 84 of 26 March 1997, pp. 22-31.

16 See: the definition of ‘critical functions’ in Article 2(35) of the BRRD: “means activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external

5 BAIL-IN PRINCIPLES OF ARTICLE 34 BRRD

The application of the bail-in principles set out in Article 34 BRRD are important for the mechanisms to be applied in the bail-in operation. Five of the principles concerned are relevant in this respect. These are listed below by citing the provision of Article 34, paragraph 1 BRRD in an abbreviated way:

Member States shall ensure that, when applying the resolution tools and exercising the resolution powers, resolution authorities take all appropriate measures to ensure that the resolution action is taken in accordance with the following principles:

- (a) the shareholders of the institution under resolution bear first losses;
- (b) creditors of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings, save as expressly provided otherwise in this Directive;
- (f) except where otherwise provided in this Directive, creditors of the same class are treated in an equitable manner;
- (g) no creditor shall incur greater losses than would have been incurred if the institution or entity referred to in point (b), (c) or (d) of Article 1(1) had been wound up under normal insolvency proceedings in accordance with the safeguards in Articles 73 to 75;
- (h) covered deposits are fully protected.

There is a close connection, as far as the position of providers of regulatory capital is concerned, with the provisions of the CRR as regards the subordinated treatment of claims held by investors in CET1, AT1 and Tier 2 capital instruments. The subordination mechanism of those regulatory capital instruments all require that the terms and conditions provide for a full cancellation of claims of the holders of capital instruments, both as relates principal and dividend, interest or comparable claims, in case of an insolvency or liquidation procedure. There is no doubt that in this respect, the resolution principles of the BRRD as set out in Article 34, paragraph 1 will be met in those cases where a bank issued CET1, AT1 or Tier 2 capital instruments. For the fulfilment of the principles of the BRRD, it is also unlikely that the national laws of the member states of the EU must be revised or supplemented with language to implement the provision of Article 34, paragraph 1 BRRD,

and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations”.

as the CRR provisions already are directly applicable and have binding vertical and horizontal effect.¹⁷

However, the position of creditors other than the regulatory capital financiers must be addressed separately in the national laws of the EU member states. For subordinated creditors holding claims pursuant to capital instruments or loans not meeting the CRR requirements for AT1 or Tier 2 capital instruments and for other ordinary creditors, the principles of Article 34, paragraph 1 BRRD are not likely to form already part of the national laws of the member states, and therefore specific provisions of national law must be introduced.

6 WHAT IS THE SCOPE OF THE BAIL-IN MECHANISM UNDER THE BRRD?

The bail-in mechanism of the BRRD follows a specific approach with respect to the selection of debt that may be subject to bail-in mechanisms. With the approach followed, certain liabilities of banks are identified that may be subject to the bail-in mechanism, whereas other liabilities are excluded from such mechanism. The BRRD obviously applies the bail-in mechanisms to shareholders and regulatory capital instrument holders of the bank. This means that all contributors to the CET1, AT1 and Tier 2 capital may be subject to the bail-in mechanism. Furthermore, other subordinated creditors are likely to be subject to the bail-in mechanism as well. Finally, certain parts of the senior medium-term or long-term unsecured debt must be “bail-in able”, meaning that the bank concerned should have sufficient senior debt instruments or loans outstanding, enabling the resolution authority to allocate senior debt, together with the other debt instruments and share capital to be subject to a bail-in proceeding once the resolution authority has decided to apply this resolution tool.

The provisions of the BRRD contain a complex system of determining the minimum requirement for own funds and eligible liabilities (MREL) that takes into account the levels of own funds established by banks pursuant to the generic regulatory requirements, with a further correcting factor to ensure that sufficient “senior liabilities” may be subject to the bail-in mechanism. By ensuring the MREL is at sufficient levels, the resolution authorities will have possibilities to enforce with individual institutions the appropriate

17 See among many other contributions: J.A. Winter, ‘Direct Applicability and Direct Effect; Two Distinct and Different Concepts in Community Law’ (1972) 9, *Common Market Law Review*, pp. 425-438 and Arthur Hartkamp, ‘The Effect of the EC Treaty in Private Law: On Direct and Indirect Horizontal Effects of Primary Community Law’, *European Review of Private Law* 3-2010, p. 530.

composition of the bank's liabilities structure and to avoid in this way that banks structure their liabilities such that effective bail-in is impeded.¹⁸

Certain debt obligations of the bank are excluded from the bail-in mechanism. Article 44, paragraph 2 BRRD excludes from the scope of the bail in the following (summarizing in my own words the complex legal language of the BRRD):

- Savings deposits, subject to the protection of deposit guarantee schemes, up to, in principle, an amount of EUR 100,000;¹⁹
- Liabilities benefiting from security interests (secured liabilities), including so-called “covered bonds” issued by banks where certain parts of the assets of the bank serve as collateral for the benefit of the holders of the covered bonds. Together with the liabilities stemming from the covered bonds issued, also certain liabilities of the bank pursuant to derivatives entered into to hedge certain risks in connection with the covered bond transaction are excluded;²⁰
- Liabilities towards clients regarding the custody of assets held by the bank for the clients in respect of investments in collective investment schemes regulated under European laws;
- Liabilities towards clients of the bank for monies held under fiduciary relationship between the bank and the client where the fiduciary relationship gives specific protection under applicable insolvency laws;
- Liabilities towards other banks or investment firms with an original maturity of less than 7 days;
- Liabilities towards clearing and settlement systems for the securities or payments markets with a remaining maturity of less than 7 days;
- Liabilities towards employees for wages and comparable employee's claims;
- Liabilities towards trade creditors that supply goods or services critical to the functioning of the bank's operations;
- Liabilities towards tax and social security authorities, provided these claims are preferred under the applicable law;
- Liabilities towards deposit guarantee schemes set up in accordance with the DGS-Directive.²¹

18 See for an elaborate discussion of this issue: Simon Gleeson, 'Legal Aspects of Bank Bail-Ins', LSE Financial Markets Group Paper Series, 205, January 2012, p. 18 and further. See also Recitals 79 and 80 of the BRRD Directive.

19 Any sums due above the guaranteed amount of EUR 100,000 may be subject to bail-in, see the third section of Article 44, paragraph 2 BRRD.

20 The claims exceeding the value of assets required to settle the obligations of the covered bonds (the over-collateralised part) may be subject to bail-in, see the second section of Article 44, paragraph 2 BRRD.

21 Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, Pb.EU L. 173 of 12 June 2014, pp. 149-178.

Furthermore, resolution authorities may exclude further liabilities from the scope of the bail-in proceedings, subject to certain strict conditions being met. With the exclusion of certain liabilities, the burden of creditors non-excluded liabilities to accept a greater proportion of their debt being bailed-in increases, in principle.²²

7 CONTRACTUAL TRIGGERS VERSUS STATUTORY TRIGGERS

Perhaps one of the most complex issues concerning contingent capital relates to the question whether or not conversion or write-off mechanisms are enforced by contractual or by statutory obligations. In other words, what is the basis for the fact that creditors must accept at a certain point of time that their claim vis-à-vis the bank is reduced, cancelled or extinguished entirely once the contingent capital mechanisms are put in motion? One could take the view that there is a double-basis for such mechanisms, it is both a contractual mechanism and a statutory mechanism.

The clearest analysis of this issue has been delivered by Bates and Gleeson in 2011 where they define this issue in the context of bail-in instruments as follows:

It might be possible in some jurisdictions – including possibly the UK – to create a bail-in regime entirely by private contract by including the relevant provisions in debt instruments issued by the entity and in the constitution of that entity. However, this would give rise to some interesting legal conundrums, since the issuer would be seeking to create debts on terms allowing the debtor, at its discretion, to eliminate all or part of the debt and to replace that debt with new shares. Even if this were possible, it seems unlikely that it would be acceptable to those creditors or the entity's shareholders that such a regime could be operated by the board of the relevant company entirely in its discretion, and even more unlikely that, in the context of the modern law on directors liability, any board of directors would in practice be prepared to exercise such a discretion. Thus even if the regime were based entirely on private law, it seems likely that the contractual provisions would need to be structured so that the initiation of the bail-in is triggered by an external act of an appropriate regulator or other public body and to ensure that any discretion about the extent of any necessary write-down or any compensatory issue of equity is also exercised by the authorities rather than the board. This would almost certainly create procedural and technical difficulties for public authorities, who in many cases would

22 See: Article 44, paragraph 3 BRRD.

perceive unacceptable risks to acting pursuant to private rights rather than public obligations.

An alternative approach would be to provide for bail-in by legislation. Bail-in backed by legislation has a number of appealing aspects – in many jurisdictions legislation will be necessary to deal with company law issues, and legislative backing would clearly underpin market confidence in the robustness of a bail-in. However, legislation is an imperfect solution for all but the smallest banks, since for the majority of banks a significant portion of their senior debt is likely to be governed by laws other than that of their place of incorporation – for example most large continental European banks are likely to have bonds governed by English or New York law.²³

It is based on these thoughts that I reiterate in this paper that both for contingent capital instruments under the ordinary CRR regime for regulatory capital – particularly the provisions applicable to AT1 capital instruments – as well as for bail-in instruments applied to creditors (no matter which status these creditors have, whether they are contributors to the regulatory capital or if they are common creditors), for the contingent capital or bail-in mechanisms to be legally enforceable and effective, a “hybrid” application of both contractual provisions and statutory provisions is necessary.²⁴

As for bail-in mechanisms applicable once a resolution process is being initiated, one could not refer to the application and effectiveness of statutory provisions only for the determination in which way the rights of bank’s creditors are reduced, cancelled or extinguished entirely. In my view, there must be a basis in the relevant contractual terms and conditions too. This particular “hybrid” construction of contractual and statutory law has been acknowledged by the European legislator as well, but only for certain cases.

In Article 55 (Contractual recognition of bail-in), paragraph 1 BRRD, the following provision is given:

Member States shall require institutions [...] to include a contractual term by which the creditor or party to the agreement creating the liability recognizes that liability may be subject to the write-down and conversion powers and

23 Chris Bates and Simon Gleeson, ‘Legal aspects of bank bail-ins’, *Law and Financial Markets Review*, July 2011, pp. 269-270.

24 See also: Bates and Gleeson, *op cit*, p. 270 where they have based their reasoning also on the complexity of the laws governing the relevant contractual relationship between the banks and investors in the (capital) instruments or the lenders of (subordinated) debt borrowed by banks. For internationally operating banks, it shall be necessary that any contractual obligation of a creditor to accept bail-in or contingent capital mechanisms must be backed up by statutory law provisions in the jurisdiction where the relevant bank is established.

agrees to be bound by any reduction of the principal or amount outstanding due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority [...].

The relevant requirement is particularly relevant for all those instances that banks enter into contracts with external financiers of “eligible liabilities” where the contractual terms and conditions are governed by the “law of a third country”. For instance, a German bank issues debt instruments in the US capital markets (e.g., a US Dollar denominated medium-term bond) where the terms and conditions are (as is customary) governed by the laws of New York. For such a debt instrument, the German bank shall be required to include in the contractual terms and conditions provisions to support the potential application of bail-in mechanisms effected by the resolution authority responsible and authorised for the resolution of the German bank. The European legislator has recognised that in such cases, one cannot rely (only) on the binding effect of the laws in the European Union for investors in other jurisdictions. The obligations of investors must be enforced by imposing specific contractual provisions in such instance.

At least for this example of an international financing arrangement involving an European bank seeking financing in the international capital markets, the European legislator is not confident that the mere application of statutory provisions applicable pursuant to the transposition of the BRRD in the laws of the Member State where the bank is established, suffices to enforce the bail-in mechanism towards the external creditors. In my view, this issue is also relevant for other situations where there is no connection to a jurisdiction outside the European Union. This is particularly caused by the fact that the European legislator has (unfortunately) chosen to use the instrument of a European directive for the implementation of the recovery and resolution schemes in the Members States of the European Union. Directives do not necessarily have direct horizontal effect, and it will therefore be dependent as to how national laws of the Member States may contain sufficiently “mandatory effect” to set aside contractual terms and conditions once a bail-in mechanism would apply to the creditors concerned having lent monies to the bank.

In line with this reasoning, it is my view that for regulatory capital instruments structured and issued in conformity with the CRR provisions for CET1, AT1 and Tier 2 capital instruments and (subordinated) loans, less doubt will exist as to the effectiveness of the bail-in mechanism. This is caused by the fact that contractual obligations governing the relationship between shareholders and creditors on the one hand and the bank on the other hand are backed up by the direct horizontal effect of the statutory CRR provisions. Even if the contractual terms and conditions would be ambiguous or multi-interpretable, the CRR provisions will ultimately determine the consequences of the bail-in mechanism applied to the bank. In my view, there is also, to a certain extent, redundancy in the BRRD

provisions that attempt to reconfirm the principles of contingent capital as set out in the CRR, certainly if it concerns AT1 instruments.

However, none of the CRR requirements for Tier 2 instruments impose to include in the terms and conditions a contingent capital mechanism, requiring the holders of Tier 2 debt to accept either conversion of the debt into equity or to accept write-down of the principal and coupon. Recent activity in the capital markets has demonstrated that a large number of European institutions commenced to introduce Tier 2 capital instruments containing contingent capital features. Some of those Tier 2 instruments convert to equity at the reaching of low triggers, others even convert when relatively high triggers are reached (the dropping of the Tier 1 ratio below 7%).²⁵

Interestingly, institutions opting for such contractual enforcement of contingent capital features are not basing their funding policies on mandatory requirements following from the CRR. Rather, the introduction of the contingent capital contractual mechanism is based on voluntary choices. Institutions that introduce these contractual mechanisms with “high triggers” even take a more aggressive stance as regards the revision of the common principles of ranking of obligations of the bank towards its shareholders and creditors. Rights and obligations of holders of CET1 and AT1 capital instruments of these institutions are determined by the CRR provisions and contractual backup of these mandatory rules. Holders of Tier 2 capital instruments with high trigger contingent capital features even effect a greater dilution of the rights of holders of the CET1 and AT1 capital instruments beyond the mandatory qualitative capital requirements.

In my view, institutions following these strategies wish to anticipate on the introduction of the bail-in regime of BRRD. By taking the lead in reshaping the regulatory capital base of the institution voluntarily introducing regulatory capital instruments beyond mandatory qualitative capital requirements, they attempt to avoid the detrimental effects of application of the resolution tool of bail-in. These strategies may well be a response of the market to the perceived undesirable effect of introducing uncertainties for the common creditors of the bank as a result of their potential participation in bail-in as imposed by the authorities once the BRRD provisions come into effect. The uncertainty is about the lack of a mandatory rule (at least as far as the provisions of the BRRD is concerned) to revise or

25 Credit Suisse Tier 2 Buffer Capital Notes, www.credit-suisse.com/investors. See for another issue of these notes: RPT-Fitch Rates Credit Suisse AG's Tier 2 Low-trigger Contingent Capital Instruments 'BBB+(EXP)', Reuters 29 July 2013, www.reuters.com/assets. See for a “low trigger issue” of AT1 instruments (still being the most common form of contingent capital instruments for European continental banks): the 1.75 billion euro and 1.25 billion US Dollar issue made by Deutsche Bank AG in May 2014 (€1,750,000,000 Undated Non-cumulative Fixed to Reset Rate Additional Tier 1 Notes of 2014 and U.S.\$1,250,000,000 Undated Non-cumulative Fixed to Reset Rate Additional Tier 1 Notes of 2014), prospectus dated 26 May 2014, www.db.com/ir/en and for a “high trigger issue” the Barclays issue of €1,076,730,000 6.50% Fixed Rate Resetting Perpetual Subordinated Contingent Convertible Securities (Callable 2019 and Every Five Years Thereafter), prospectus dated 17 June 2014, www.barclays.com/content/dam/barclayspublic/InvestorRelations.

amend the contractual terms and conditions of financing instruments qualifying as ordinary debt issued by banks to address the potential impact of bail-in as imposed by the resolution authorities for those creditors.

In such circumstances, it is easier for a bank to place new Tier 2 instruments in the markets containing clear contractually enforceable provisions as regards the contingent capital mechanism, than to repaper existing contractual relations with ordinary creditors. Such repapering exercise would not be backed by mandatory law provisions. Such repapering would, therefore, need the consent of the creditors concerned. Absent a mandatory law provision enforcing such consent to be provided (or replacing it), banks would be either too dependent on the cooperation of the creditors. Banks could also take the risk of relying on interpretations as regards the effectiveness of the provisions of the national laws implementing BRRD giving the resolution authorities the (superior to contractual rights) authority to extinguish the rights of common creditors once the bail-in comes into force. Such reliance on the effectiveness of statutory law will be, at least, qualified to the extent complexities arise in international transactions involving multiple jurisdictions and international private law complexities not covered by Article 55 BRRD.²⁶ In other words, Article 55 BRRD is flawed to the extent that it only imposes obligations on banks to consider implementing contractual bail-in mechanisms for debt obligations where there is a relation with a third country creditor.

8 BAIL-IN MECHANISMS FOR REGULATORY CAPITAL PROVIDERS UNDER THE BRRD

When referring in the previous paragraph to the fact that for the application of the principles of Article 34(1) BRRD as regards the bail-in mechanism, there is no need to introduce provisions in the national laws of the EU member states; this does not mean that the application of the bail-in mechanisms of the BRRD as regards regulatory capital instruments will follow automatically from the CRR provisions. This is, obviously, not the case. Rather, the various rights and obligations attached to regulatory capital instruments as provided for in the CRR are likely to form the foundation of bail-in mechanisms carried out under the BRRD, but CRR rules concerning the reduction or limitation of claims of holders of CET1, AT1 or Tier 2 instruments are complimentary to the BRRD regime and does not substitute the BRRD regime.

The concurrent principles of CRR and BRRD makes it also very complex to analyse what the exact consequences are for holders of the CET1, AT1 and Tier 2 capital instruments in a situation where a resolution mechanism is applied towards a bank and where the res-

26 See Bates and Gleeson that seem to support this conclusion, *op cit*, p. 270.

olution authority decides to apply the bail-in tool as set forth in Article 37, paragraph 3 (d) BRRD. This is certainly the case if the bail-in mechanism is applied after some of the “bail-in features” of the ordinary CRR provisions already have been put in motion in the past. For instance, a situation may occur where a bank has notified the holders of the AT1 or Tier 2 capital instrument holders, that a trigger event has occurred and that the principal sum of the capital instruments needs to be converted into CET1 capital. Such trigger mechanism may be applied, in circumstances where a bank is still properly capitalised and meets all the requirements to maintain sufficient levels of own funds under the provisions of the CRR. A subsequent application of the BRRD bail-in mechanism may effectively result in a subsequent and additional reduction of claims of the holders of the CET1 capital instruments they obtained after the contingent capital mechanism has been applied pursuant to the CRR rules when a bank was still way before the “point of non-viability”. Such subsequent application of bail-in mechanisms effectively results in a “double dip” situation for bank regulatory capital providers. The BRRD bail-in rules do not provide for protection of the position of the holders of CET1 instruments that they obtained after the application of the contingent capital mechanism prior to the application of the bank resolution regime under the BRRD.

It is noteworthy that in practice, some of the issuers of contingent debt capital instruments have introduced “dual triggers”, where the bank debt converts to equity based on either the (i) passing of the regulatory threshold for minimum capital or (ii) a decision of the relevant resolution authorities. With such a contractually agreed-upon “dual trigger”, the investors in such contingent capital instruments are clearly agreeing on the possibility that a double dip mechanism may be applied. Either their claims convert to capital in a going concern situation with the bank in case certain capital ratios are no longer met, or the conversion takes place gone concern, when the resolution authorities have taken over the management of the bank²⁷ or where such resolution authorities wish to avoid the reaching of the “point of non-viability”.

In Article 45 BRRD (Application of the minimum requirement), it is determined that the member states of the EU must provide the resolution authorities the power to determine the “minimum requirement for own funds and eligible liabilities” that should be met by banks. This minimum requirement shall be “calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the

27 Such dual triggers in issued contingent capital particularly (and as far as I could investigate exclusively) are agreed upon in terms and conditions of Swiss Banks issuing contingent capital instruments. See for a further background of this: Deutsche Bank Research, ‘Contingent Convertibles’, 23 May 2011 in which it is stated: “Under the new Swiss capital regulations [...] CoCos were placed in the market in a comparable way for the first time, as opposed to previous issues of bonds similar in nature to CoCos. The CoCos featured a 30-year maturity, a coupon of 7.875% and a trigger deemed to have been met if the core capital ratio drops below 7%. Conversion may also be made if the national supervisory authority is of the opinion that the bank would reach the point of non-viability without such a swap.”

institution (this means, amongst others a bank, *add. author*).” With “own funds”, reference is made to the Tier 1 and Tier 2 capital of the bank.²⁸ With “eligible liabilities”, reference is made to the liabilities that may be in scope of the bail-in mechanism (other than the “own funds” that are automatically in scope) pursuant to Article 44, paragraph 1 BRRD. Eligible liabilities are, in brief, unsecured, non-preferred medium-term liabilities²⁹ of banks, always with the exception of the part of the deposits covered by the deposit guarantee schemes applicable to the bank concerned.

The “resolution authorities” may determine the minimum requirement of own funds and eligible liabilities in order to make potentially applied bail-in mechanisms upon a resolution proceeding being applied in the future effective. The reasoning is that once a bail-in mechanism is applied, there should be sufficient room for conversion or write-down of liabilities that either (i) a bank may be reinstated to act in compliance with the requirements for authorisation or (ii) sufficient capitalisation is available for a bridge institution or an acquiring bank pursuant to the application of the sale of business tool or asset separation tool. See the provision of Article 43, paragraph 2(a) and (b) BRRD for a description of this objective.

From the perspective of own funds requirements, this provision of the BRRD is a potential source of conflicts between views of the resolution authorities and the ordinary competent authorities that supervise banks for a number of reasons. Quantitative levels of regulatory capital are determined by the provisions of the CRR for ordinary risk exposures and in respect of the additional capital buffers (that is, the capital conservation buffer, countercyclical buffer and systemic risk and systemically important institution buffers) by means of the national law provisions implementing the CRD IV Directive. The regulations of the BRRD determining the powers of the resolution authorities in the member states provided for a separation of functions, in principle, of the resolution authorities on the one hand and the ordinary competent authorities on the other hand. See the provisions of Article 3 BRRD for further detail on this respect.

It is not clear whether the resolution authorities, applying the provision of Article 45 BRRD as regards the minimum level of “own funds”, may take different views about the levels than the national competent authorities on the basis of the CRR and CRD IV Directive provisions. In other words, how must banks deal with potentially conflicting views by the two different competent authorities if the views on the levels of own funds are conflicting? And furthermore, where the CRR and CRD IV Directive provisions on capital adequacy for banks are already a significant driver to force banks to increase levels of own funds, is the BRRD regime interfering with this process of recapitalisation of banks

28 The definition of “own funds” in Article 2, paragraph 1 (38) BRRD refers to the definition of “own funds” within the meaning of Article 4(1)(118) of the CRR.

29 The liabilities should have a maturity of no less than 12 months, see Article 45, paragraph 2 BRRD.

that is the effective result of the Basel III standards? For instance, if a resolution authority determines that a bank must maintain the liabilities that may be subject to bail-in mechanisms pursuant to the BRRD in the form of a certain percentage of “own funds” pursuant to the application of Article 45, paragraph 6 BRRD that deviates from the ordinary CRR and CRD IV Directive levels, how will this conflict be resolved?

This is one of the examples where the introduction of the BRRD raises concerns as to whether or not the European lawmakers have sufficiently thought of the combined application of CRR and BRRD, certainly if one looks at the original motives of the new capital requirements for banks upon adoption of the Basel III standards.

9 BAIL-IN MECHANISMS FOR ORDINARY CREDITORS UNDER THE BRRD

European politicians were keen to adopt a regime where the bail-in mechanisms applicable in the case a bank is failing extends to ordinary creditors as well. “Ordinary creditors” denotes all creditors that are not subject to the qualitative capital requirements provisions of the CRR. This means that this may concern creditors with an ordinary claim on the bank that would rank *pari passu* with all other ordinary creditors, but it may also comprise subordinated creditors that exercise claims under a subordinated loan provided to the bank that is not eligible to be comprised in the Tier 1 or Tier 2 compartments of the regulatory capital of the bank.

For the definition of liabilities that may be within the scope of the bail-in mechanism, the BRRD provisions provide for a list of eligible liabilities in Article 44, paragraph 2 BRRD. The list is drawn up as a negative list of excluded liabilities that are outside the scope of applicability of the bail-in mechanism applied if a resolution proceeding becomes applicable and the resolution authorities have decided to apply the bail-in tool. In drawing up the list of liabilities excluded from the bail-in mechanism, a number of choices have been made by the European law makers. The obvious exclusion concerns all depositors with a coverage under the deposit guarantee schemes applicable to banks in the European Union. Effectively, this means that depositors will be protected against the bail-in mechanism up to EUR 100,000 of the deposit made with the bank. Other obvious exclusions concern certain wage liabilities of banks towards employees of the bank and other comparable preferred claims that are customarily excluded in insolvency proceedings from the application of the principles of *concursum creditorum*.

The BRRD introduces a number of new principles applicable to the bank’s financing to regulate the subject matter of effective bail-in mechanism. In this working paper, two of these innovative elements are discussed. First, it concerns the subject matter of quantitative requirements imposed on banks with respect to maintaining sufficient eligible liabilities that may be subject to bail-in mechanisms. Secondly, it concerns the qualitative

requirements to be imposed on creditors that have an ordinary claim on a bank, and that must be eligible for application of the bail-in mechanism.

The quantitative requirements follow from the application of Article 45, paragraph 1 BRRD that has been highlighted before when discussing the subject matter of effects of the bail-in mechanism for the providers of Tier 1 and Tier 2 bank regulatory capital. The provision of Article 45 BRRD determines the following:

Member States shall ensure that institutions meet, at all times, a minimum requirement for own funds and eligible liabilities. The minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution.

With “eligible liabilities”, reference is made to the provision of Article 44, paragraph 2 BRRD. These are the ordinary claims and subordinated claims of creditors that do not participate in the regulatory capital of the bank and that are not otherwise excluded from the bail-in mechanism. Typically, this provision of the BRRD will have a significant influence on the manner in which banks will be capitalised in the future, as it will to a great extent determine, in my view, the costs of funds that banks may raise by means of savings from depositors not being protected by deposit guarantee schemes as well as by means of the issue of regulatory capital instruments and other debt instruments not qualifying as regulatory capital. Although depositors being covered by deposit guarantee schemes are protected against potential bail-in mechanism to the extent of coverage (being EUR 100,000), any other depositors may face a threat that its claim may be comprised in the bail-in mechanisms upon resolution of the bank. The pressures on the funding schemes by banks come from two sides. On the one hand, banks would like to encourage creditors to finance the bank with loans and deposits that may be excluded from potential bail-in mechanisms in order to avoid the costs of funding to increase. On the other hand, resolution authorities may impose on banks to have a significant tranche of eligible liabilities written in the books in order to make the bail-in mechanism effective.

This detrimental effect of the BRRD is amplified by the second innovative element that I wish to highlight in this working paper. This concerns the qualitative requirements for “eligible liabilities” as set forth in Article 45, paragraph 4 BRRD. In this provision, the following list of requirements is set forth in order for liabilities to be eligible for bail-in mechanisms:

4. Eligible liabilities shall be included in the amount of own funds and eligible liabilities referred to in paragraph 1 only if they satisfy the following conditions:
 - (a) the instrument is issued and fully paid up;
 - (b) the liability is not owed to, secured by or guaranteed by the institution itself;

- (c) the purchase of the instrument was not funded directly or indirectly by the institution;
- (d) the liability has a remaining maturity of at least one year;
- (e) the liability does not arise from a derivative;
- (f) the liability does not arise from a deposit which benefits from preference in the national insolvency hierarchy in accordance with Article 108.

The reference in this clause to “own funds” is a complete redundant and confusing one. All of the requirements listed in this provision are already regulated in the provisions of the CRR. In this respect, I take the view that for regulatory capital instruments, in so far as they have not already been subject to the contingent capital mechanisms prior to the entry into force of the resolution proceedings, the contractual and statutory backing of the obligations of the creditors holding such instruments rather follows from the original contract and the CRR provisions and not necessarily from the Member State law provisions implementing the BRRD. For other “eligible liabilities”, this provision introduces a new concept of law that fundamentally deviates from the ordinary provisions of company law and contract law that usually govern the relationship between a bank and its (ordinary) creditors. These requirements effectively reduce the quality of the claim of the creditor on the bank and results into a shift of these claims to the compartment of high-risk investments. Such loans or investments made by external financiers, will, consequently, be priced in accordance with this high-risk profile and will be resulting into high-yielding debt obligations for the bank.

10 CLOSING REMARKS

In the political discussions that have been held in connection with the adoption of the BRRD, one could note observations that the bail-in mechanism introduced intends to ensure that public (tax payer) monies would no longer be needed to rescue failing banks. Rather, the “private sector” should be fully absorbing the losses with such banks through the application of the bail-in mechanisms. Bail-outs of banks should be replaced with bail-in processes.

As noted earlier, many politicians took the view that failures with banks should result in penalisation of the private sector by imposing drastic measures. In these discussions, it is often forgotten (or deliberately ignored) that Basel III and the implementation of these standards in the CRR already introduced far-reaching limitations of the rights of the providers of regulatory capital financing to banks. In other words, the achievements of the BRRD introducing a bail-in mechanism for these types of creditors are, in my view,

rather concurrent with the already existing rules in the CRR for the qualitative requirements for CET1, AT1 and Tier 2 capital instruments and loans.

In my view, the lawmakers in Europe have insufficiently addressed the potential competing and conflicting principles of CRR and BRRD with respect to capital requirements for banks. The provisions of the CRR and BRRD again result in a patchwork of provisions in Europe as regards capital requirements for banks, where it has been the objective of the CRR to reduce the differences in the member states in the EU as much as possible. There are many examples in the provisions of the BRRD where these conflicts of laws and potential overlapping provisions can be observed. It would take too much space to address all of these BRRD provisions to the fullest extent. The example given earlier (and my views are not limited to this example), demonstrates this issue in a clear way.

BRRD is also flawed as regards the subject matter of the effectiveness of the bail-in mechanism that is not otherwise supported by clear contractual obligations of the common creditors concerned. As noted in this working paper, a hybrid application of both contractual rights and obligations and mandatory law provisions would be the most effective way in introducing enforceable bail-in mechanisms that also encompass the position of common creditors that are to be selected as being part of the sum of eligible liabilities that may be subject to bail-in.

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THE SINGLE RESOLUTION MECHANISM: POSITION OF COUNTERPARTIES, ESPECIALLY IN REPOS AND DERIVATIVES CONTRACTS^{*}

Patrick Clancy^{**}

This paper considers the potential use of the new resolution tools in the context of counterparties, particularly repo and derivative counterparties to a financial institution¹ where that institution is facing financial difficulties sufficient to raise the risk of the Single Resolution Board or any national resolution authority placing the institution in resolution and using any of those tools.

1 WHAT IS PERCEIVED TO BE THE BIG ISSUE WITH COUNTERPARTIES, FOR EXAMPLE, UNDER REPOS AND DERIVATIVES?

Repurchase agreements (repos) and derivatives contracts are forms of financial contract that generally are exempt from stays arising on certain insolvency processes. They are not the only such financial contracts, but they are probably the most prevalent, being responsible for a significant portion of any trading institution's gross assets and liabilities. On the occurrence of an event of default (as set out in the relevant contract) in relation to the institution (which would include various insolvency and restructuring events but which would generally not include most of the new resolution tools), a counterparty under such financial contracts will usually have the ability to close out by giving notice, or the contracts may close out automatically (this is the case with repos generally on the commencement of winding up). Where close-out occurs, it is usually for the counterparty as the non-defaulter to value the positions closed out and/or to access any security or collateral provided in order to realise it and apply the proceeds to settle the liability (if any) of the

^{*} This paper was prepared in autumn 2014. The relevant regulations have developed considerably since then, not least by the publication of various regulatory technical standards.

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¹ No distinction is drawn below between the type of financial institution or group that is potentially subject to resolution: There is no particular distinction drawn in the rules and regulations in relation to the use of resolution tools dependent on whether, for example, the entity to be subject to resolution is a credit institution or bank or a financial firm. Reference is therefore made throughout this paper to an "institution".

institution under the closed-out contracts. It has been thought that the ability of counterparties to do this was a big stumbling block to the successful resolution of an institution without recourse to traditional insolvency arrangements or taxpayers' funds, as all such financial contracts are liable to be terminated, and the values at which the close-out would occur and/or the collateral be realised would be unlikely to be the highest values obtainable in favour of the institution. Given the size of the derivative/repo book at a trading institution, the monetary loss generated by these close-outs and the realisation of security or collateral at values that are in favour of the counterparty can be very large. In the new world, the resolution authorities may be keen to prevent close-outs in order to preserve a significant business (and associated liquidity) to sell.

So, the very act of closing out can exacerbate the problems faced by the institution, in that it may significantly increase the realised losses. This will make resolution of the institution as a continuing business costlier and therefore inherently more unlikely to be successful. If the close-out or the realisation of security or collateral involves the sale of collateral in the markets, then this can have a second-order effect of itself destabilising the market in that the price of collateral securities may be depressed by sudden over-supply in the market, leading to further losses for the institution and to other entities, which may find that their positions under other contracts have fallen in value where those contracts use market inputs for valuation, which are driven, even partly, by the market prices of such collateral securities. This is a form of contagion.

These are exactly the sorts of issues that the new resolution arrangements are designed to tackle.

2 THE THRUST OF THE CURRENT REGULATORY AND NON-REGULATORY FRAMEWORK (OUTSIDE BRRD AND THE SRM REGULATION²)

2.1 *Collateral*

Legislators have been keen to make collateral arrangements robust in the face of insolvency risks. While the Financial Collateral Directive,³ as implemented in national law, has created new and unexpected difficulties in some jurisdictions, it is clear that the intention was to support title transfer and security-based collateral arrangements and repos by making these arrangements as fail-safe as possible.

2 BRRD and SRM Regulation are defined below.

3 Directive 2002/47/EC.

EMIR⁴ requires financial counterparties to enter into collateral arrangements for uncleared derivative transactions with various counterparties, although some are required only to the extent that they are appropriate. It is a consequence of the generally even-handed nature of derivative framework documentation to date (in particular, the ISDA Master Agreement) that sauce for the goose is sauce for the gander, and so any financial counterparty wishing or obliged to set up a collateral arrangement in its favour will often be obliged to reciprocate by delivering collateral or giving security to its counterparty if the value of the positions is in favour of the counterparty.

2.2 Safe Harbours

Derivatives contracts and repos are generally within the safe harbour in the US from the automatic stay that will apply in US insolvency and reorganisation proceedings. This means that, where the counterparty has a contractual right to terminate arising on the instigation of such insolvency or reorganisation proceedings, it will have the ability to terminate and value the positions. To some extent, the Financial Collateral Directive has provided some of this sort of protection within Europe, where a close-out netting provision is, or forms, part of an arrangement with a financial collateral arrangement protected by that legislation, as the directive requires that stays and other impediments to closing out and realising collateral that would arise under local insolvency law are rendered inapplicable. But it is also fair to say that in a number of jurisdictions, there never was a stay that would apply, and so derivatives contracts and repos did not actually need special status as “safe-harboured” contracts.

2.3 Stay on Termination

There is currently considerable pressure being exerted by regulators to have the derivatives market agree on a consensual basis to a temporary suspension of the right of a derivative counterparty to terminate derivative transactions with an institution in some form of resolution process, to give the relevant regulators some (albeit short) time to sort out a transfer or sale, with the idea that after that transfer or sale, only a default by the transferee/purchaser (provided that the derivatives contracts were in fact transferred/sold) would give rise to the right to terminate. This is, of course, rather at odds with the safe harbour position, which had previously been generally supported by regulators across the globe on the basis of the risk of contagion that would arise if there were a mandatory delay

4 Regulation (EU) No. 648/2012.

in the ability to close out and value the positions leading to a consequential delay in recreating any hedges with other counterparties in the market.⁵

2.4 *Information, Clearing and Marking to Market*

Europe-wide rules⁶ now require parties entering into derivative transactions to provide transaction reports to repositories so that aggregated data can be made available to the market and to the relevant regulators. These rules also require that parties reconcile the transactions that they have on foot on a regular basis, value them on a regular basis and deal in a timely manner with differences in such valuations.

Finally, the requirements for clearing of clearable derivative transactions will result in large portions of the plainer vanilla derivative market being moved to clearing with central counterparties. Where this is the case, a derivative transaction that would currently have a non-financial counterparty facing a financial institution is likely to turn into a derivative transaction in which the non-financial counterparty is not directly exposed to the continuing performance and creditworthiness of the financial institution. Where both parties were financial institutions, the derivative transaction, when cleared, may result in the two financial institutions facing the central counterparty only, in place of each other.

3 A THUMBNAIL SKETCH OF THE NEW ARRANGEMENTS FOR RESOLUTION, TO THE EXTENT RELEVANT TO THIS PAPER

The European rules that are the subject of this paper are found in Directive 2014/59/EU, the so-called Banking Recovery and Resolution Directive (or BRRD for short), of 15 May 2014 and Regulation 806/2014 (known as the SRM Regulation) of 15 July 2014. EU States are obliged to enact laws and regulations to reflect BRRD by the end of December 2014, such laws and regulations to be effective from 1 January 2015 (or 2016 in relation to bail-in).⁷

The SRM Regulation establishes the Single Resolution Mechanism (SRM) in the context of the Single Supervisory Mechanism (SSM) and provides for the establishment of suitable Community infrastructure to consider and make determinations with respect to the application of resolution tools to institutions in the jurisdictions that are subject to the SSM. It establishes uniform rules and a uniform procedure to be applied by the newly established Single Resolution Board (the Board), together with the Council and the Com-

5 Since this paper was written in October 2014, there have been significant developments in this area, not least the ISDA 2014 Resolution Stay Protocol and the ISDA 2015 Universal Resolution Stay Protocol.

6 Title II, Regulation (EU) No. 648/2012 (EMIR).

7 BRRD Article 130.

mission and the national resolution authorities within the framework of the SRM. The SRM is to be supported by a single resolution fund (the Fund). Thus, the Board is to work on a cross-border, multi-state basis (hand-in-hand with the European Banking Authority, various other Community institutions and relevant national resolution authorities) to deal with making decisions on the resolution of such institutions. In general, the resolution decision by the Board in relation to such an institution is to be implemented by the relevant national resolution authority, although the Board has the powers to step in itself to carry out the resolution activities if it considers that the relevant national resolution authority is not doing so, not doing so appropriately or is delaying its implementation of the Board's determinations. The toolkit available to the Board under the SRM is the toolkit that is to be incorporated into national legislation by virtue of BRRD, and so the vast majority of this paper focuses on BRRD.

3.1 Some Key Principles Underlying BRRD⁸

Authorities should have new powers to apportion losses in a manner that is fair and predictable (Recital 5). Where creditors within the same class are treated differently in the context of resolution action, such differences should be justified in the public interest and proportionate to the risks being addressed (Recital 13). The resolution tools should include the bail-in of the shareholders and creditors of the failing institution (Recital 59). Interference with property rights should not be disproportionate, and accordingly, affected shareholders and creditors should not incur greater losses than those that they would have incurred if the institution had been wound up at the time that the resolution decision is taken (Recital 50). It is not appropriate to apply the bail-in tool to claims in so far as they are secured, collateralised or otherwise guaranteed. However, in order to ensure that the bail-in tool is effective and achieves its objectives, it is desirable that it can be applied to as wide a range of the unsecured liabilities of a failing institution as possible (Recital 70). Senior liabilities should be converted or written down if the subordinate classes have been converted or written down entirely (Recital 77). It may be useful or appropriate to suspend some contractual obligations and to restrict certain close-out, acceleration and termination rights to give the resolution authority the time to use certain resolution tools effectively (Recitals 93 and 94). There should be safeguards to prevent splitting linked liabilities, rights and contracts, such as contracts covered by security arrangements, title transfer financial collateral arrangements, set-off arrangements, close-out netting agreements and structured finance arrangements (Recital 95).

8 All references in this paper to Articles and to Recitals are to those of BRRD unless specifically stated otherwise.

BRRD provides that the resolution tools in the toolkit⁹ are to be: (1) the sale of business tool; (2) the bridge institution tool; (3) the asset separation tool; and (4) the bail-in tool, but there is always the possibility of a more traditional winding up or other insolvency process to resolve a failing institution: In some situations, this will be the first choice and in others, it will be required in conjunction with other resolution tools (for example, in a good bank, bad bank arrangement, it will likely be required in relation to the bad bank¹⁰).

Article 31 sets out the resolution objectives to which the relevant resolution authorities are to have regard in applying resolution tools and using resolution powers. There are five, each of equal significance (unless BRRD provides otherwise): (1) ensuring continuity of critical functions; (2) avoiding significant adverse effect on the financial system; (3) protecting public funds by minimising reliance on extraordinary public financial support; (4) protecting certain depositors and investors; and (5) protecting client funds and client assets.

Article 63 sets out the resolution powers (Article 63(1)(k) is discussed later), and Article 64 sets out ancillary powers, among which is the very wide power for a resolution authority, when exercising a resolution power and where it considers that this will help to ensure that the resolution action is effective or to achieve a resolution objective, to “cancel or modify the terms of a contract to which the institution” is party.¹¹ There are some limitations on this under Articles 76-79.

The SRM Regulation, which by its own terms does not apply to all European jurisdictions, states that the resolution tools should “be applied only to those entities that are failing or likely to fail, and only where necessary to pursue the objective of financial stability in the general interest. In particular, resolution tools should be applied where the entity cannot be wound up under normal insolvency proceedings without destabilising the financial system and the measures are necessary in order to ensure the rapid transfer and continuation of systemically important functions and where there is no reasonable prospect for any alternative private solution, including any increase of capital by the existing shareholders or by any third party sufficient to restore the full viability of the entity”.¹² This certainly seems to be a narrower scope of opportunity than that laid out in BRRD.

9 Article 37(3).

10 Article 37(6).

11 Article 64(1)(f).

12 SRM Regulation Recital 61.

**4 HOW WOULD THE RESOLUTION TOOLS WORK IN THE CONTEXT OF
COUNTERPARTIES TO FINANCIAL CONTRACTS IN THE FORM OF REPOS AND
DERIVATIVES?**

Resolution authorities and group-level resolution authorities are to draw up resolution plans for each institution or group for which they are responsible. Within the ambit of the SRM, it is the Board that undertakes this task. These plans will necessarily, so it appears, take multifarious forms as the plans need to adapt to the different circumstances in which resolution may be required. The plans must be reviewed, and if appropriate, updated at least annually. It would seem that these plans should take into account the various resolution tools that may be used and the resolution actions that may be undertaken in relation to the relevant institution or group. It is not clear from BRRD or the SRM Regulation how the resolution plans are to be established both with sufficient detail and with sufficient flexibility to address the ever-changing positions that may be found in a repo or derivatives book. As noted earlier, it will be the relevant national resolution authority that operates the relevant resolution tools, even if the Board is the body that determines that they will be used, except where the Board steps into the shoes of a national resolution authority, which is obliged to carry out the Board's bidding and does not and so, for a jurisdiction in which the SRM applies, the Board will be preparing plans for the execution of which it will not be responsible.

As noted, resolution under BRRD or the SRM Regulation is an alternative to traditional insolvency processes. If a traditional insolvency process can be conveniently applied without risk to the market or to market and financial stability and without the use of state funds, then it should be used. It is against that backdrop that resolution is made available. Resolution is an alternative (and perhaps better) way to deal with the failure of an institution by avoiding formal insolvency (which, for an institution, is almost always significantly value-destroying) but still allowing the sale or transfer of valuable or critical parts of the business and for the preservation of value to support covered deposits.

In a traditional insolvency, administration or restructuring, an event of default under repos, derivatives contracts and other financial contracts would usually be triggered in relation to the institution, leading to the counterparty having the right to close out, terminate or accelerate (as appropriate to the contract) or, in some contracts and circumstances, to the automatic close-out, termination or acceleration of the liabilities. In relation to repos and derivatives contracts, the counterparty would, on close-out or termination, be the party to determine the amount payable as a result (which might be payable by either party to the other). Where the counterparty has a right to terminate a derivative contract, it is not obliged to do so but can, within fairly wide limits, choose if and when to terminate, and it will have the benefit of a suspension of its own contractual payment and delivery

obligations under the relevant derivatives contracts until the default has been cured or the contracts are closed out or terminated.

4.1 *The Sale of Business Tool*

Under the sale of business tool, all the shares or all or any assets, rights or liabilities of an institution under resolution may be transferred to a purchaser. The transfer of shares may not be of great concern to a counterparty, as it would still face the same legal entity. But where there is a transfer that includes a transfer of assets, rights or liabilities under the relevant repos and derivatives, the counterparty may face a different entity. It is to be expected that a transfer under the sale of business will be (1) of a business that has positive value and (2) to a purchaser who is properly authorised and capitalised and able to carry on the business transferred. Given that an institution has to have gone a fair distance down the track towards financial disaster before the resolution tools are available to be applied, a counterparty is probably in a better position facing the purchaser than it was facing the institution under resolution. If there is an asset and liability transfer, it is always possible that repos and derivatives would be left behind untransferred: Given that such a transfer is supposed to be for proper value, it is unlikely of itself to give rise to a breach of contract or default on the part of the institution vis-à-vis the counterparty.

A change of institution is not something that counterparties are properly accustomed to and would (absent BRRD) likely constitute a breach of contract (as a transfer without consent). However, while a counterparty may complain for a variety of reasons about the effective substitution of the institution, BRRD requires that a resolution authority has the power to provide for that substitution at a contractual level¹³ and provides that resolution action (among other things) is not to be capable of triggering any termination right¹⁴ of any affected counterparty,¹⁵ so the counterparty is unlikely to be in a position to do anything about that substitution.

4.2 *The Bridge Institution Tool*

Similarly, the bridge institution tool allows the resolution authority to transfer shares, or all or any assets, rights or liabilities of a failing institution to a bridge institution, being a legal entity that is, in essence, owned by the state and created for the purpose. In the case

¹³ Article 64, particularly paragraph 3.

¹⁴ “Termination right” is widely defined to include a right to terminate a contract, to accelerate, close out, set off or net obligations or any similar provision that suspends, modifies or extinguishes an obligation of a party to the contract or a provision that prevents an obligation under the contract from arising that would otherwise arise (Article 2(1)(82)).

¹⁵ BRRD Article 68(3).

of a transfer of assets, rights or liabilities, a counterparty might find itself facing the bridge institution, rather than the institution under resolution. The same issues arise for a counterparty as referred to under “The sale of business tool” above, except that a bridge institution has different characteristics from a third-party purchaser. A bridge institution is only ever a short- to medium-term arrangement, there being a requirement to bring the arrangement to an end after 2 years;¹⁶ so it is really only a stepping stone to some other longer-term resolution solution, whether that be a sale to a market purchaser, a winding up or liquidation or an asset separation. In due course, the counterparty may find itself, therefore, facing a further entity. Furthermore, a bridge institution, being created for the purpose, will not have other business to transact, may not be well capitalised (like a market purchaser) and may not be responsive to market forces in the way that a third-party purchaser would be.

4.3 The Asset Separation Tool

The asset separation tool requires that resolution authorities have the power to transfer assets, rights or liabilities from an institution under resolution or a bridge institution to one or more asset management vehicles. The aim of the asset management vehicle is to manage the assets transferred to it with a view to maximising their value through eventual sale or orderly wind down. This is not a destination for critical business that must be kept operating for the stability of the market. It is, therefore, unlikely that the asset separation tool will by itself result in a derivatives or repo counterparty facing the asset management entity in place of the institution under resolution or a bridge institution.

4.4 The Bail-In Tool

The bail-in tool allows a resolution authority to write down or write off or cancel share capital and to write down, write off, cancel or convert into share capital (i.e., common equity Tier 1-type capital) certain other liabilities. Those liabilities may include derivative liabilities.

It is the general principles governing resolution that require that derivative liabilities should be capable of bail-in. The general principles (see Article 34) require resolution, in effect, to abide by principles that the shareholders bear first losses and the creditors thereafter bear losses in accordance with the order of priority (i.e., lowest priority bears losses first) that their claims would have under normal insolvency proceedings, except where BRRD provides otherwise, and that creditors of the same class are treated in an

16 BRRD Article 41(5).

equitable manner, that is, vis-à-vis each other. So derivative liabilities (assuming them to be unsecured, or to the extent unsecured) would normally be senior unsubordinated liabilities of an institution, ranking at the same level as other senior liabilities and so should, in principle, be available for bail-in at that level. At the level of general principles, it is difficult to argue with this. The same is, of course, true for liabilities of an institution that arise under repos or other financial contracts, to the extent that these are not actually secured¹⁷ and are not part of the subordinated capital structure of the institution.

Bail-in is available as a resolution tool only for very specific purposes,¹⁸ namely (1) to recapitalise an institution to restore its regulatory capital (although under Articles 46 and 48 it is clear that this means restoring only the Common Equity Tier 1 ratio) and to sustain sufficient market confidence in the institution; or (2) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred to a bridge institution (in order to provide capital for that bridge institution) or under the sale of business tool or the asset separation tool.

Article 63, which sets out powers that a resolution authority is to have in connection with the exercise of any resolution tool (but which is referred to specifically in the first paragraph on bail-in under Article 43), provides in paragraph 1(k) that the resolution authority may close out and terminate financial contracts or derivatives contracts for the purposes of applying Article 49 (which applies only to bail-in of derivative liabilities). While repos and derivatives are generally “financial contracts”¹⁹ and can therefore be terminated under the first part of Article 63(1)(k), repos are not derivatives contracts and so do not fall under the special regime for the termination of derivatives contracts that are to give rise to derivative liabilities to be bailed in. Although secured liabilities (which, as discussed later, include repo liabilities) are excluded from bail-in under Article 44(2), the power to terminate financial contracts under Article 63(1)(k) is restricted only by reference to its use in connection with exercise of a resolution tool. Where such termination results in a liability of the institution to the counterparty which is not, or is no longer, secured, it would appear that that liability is itself able to be bailed in, subject to Article 49 in the case of derivatives.

So, (1) where financial contract assets and liabilities are transferred on sale to a purchaser or to a bridge institution or an asset management vehicle or (2) where the shares in an institution are sold or transferred to a bridge institution or (3) where the institution is to be recapitalised and rehabilitated to the market, any financial contract can be terminated and, seemingly, any liability of the institution (or its substitute) resulting from that termi-

17 Under ordinary legal principles, repos transacted under standard European-style documentation are not in fact secured.

18 Article 43(2).

19 Article 2(1)(100).

nation, to the extent that it is not a “secured liability”,²⁰ can be bailed in. The only apparent limitation is that, if derivatives contracts are to be terminated for the purposes of bailing in the resulting derivative liability, then the requirements set out in Article 49 must be complied with. Those requirements do not otherwise apply.

Bail-in, then, is generally available and can take the form of either a write down or write off of the liability in question or a full or partial conversion into Tier 1 common equity, although, as noted below, the majority of derivatives contracts that could be bailed in (i.e., those giving rise to derivative liabilities of the institution on termination) and all repos are “secured liabilities” and so are not required to be bailed in. Conversion is only to be used to restore the capital of an institution that is to be returned to financial health, that is, by restoring its required Common Equity Tier 1 capital ratio to continue its authorised/regulated businesses. The numbers are instructive.

An institution is obliged to have prescribed minimum amounts of various types of capital. The prescribed minimum amounts, measured by reference to risk-weighted assets, are as follows: 4.5% of Common Equity Tier 1 capital; 1.5% of Additional Tier 1 capital; and 2% Additional Tier 2 capital. There is, in addition to these minimum capital requirements, a mandatory capital conservation buffer of 2.5% as well as four further capital buffers that may be applied depending on the type of institution being regulated. In total, the maximum level of regulatory capital that an institution can be required to hold is 22%. The absolute minimum requirement is 10.5%.

Article 46 requires that, for bail-in, the resolution authority determines how much needs to be written off beyond share capital to reach a net asset value for the institution of zero and also how much needs to be converted into common equity to restore the required Common Equity Tier 1 capital ratio. Therefore, in order to convert into share capital any derivative liabilities or claims resulting from the termination of repos, given that these liabilities will rank higher than all the regulatory capital instruments of an institution, the losses to be absorbed will need, in any event, to exceed the actual Tier 1 equity share capital and, if the example were an institution with 22% regulatory capital, would need in total to use up not less than 17.5% (so that conversion of the remaining regulatory capital instruments would be insufficient to fulfil all the Common Equity Tier 1 capital requirement going forward). If we imagine a situation like this where losses were equal to exactly 17.5% and the remaining regulatory capital is converted to provide 4.5% common equity, it is not clear (at least to me) how the institution is genuinely to survive without the more generous quantities of regulatory capital (after all, in this situation a single euro of realised losses would leave the institution with a shortfall of Tier 1 capital), but there is no mechanism in BRRD to use any further of the liabilities of the institution to provide an increased quantity of capital. It may be that the idea is for the institution at

20 See below under “What derivative, repo and other liabilities are excluded from bail-in”.

that point to raise funds in the markets, but if this is the case, it seems to me likely that some form of state underwriting will be required: This would, of course, put state funds at risk, raise questions on state aid and open up all the bail-out questions that these new rules are intended to consign to history.

It may be that bail-in by conversion of liabilities at the level of derivatives and repos is unlikely. First, a bail-in of this magnitude at this level of the creditor rankings suggests that the rehabilitation of the institution is the wrong form of resolution. Secondly, bail-in at this level leaves the institution with an amount of regulatory capital that the market will likely consider just inadequate, and this would affect the ability of that institution to continue in business. Even if bail-in at this level has occurred, with a view to the sale of the institution to a purchaser, there are tremendous difficulties for the purchaser, which will need the more regular quantities of capital and will itself have to plug the gap.

Bail-in of derivatives liabilities is not easy in any event. In order to bail in derivative liabilities, the derivative contract(s) must be terminated. There is no suggestion that bail-in of derivative liabilities could attach to the individual payables and receivables under a derivative contract (unless perhaps there was only one remaining payment obligation): It can only attach to the single derivative liability resulting from termination.²¹ Until the appearance of BRRD, it was clear that, where a party to a derivative contract was in financial difficulties and suffered an event of default, it was only the other party that would have the consequential right to terminate that contract. This was a right and not an obligation. The bail-in tool requires that resolution authorities specifically have the power to close out and terminate any financial contracts and any derivatives contracts for the purposes of applying bail-in to derivatives in accordance with Article 49.²² The better reading of Article 49(2) is that the relevant resolution authority may only terminate and close out a derivative contract under the arrangements set out in Article 49 for the purpose of exercising the bail-in power in relation to a liability arising from that termination or close-out. It appears, then, that a resolution authority is not to be empowered to terminate a derivative contract under Article 49, which is expected to result in an asset rather than a liability for the institution under resolution, although it can clearly terminate such a derivative contract under Article 63(1)(k). This is an important distinction from the perspective of valuation on termination, as set out below.

A derivative transaction will at any time usually involve the future payment or delivery of money, transferable instruments or tradeable assets (like oil or coal). Those future payments or deliveries may be dependent on the exercise of options, and the quantum of future payments may be uncertain until closer to the time of their payment (for example,

21 Article 49(3) requires the consequences of any netting agreement to be taken into account, so, for example, all the transactions under a single ISDA Master Agreement would need to be taken together.

22 Article 43(1) and Article 63(1)(k).

when they are based on interest rates such as LIBOR or EURIBOR, which are current at a future date). But it is the essence of derivatives contracts that they can be valued at any time by reference to market prices and market rates (including forward rates) that are current at that time, so that the parties to the derivative contract can understand what is the current market value of the position. This is generally known as the mark-to-market value. The mark-to-market value is not necessarily absolutely accurate: It has no need to be, as it does not represent a liability that is actually payable. To turn it into an actual liability, the derivative contract has to be terminated (or, in market jargon, closed out) early, whether by agreement or by the exercise of a right of early termination. If termination occurs, the performance obligations under the contract are replaced by a single payment obligation of one party to pay to the other a termination amount. The termination amount actually payable is assessed under the terms of the contract (usually by the non-defaulter if termination was the result of a default) and will take account of all the future payables, deliverables and receivables, including option rights and of all unpaid and unperformed obligations already past due. While the amount actually payable is likely to bear some relation to the mark-to-market value previously assessed, it will differ for a number of reasons, including the following: (1) any changes in market prices and market rates, including by reason of whatever event (if any) has led to the early termination, which may have very significant consequences in the markets (as seen with Lehman Brothers); (2) the person carrying out the valuation having to be able to justify the calculations (which may result in the need to obtain and average actual market quotations for equivalent replacement transactions); and (3) the fact that a non-defaulter will be assessing the value based on market prices for which there is usually a bid/offer spread from which the non-defaulter will legitimately choose the side of the spread that favours him (whereas the assessment of a mark-to-market value is usually done at mid-market). The change in value from the mark-to-market valuation to the termination amount (which would rarely be in favour of the institution) can be loosely described as a “jump to default” amount and can apply both where the resulting termination amount is payable by the defaulter and where the termination amount is payable by the non-defaulter (in the latter case, the result is merely that the termination amount payable is less than it would have been if it had matched the mark-to-market value). In each of these cases, there may be a perception (by the regulators) of value destruction.

Where a resolution authority terminates and closes out derivative transactions in order to bail in the resulting liabilities, how is the quantum of those liabilities to be determined? Article 49(4) requires that resolution authorities determine the value of derivative liabilities in accordance with: (1) “appropriate methodologies” for valuing classes of derivatives; (2) principles for establishing the relevant point in time at which the value of a derivative position should be established; and (3) appropriate methodologies for comparing the destruction in value that would arise from the close-out and bail-in of derivatives with the

amount of losses that would be borne by derivatives in a bail-in. The European Banking Authority (EBA) is obliged to develop draft regulatory technical standards specifying the methodologies and principles for that valuation exercise (a draft is to be submitted to the Commission by 3 January 2016).^{23,24} There is no certainty that these will, in essence, replicate the methodologies and processes and particularly timing that would be applied in the absence of bail-in, that is, the methodologies and processes applied to valuation of terminated derivative positions in the ordinary course of business or perhaps on ordinary insolvency (in which, as already noted, the non-defaulting party, that is, the counterparty, is not normally obliged to terminate either immediately or at all). However, where the derivative transactions are subject to a netting agreement, EBA has to take into account the methodology for close-out set out in the netting agreement. There must be a risk, given the widely held view that counterparty termination is particularly value destructive, that the valuation for these purposes will be at mid-market, and there is also a risk that EBA may require the valuation to be as at a time immediately before the exercise of the resolution tools, even if the actual termination of the derivatives contracts occurs later. These risks are exacerbated by a number of things: Article 68, which provides that exercise of resolution powers is not *per se* to be taken as an enforcement or insolvency event; the ability of resolution authorities to suspend counterparties' rights to terminate or enforce security for up to 2 days (Articles 70 and 71); and the ability of resolution authorities to terminate the relevant derivatives contracts anyway (Article 63(1)(k)).

This would represent quite a radical departure from the status quo: The determination of the amount payable on a default-based termination and close-out has historically been based on the idea that the non-defaulter should be able to claim for an amount equal to the cost to him of entering into equivalent transactions with other providers in the market (for which purpose a valuation on the side of the spread that favours the non-defaulter makes sense, as that will represent that spread that another market provider will charge for the replacement transaction), that is, the claim should be based on his loss. Of course, that thinking (i.e., a claim for loss or damages) would ordinarily result in a one-sided claim (i.e., a non-defaulter would not suffer damage if the cost to him of entering into equivalent transactions with the market would in fact result in the receipt by him of a premium), but in the standard derivatives world, that "premium" would, as a contractual matter, be payable by him to the defaulter. If the EBA regulatory technical standards provide for a mid-market valuation to prevail, then the principle that the non-defaulter should be made

23 Article 49(5).

24 EBA published a consultation paper on 13 May 2015 and published the final draft Regulatory Technical Standards on 17 December 2015. These Regulatory Technical Standards will, when adopted and in force, provide for the counterparty to submit a valuation to the resolution authority, which the latter can accept or reject, and for the resolution authority, in the absence of acceptable or timely valuation submissions from the counterparty, to impose its own valuation. It remains to be seen how this will work in practice.

whole on a default will be over-ruled. And if the EBA determines that the date and time for the valuation are not, in effect, the current date and time at which the non-defaulter could now replace his derivative positions with an alternative market provider, then that will create a further material change to the established mechanics for valuation.

Many counterparties to institutions will have in place security or collateral arrangements for their derivative transactions. While there are a number of different approaches taken, involving independent amounts, the majority of these collateral arrangements (at least in Europe) work on the basis of the delivery, by outright title transfer, by one party to the other of collateral in the form of cash or securities with a value (after applicable haircuts) equal to all or part of the mark-to-market value. The idea is that the party in whose favour the mark-to-market stands will be the recipient of the collateral. Clearly, as the mark-to-market value and the value (after haircuts) of the collateral change over time, adjustments will be made to the collateral postings. Where there are many transactions between the two parties, the valuations for these purposes will likely be performed daily, and demands for the payment of further collateral and return of collateral may also be that frequent.

In the new world of BRRD, there are six things here in relation to collateral that parties to derivatives contracts should consider: (1) what portion, if any, of the exposure may be permanently uncollateralised (i.e., have the parties agreed to risk each other's credit to some degree on a permanent basis); (2) what portion may be uncollateralised because the parties have agreed only to collateralise when the collateral delivery requirement exceeds a minimum threshold (usually to avoid frequent collateral postings of minimal amounts); (3) what portion may be uncollateralised because valuation was performed at less than daily intervals (i.e., what swings in value may have occurred before the time for trueing up again); (4) what portion may be uncollateralised because the delivery of collateral may take 1 or 2 days to complete (again, this is the change in value over time, which will be uncollateralised); (5) what portion may be uncollateralised because of the prohibition on exercising rights of termination imposed by the resolution authority for up to 2 days; and (6) what portion may be uncollateralised because, so far, parties have not generally demanded collateral for the jump to default risk. I have not listed here the risk that the usual valuation on default will be replaced by the EBA regulatory technical standards, which might require valuation on default at mid-market. While this would represent, in effect, an actual loss (i.e., the difference between mid-market and the non-defaulter's side of the market spread) incurred by the non-defaulter, it would not be a loss for which the non-defaulter could make any claim, and so there would be no benefit in holding collateral against it.²⁵

25 This risk of this appears now to have receded, given the EBA proposals on valuation as published in the final draft of Regulatory Technical Standards referred to in footnote 24.

4.5 *What Derivative, Repo and Other Liabilities Are Excluded from Bail-In?*

Article 44 provides that certain liabilities will be outside the scope of the bail-in tool. In particular, excluded from the requirement to bail in are “secured liabilities”,²⁶ which will include repos and derivatives that are secured by collateral or supported by title transfer collateral arrangements. Repos will be secured liabilities both where the institution is the buyer and where it is the seller, irrespective of whether the repo documentation contains margin provisions dealing with change in value or exposure. Derivatives contracts will be secured liabilities, irrespective of the party in whose favour the mark-to-market value may stand, so long as there is a security or title transfer arrangement under which some collateral has been posted or delivered and remains outstanding; where there is a security document, for example, over an account or a credit support annex, but nothing is in the account and no collateral is currently posted under the credit support annex, these cannot, to my mind, count to make the derivative transactions into “secured liabilities”. Notwithstanding that a contract is a secured liability and therefore excluded from the requirement for bail-in, the resolution authorities are entitled to bail it in to the extent that the liability exceeds the security given for it, but they are not obliged to do so.

Article 44(3) allows the relevant resolution authority to exclude or partially exclude certain liabilities from bail-in “in exceptional circumstances”, namely where (1) it is not possible to bail in such liabilities within a reasonable timeframe, (2) the exclusion is strictly necessary and is proportionate to achieving the continuity of critical functions and core business lines for the institution under resolution, (3) the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion in a manner that could cause a serious disturbance to the economy of a Member State or of the EU, or (4) such bail-in would cause value destruction, which would increase the losses borne by other creditors compared with not bailing those liabilities in. It is not unlikely that derivatives may fall into one of these categories as well, in particular where the counterparty to an institution in resolution is in fact another institution (for example, in circumstances where the aggregate mark-to-market of all the derivative positions between them is below the threshold at which they have agreed they will start to post collateral). The close-out and bail-in of derivative liabilities owed to other institutions may be something that could give rise to market turmoil and spreading contagion.

Articles 77 and 78 provide that certain linked arrangements cannot be split up or modified in certain ways. The arrangements that benefit here are title transfer financial collateral arrangements, set off and netting arrangements and security arrangements. In

26 “Secured liability” is defined to include liabilities where the creditor [which could be the institution or its counterparty] is secured by collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements. See Article 2(1)(67).

effect, these provisions require that such linked arrangements are kept together on any transfer of assets and liabilities, but that does not prevent the resolution authority from exercising its rights to terminate financial contracts, so long as the arrangements themselves are not thereby, in effect, prevented from taking effect in accordance with their terms.

4.6 The Laws of Third Countries

BRRD recognises that resolution action taken by a resolution authority in one jurisdiction may be ineffective or potentially ineffective under the governing law of the liability to be affected.

Article 17 addresses certain powers that a resolution authority may have where it has determined that there are substantial impediments to the ability to resolve an institution. Ultimately, a resolution authority may require the relevant institution to attempt to renegotiate any eligible liability (which includes derivative liabilities where these are not “secured liabilities”) with a view to ensuring that any decision of the resolution authority to bail in that liability would be effective under the law of the jurisdiction governing that liability.²⁷ If derivatives contracts were implicated here, that is, formed part of the “substantial impediments”, across a number of institutions, there would likely be discussion of some industry-wide protocol to resolve the issue, but the increasing use of collateral arrangements should mean that derivatives that are not “secured liabilities” under BRRD form a smaller proportion of derivative activity.

Article 55 contains an interesting requirement that institutions are to be obliged to include contractual terms in certain future foreign law (i.e., non-EU jurisdictions) contracts under which the counterparty recognises the risk of bail-in and agrees to be bound by the exercise of bail-in powers by the resolution authority, that is, on a contractual basis. This will not be required in an EU jurisdiction in relation to a foreign law where that EU jurisdiction has decided that bail-in works under the foreign law or will be recognised by that foreign law. While this has no application to repo contracts or those derivatives contracts that are “secured liabilities”, it appears to apply to all other derivatives contracts. This is yet another reason why counterparties should consider structuring their derivative arrangements with an institution to qualify as “secured liabilities”.

4.7 Equitable Treatment of Creditors and Shareholders

The equitable treatment provisions found in Articles 74 and 75 may also render derivative bail-in more unlikely. Under these provisions, an ex-post valuation is to be carried out to

²⁷ Article 17(5)(j).

determine what treatment the various creditors and shareholders would have received under a normal insolvency proceeding and what treatment they actually received and then, of course, what is the difference. If the relevant shareholder or creditor has incurred greater losses under resolution, then it is entitled to payment of the difference payable out of the resolution financing arrangements (which are broadly intended as funds raised before or after the event from the institutions that are regulated under these rules and will ultimately, in the case of the SRM, be a single cross-jurisdiction resolution fund). This seems likely to render derivative bail-in unusual in that, under a normal insolvency proceeding, a non-defaulting counterparty can choose when, and indeed whether, to terminate its derivative transactions with the insolvent institution, with a potentially significant effect on the value of its claim, and so it may prove to be impossible to carry out this required valuation exercise.

4.8 *Protecting against Value-Destroying Early Termination*

Article 68 provides that the exercise by resolution authorities of their resolution powers (among other things) is not to be deemed to be an enforcement event or an insolvency proceeding, provided that the substantive obligations under the contract, including payment and delivery obligations and the provision of collateral, continue to be performed. Moreover, subject to the same proviso, that exercise of resolution powers shall not, *per se*, give a person a right to terminate or suspend its own performance. For these purposes, any non-performance by the institution during a period of suspension provided for under Articles 69, 70 and 71 (see the next paragraph) will not be a breach of this proviso.

Resolution authorities have, under Articles 69, 70 and 71, the ability to suspend certain payment or delivery obligations of an institution under resolution and certain security enforcement rights and termination rights of counterparties for periods up to midnight on the business day following the day of publishing notice of the suspension. These suspensions are deemed not to constitute non-performance by the institution. These suspensions also, in effect, override the Financial Collateral Directive, in that they are specifically not events against which the provisions of that Directive will give any protection; so security and collateral arrangements, which, under that Directive, can otherwise be enforced generally without let or hindrance, will be subject to these suspensive provisions.²⁸

Apart from these restrictions, which clearly place on the counterparty considerable risk of changes in value of positions resulting from market movements, from which the counterparty cannot immediately protect itself (and from which, even when the suspension period is lifted, it may not always then be able to protect itself, for example, if the institution has in fact filed for bankruptcy), I have noted earlier the valuation provisions of Article

28 Article 118.

49 for derivative liabilities that are to be bailed in, which may, in due course when EBA submits its draft regulatory technical standards,²⁹ further “protect” the institution by imposing valuation arrangements that place the jump to default risk, to a greater or lesser degree, as for the account of the counterparty.

5 SOME PRACTICAL ISSUES AND CONSEQUENCES

Traditionally, bank business was, for the most part, unsecured. That time seems now to have passed. Investors providing regulatory capital will still be unsecured. But no counterparty to a derivative contract with an institution should go forward without considering some form of security or collateral arrangement.

For many institutions, the repo business and the derivatives business will be important parts of their customer-facing business. For the bigger institutions with significant trading activities, they can represent a very large part of the business. There is some anomaly to the idea that, in order to restore an institution to the market or to sell the valuable business of the institution to a purchaser, it may be necessary to cut into that same business by bailing in liabilities (i.e., terminating business) at the level of the institution’s commercial activity, rather than liabilities that represent the funding required to be able to carry on that business.

One of the features of derivatives that is strikingly different from bonds or loans is that the value of derivatives (meaning the amount that would have to be paid on an early termination, which is mimicked by the mark-to-market value) may fluctuate considerably in very short time frames and may be significantly affected by resolution action (because of market reaction to resolution action, which may create considerable market volatility), whereas the amount due on a bond is unlikely to change by more than the accrual of interest. One consequence of this is that the resolution authorities need access to accurate real-time data in relation to the derivative book of any institution, at a level of granularity reflecting bilateral relationships of that institution with each of its counterparties, in order to make any effective and well-informed determination as to whether to terminate and/or bail in any derivative liabilities and which ones to pick. This is quite a burden on a resolution authority in a very short time frame.

It does appear that derivatives are singled out for special treatment. In particular, Article 49 effectively imposes a special valuation methodology on derivatives that is not imposed on other financial contracts. If the EBA regulatory technical standards on derivative valuation do in fact change the way in which a non-defaulter’s claim is measured (for example, by requiring the claim to be measured at mid-market), then the counterparty

29 As noted in footnote 24, these have now been published.

can tell on the day it first trades that, if there is a close-out and bail-in of the trade (i.e., after dealing with the collateral held), it will not have a claim for part of the cost to it of replacing its derivative position with another market provider. Is that a loss against which the counterparty, if it is a regulated institution, must hold regulatory capital and if so, how much and how will it be calculated?

Bail-in by way of conversion of liabilities (whether arising from terminated repos or derivatives or otherwise) into common equity seems to pose a number of potential issues. There are plenty of counterparties (perhaps UCITS, ERISA and other pension funds first come to mind) that have significant restrictions on the sorts of instruments in which they can invest. Some will no doubt have prohibitions on holding equity, perhaps particularly equity in institutions. It is not clear how these issues may be overcome.

6 WHAT REACTION SHOULD WE ANTICIPATE FROM THE FINANCIAL COMMUNITY?

6.1 *Overall Risks*

How should we expect the market to react to the risk that its transactions with institutions might be transferred to another entity, which may or may not satisfy the approval, due diligence, credit and other requirements of the counterparty or that those transactions might instead be closed out by the defaulting party, valued by the defaulting party (including potentially on a basis not consistent with the age-old principles of proper compensation for loss) and the liability resulting from that close-out paid in part or not at all, including the possibility that the non-defaulting counterparty might end up, perhaps, even holding equity in the institution?

All the work done by the authorities in requiring institutions to develop recovery plans, to monitor their businesses more carefully and to hold more regulatory capital is likely to have improved the resilience of institutions to external crises and shocks and also improved the manner in which internal controls function, with the likely result that the risk for a counterparty of dealing with an institution that subsequently falls into resolution is in fact reduced.

But the specific risks have changed, with very particular risks now arising afresh (e.g., the risk of bail-in and becoming a shareholder) and others being passed to the counterparty (e.g., risk of termination by the defaulter, adverse valuations). Counterparties in the market will be concerned by this, but it will likely take some time before the general response of those counterparties becomes clear.

So what will the counterparties likely do?

6.2 Collateral Solutions

There will be no excuse for trading in derivatives of any sort with an institution without some collateral arrangements in place. In order to make a derivative into a secured liability, that collateral arrangement can be one-sided in favour of the institution. This will mean that the derivative transaction will not be on the mandatory list for bail-in, so long as collateral has in fact been delivered. That seems to be the first step. However, one-sided collateral arrangements do not protect a counterparty from risks other than the risk of mandatory bail-in.

The second step is to ensure that those collateral arrangements are in use: Historically, a number of credit support annexes had thresholds set sufficiently high that collateral only started to be posted when the positions developed mark-to-market values that were very large. If this is how the collateral arrangements operate, then from the perspective of avoiding bail-in, they will be useless where there is no actual collateral.

The third step is to consider whether the collateral arrangements should take account of the jump to default risk, that is, should the collateral be calculated on the basis of the likely loss if there were in fact to be a default and close-out. This means, calculating an add-on beyond the mark-to-market value for the purpose of determining collateral.

If the answer to that is “yes”, then the legal and practical issues may be more complex. Imagine that the mark-to-market value (at a mid-market level) today is 100 in favour of the counterparty. For the sake of simplicity, imagine also that both parties are agreed that the possible development of that mark-to-market value over the following half week is plus or minus 10 and over the following full week is plus or minus 20 and that the parties agree that the spread cost (i.e., the difference between the mid-market price and the price on one or other side of the market spread) could be as much as 5. The time horizon for the add-on amount may be different between the counterparty and the institution. Imagine that, on a Friday, the parties agree upon a mark-to-market value as at Thursday night, which requires the institution to deliver further collateral. That collateral, in the form of securities, has a 2-day delivery timetable, so the counterparty would not expect to receive that until the following Tuesday. But on the Tuesday, the institution enters resolution, and the obligation to deliver collateral is suspended under Article 69 until the close of business on the following day. So the first day on which the counterparty can in fact close out for a failure to deliver collateral (entirely ignoring grace periods in the contractual documentation) may be the Thursday. Now if the collateral was not in fact delivered, then the last mark-to-market value that could have been properly collateralised would be the previous Wednesday night’s value as determined on the previous Thursday. So, there is at least a week (which will in practice be increased by grace periods) between the most recent possible correct collateralisation and the ability to terminate for failure to collateralise. On the other side, if the default is going to be that of the counterparty, for example, in returning collateral,

(here assuming, for the purposes of this example, that the counterparty is not itself an institution) the time period is slightly shorter, as the institution's right to terminate will not be suspended. I have, for ease of the example, simply assumed an overall period on the institution side of 1 week and on the counterparty side of half-a-week. Although this is not taken into account in the example, it is entirely possible that the two parties could also legitimately take different views (and agree them with each other) as to the likely volatility on each side. If the institution enters resolution (where the longer period applies), the market volatility is likely to be much greater than if the counterparty (assuming it is not an institution) defaults.

The counterparty would then wish, in order to be fully collateralised, to receive collateral having a value, after haircuts, of 100 plus 25 (being one week's volatility of 20 plus the spread cost of 5). The institution would wish to deliver collateral of 100 minus 15 (being half-a-week's volatility of 10 plus the spread cost of 5) or to deliver collateral of 100 and receive collateral of 15.

Across the European markets, most collateral is delivered by way of outright title transfer of cash and securities against an obligation of the collateral taker to return equivalent cash and securities to the collateral provider when the collateralised liabilities have been settled or the collateral is no longer required. The claim of the collateral provider to the return of the collateral is, at law, an unsecured claim. Title transfer collateral is much used because it is highly effective, legally robust, easy to use and allows the collateral receiver to use that collateral for its own purposes, so that the collateral is not locked up. But if our two parties collateralise by title transfer by delivering 125 in one direction and 15 in the other, the net effect is a delivery of 110 in only one direction (by virtue of the claims for the return of collateral being unsecured and therefore netted or set off against each other). This was not the effect that the parties wished to create. It also leads to the institution, in this case, being actually exposed on an ongoing basis to the counterparty for at least 10, being the amount of net excess collateral delivered (i.e., it delivered 110 net collateral when the mark-to-market exposure of the counterparty was actually 100). There are solutions, if the parties choose to go down this route, although neither that is described in the following paragraph is perfect. No doubt there are others.

The parties could collateralise by way of security interests: So all collateral could be delivered to an account of the collateral provider with a third-party bank or custodian (depending on whether it is cash or securities) over which the collateral provider has granted a pledge to the collateral taker. Although this is possible, it is less than ideal. The collateral is not reusable: It could be made reusable, but this leads to the same netting and unsecured problem as is noted in the previous paragraph. Security interest collateral has some significant legal uncertainties associated with it. It is not so easy to operate as title transfer collateral, and enforcement of security is subject to the stay on enforcement of security, which may be imposed by a resolution authority under Article 70. Title transfer

collateral requires no enforcement in any meaningful sense: The collateral taker owns collateral outright and will likely already have used it. All that is required for “enforcing” title transfer arrangements is the valuation of the collateral, which the collateral taker would otherwise be obliged to return, and so “enforcement” in the title transfer world is not subject to any suspension under Article 70.

The other possibility is to operate two forms of collateral arrangement side by side. The mark-to-market portion of the collateral (which broadly would represent gains and losses on the derivative positions to date) could be dealt with by means of title transfer. These are the values that show the greatest change in value from day to day and so would result in frequent collateral movements between the parties. The 25 and the 15 could be delivered by means of security interests by credit to separate accounts over which the collateral provider has granted a pledge to the collateral taker. Those separate sums may need adjustment from time to time, but that could be much less frequent than the mark-to-market adjustment and should generally be in much smaller amounts. In this manner, both parties could be simultaneously fully collateralised against the other.

This is, of course, rather like the margin that is demanded by a central counterparty, which will receive initial margin and will pay and receive variation margin from time to time. Initial margin (which sits at the central counterparty until the maturity of the position) is intended to cover the risk of loss to the central counterparty on a clearing member default between the date of the last variation margin settlement and the time at which the position might be able to be terminated by the central counterparty – a time period of perhaps up to a week. Variation margin reflects the market value of the position (i.e., its change in value day by day) and so may be payable to or by the central counterparty.

One issue to be avoided, if possible, in relation to collateral is the risk of over-collateralising the institution on a title transfer collateral basis. Given that the resolution authorities can terminate any financial contract, it is not a risk that counterparties should lightly take to give excess collateral to an institution that would result, on a termination by the resolution authorities (or even, where permitted, by the counterparty) in a claim against the institution for the excess value, because that may be an unsecured liability after termination, which could be bailed in. Some thought must therefore be given to the structure of collateral involving independent amounts, the frequency of valuation and collateral delivery, the size of haircuts on the collateral itself and the minimum collateral transfer and return amounts (including rounding).

All this may result in the need for further collateral (e.g., the 25 and the 15 in the example) to be held without reuse in secured accounts. While this has implications for the counterparty, it would also increase the requirements for the institution to have access to adequate liquidity to be able to supply that further collateral given its inability to reuse such collateral secured in its favour. And this would increase the costs to the financial institution and therefore to the market of this sort of business.

6.3 *Open-Ended Rights to Terminate*

It is possible that counterparties will generally wish to include in their documentation non-specific rights to terminate all transactions on notice and without reason. This would or might then allow a counterparty that was not prepared to continue a relationship with the replacement institution to terminate such transactions and (if it needed to) to replace the positions with some alternative provider. There are already many counterparties, such as ERISA funds and UCITS funds, which are obliged to require these sorts of termination rights in derivative arrangements. While the ability to exercise such a right would likely be suspended under Article 71, it would arise thereafter and could be of use to the counterparty if, for example, it were unhappy at the transfer of its positions to a bridge institution or purchaser.

Even without a specific right to terminate on notice and without cause, there is a possibility that counterparties will request the termination of their outstanding positions (when they think there is a material risk of bail-in of a net liability owed to them or they see the relevant institution facing financial difficulties). Traditionally, an institution will tell its counterparties when they enter into a derivative transaction that the counterparty has no need of a *right* to terminate, as the institution will always be happy to terminate on request – and this has generally been the case in practice, as an institution will quote a termination price, which will include a further market spread in favour of the institution as a price of that termination, which represents profit to the institution. However, in the new world, there is a material risk that an institution will not be prepared to unwind derivatives on request when it is facing financial difficulties and in any event, if a counterparty wishes the ability to unwind in circumstances where it sees the institution facing financial headwinds, it is unlikely to be prepared to allow the financial institution complete freedom to set the price for that termination. In the new world, then, noting also that consensual or contractual termination will not be governed by the valuation rules in Article 49, there may be a rapid reduction of the derivatives/repo books of an institution in the days before resolution, given the uncertainty of outcomes that would face counterparties who stay put.

6.4 *Use Only the Biggest Institutions in the Relevant Market*

It may be more likely that the derivatives and repo businesses of the bigger institutions will be seen as core business lines and/or more valuable and so liable to be preserved by sale or other bail-in, whereas for smaller institutions that might not be so. This might suggest that there is relative safety in the bigger players.

6.5 *Clearing*

Clearing of repos and derivatives contracts avoids the resolution issues relating to institutions. But clearing is likely only to be available for the more standardised products, and there is and will continue to be a market for tailored hedging and derivatives. Unless the counterparty is itself a clearing member of a central counterparty, then the clearing of a contract would usually result in the counterparty facing the institution on a contract, with the institution facing the central counterparty on an equivalent “back-to-back” contract. While the resolution authorities appear to have the ability to terminate the contract between the customer and the institution (which would result in the termination of the back-to-back contract, with the pricing reflecting the central counterparty pricing), the liability of the institution to the counterparty on that terminated contract is likely to be some form of trust property outside the proprietary estate of the institution and would therefore not ordinarily be available for bail-in. There are other remedies that a counterparty would have to transfer its positions (and margin) to another institution to become its clearing member facing the central counterparty under “porting” arrangements. It is highly unlikely that a resolution authority would terminate such trades unless the counterparty chose not to port to another institution, and the resolution authority was keen to reduce the overall business of the institution in that area.

6.6 *Alternative Providers and Competition*

While the risk of actual bail-in of derivatives seems unlikely, the perceived risks of all the resolution tools and powers may lead to a move for counterparties to transact more with entities that are not subject to BRRD or equivalent legislation. It is not clear whether this would be seen by regulators as a good or bad thing.

6.7 *Information on Creditworthiness*

The markets react to information. It is interesting to speculate as to how much ahead of the market the resolution authorities and competent authorities will be when the time approaches for resolution. Article 32 suggests that an institution has to have gone a fair way down the track towards disaster before the relevant authority will be entitled to take resolution action (among other things, the institution has to be determined to be failing or likely to fail, with no reasonable alternative prospects). It seems likely that the market will have woken up to concerns before resolution action is in fact taken and may have taken action to terminate (if contractually allowed) or request termination otherwise long before actual resolution is started.

Recital 67 suggests that the existence of the bail-in tool will “give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances...”. In effect, good health at an institution is to be promoted by monitoring by creditors (among others) who are at risk of bail-in. That is an interesting proposal that seems not to be reflected in the main body of BRRD, unless it is in the oblique reference in Article 45(19)(m), which says that the EBA must report to the Commission by the end of October 2016 on whether it is appropriate for institutions to be required to disclose their minimum requirement for own funds and eligible liabilities or their actual level of the same, and if so the frequency and format of that disclosure. For a creditor to monitor the institution’s health, it must have relevant information.

It seems likely that the failure of an institution or the resolution of an institution will have a significantly smaller adverse effect in the markets if the markets have already “seen it coming”. That can only be safely accomplished if the information on the basis of which failure or resolution can be foreseen is in fact made available to the market. But at a more granular level, counterparties to institutions should discuss what information they can have access to, given that they are now in a position whereby they could be turned into shareholders in the future without their consent.

6.8 *Use of Credit Derivatives*

There may be an increase in the use of credit derivatives under which the relevant institution is the reference entity.

6.9 *Revisions to Documentation*

Market standard documentation really needs revision to reflect the new practices required by BRRD (and a host of other legislation). Anyone who has looked recently at the myriad agreements and protocols that now make up, for example, a derivative relationship between a counterparty and a European institution will be aware that the documentation is no longer (even if it ever was) short, straightforward and found in one place. This needs to be addressed in order to reduce the start-up cost to the market of documenting new relationships. That is a big task.

7 FINAL THOUGHTS

Regulators are now to be under greater pressure than ever. It will be their fault if an institution fails. The institution is obliged to give all relevant information to the Board/the

national resolution authority for the purpose of drawing up and monitoring resolution plans and, when the time comes, deciding on their implementation. While any financial crisis at an institution may be created by its existing management or by external events, it is the resolution authority who has the toolkit and the powers (lots of them) to protect that situation and save the day. The BRRD is written on the basis that it will be possible to save the situation, that the resolution authority will know how to do it and that the Board or the resolution authority will choose the right tools to accomplish the job. If any resolution fails, now that the authorities have all the rights they could possibly need, it will be the regulatory authorities who should have done better.

People have written about the need to end the culture of “Too Big to Fail”. While that makes sense, the BRRD and the SRM Regulation have potentially reached the point where institutions should be virtually unable to fail, for at the first sign of ill-health, the resolution authority is to rush in like a doctor with a medical bag and revive the patient. It would appear that the quality of the doctor may need to be taken into account by the market in assessing the ongoing health of the patient.

The Commission is accustomed to helping the market understand various nuances of the legislation by issuing and revising answers to FAQs. Some of the answers have been seen as themselves making helpful revisions or supplements to the legislation. While the toolkit available to resolution authorities under BRRD is very extensive, there is still ample scope for effective revision and enhancement through regulatory technical standards and the Commission’s answers to FAQs.

REPORT OF THE ANNUAL CONFERENCE OF THE NETHERLANDS ASSOCIATION FOR COMPARATIVE AND INTERNATIONAL INSOLVENCY LAW ON 6 NOVEMBER 2014

*L.G.A. Janssen and T.C.A. Dijkhuizen**

1 ANNUAL ADDRESS BY BOB WESSELS

Bob Wessels opened the fourth annual conference of the Netherlands Association of Comparative and International Insolvency Law (NACIIL) with an annual address, which related to the themes that were to be discussed during this conference, such as the legal protection of third parties and counterparties under the Single Resolution Mechanism (SRM). More generally, his contribution focused on the recognition of foreign recovery and resolution measures and on the harmonisation of rules regarding this subject, which has been terra incognita for a long time.

In October 2011, the Financial Stability Board (FSB) published its Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes), which have become to be regarded as the umbrella standard for resolution regimes covering financial institutions of all types that could be systemic in failure and which set out the core elements for an effective resolution regime. Three years later, the FSB adopted additional Key Attributes specifically relating, *inter alia*, to information sharing for resolution purposes and the protection of key client assets in resolution. However, the FSB still struggles with how to implement a regime for giving legal effect to resolution measures beyond the territory in which they have been taken and regards this as one of the main obstacles to the resolution of cross-border operating systemically important financial institutions (SIFIs).

In September 2014, the FSB published a Consultative Document (the Document) comprising a two-part package of policy measures and guidance, containing (1) statutory changes that jurisdictions should consider adopting in order to enhance the effectiveness of a cross-border resolution; and (2) contractual approaches that global SIFIs should implement to achieve the same purpose pending widespread adoption of comprehensive statutory changes. This Document also states that statutory frameworks are to be preferred

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as a longer-term solution, but acknowledges that very few jurisdictions have such frameworks in place and that it will take time to implement these. Therefore, the FSB, for the shorter term, proposes contractual solutions for two substantive areas perceived to be critical to achieving orderly cross-border resolution, namely, (1) contractual arrangements that will provide for the recognition of temporary restrictions or stays on early termination rights in financial contracts; and (2) contractual recognition of the possible bail-in of debt instruments in resolution where the relevant instruments are governed by the laws of a jurisdiction other than that of issuing entity. With regard to the former, 18 SIFIs agreed last week to delay by 24 hours their right to exercise certain early termination and cross-default rights against one another in connection with certain over-the-counter transactions when their counterparty is in imminent collapse and their fate is in the hands of the national regulator.

But these contractual solutions are not to be seen as a substitute for statutory regimes, and for that reason the Document also contemplates two statutory approaches for giving effect to foreign resolution measures in a manner consistent with the earlier-mentioned Key Attributes, namely (1) recognition of a foreign proceeding; and (2) support for a foreign proceeding in the context of a domestic proceeding. Although Wessels considered these approaches to be welcome, he argued that the recognition-based framework should not be left to the discretion of each individual jurisdiction. His proposal is that a text very similar to the UNCITRAL Model Law on Cross-border Insolvency will be incorporated into a EU Regulation. This could provide “a staged system of recognition of resolution measures similar as provided to such judgements opening insolvency proceeding in which the courts can investigate whether the interests of all parties concerned are adequately protected”.

He further suggested an European Union (EU)-wide uniform approach to recognition of resolution measures initiated outside the EU as this will be “coherent with the way the EU has crafted its framework for bank resolution and recovery, it will enhance the proper functioning of the internal market and it will support a unified external trade policy”. Such a Model Law for financial institutions will be complementary to the current regime comprising the Bank Recovery and Resolution Directive (BRRD). The text of such a Model Law must be aligned with the specifics of financial institutions as, for example, prompt action is required to avoid a bank run.

He concluded that “in the area of our association interests, there are quite some challenges ahead”, but as NACIIL is in the forefront of these legal developments, it will seize all the opportunities resulting from the challenges with the aim of further enriching its members.

2 SASKIA NUIJTEN

Matthias Haentjens, the chair of the proceedings, then continued to introduce Saskia Nuijten as the first speaker to make a presentation. This presentation concerned the legal protection against actions and decisions of the Single Resolution Board (SRB) under the SRM. The latter mechanism aims to ensure that if a bank would face serious difficulties despite stronger supervision, its resolution could be managed efficiently with a minimum of costs for taxpayers and the real economy. Nuijten started her presentation with an explanation of the failure-preventing measures taken at the national and European level. She considered five different measures, namely (1) bank rescues; (2) analysis, in particular the comprehensive assessment of 130 banks by the European Central Bank (ECB); (3) the single rule book; (4) the introduction of the Single Supervisory System (SSM); and (5) the introduction of the SRM. All these failure-preventing measures might have the effect that the considerations of Nuijten on legal protection will never be tested, but she, nevertheless, discussed the main issues regarding legal protection in a phase-by-phase manner.

In Phase 0, the emphasis lies on the drawing up of a resolution plan of a bank by the national resolution authority. In this phase, the SRB has no instruments that can be used against banks. In actual practice, the bank will be required to assist in the drawing up of a resolution plan on the basis of national legislation. Therefore, the national legal protection regime will apply. For example, the Dutch Central Bank (DNB) will probably use its authority to request information when fulfilling its obligation to draw up a resolution plan. On a national level, there is little protection from such a request because under Dutch law the administrative court will not provide such protection, and the civil court would only perform a very limited review. If the SRB, after an analysis of the resolution plan, determines that there are substantive impediments to the resolvability of the financial entity or financial group, it will prepare a report, which is not a decision, and submit it to the entity or group. The latter must then propose possible measures to address or remove the impediments. If these measures are not effective or not existent, the SRB issues a decision, by way of an instruction, to the national resolution authority, which has to use its own powers to require the group or entity to address or remove the impediments. The latter decision is pursuant Art. 85(3) of the SRM Regulation (SRMR) open for appeal to the Appeal Panel, but only the national resolution authority can appeal as the decision is addressed to this authority. One could argue that the original report has legal effect because it results in the obligation to propose measures to a bank and, furthermore, one could argue that the latter decision is of concern to the involved group or entity itself, but in both instances there is no legal protection for these actors. As the legal effect only materialises after the DNB follows the instructions of the SRB and takes action, only national legal protection is available in this phase.

In the next phase, Phase 1, the ECB might conclude that a bank is likely to fail when it is not performing well. This determination is an important decision, but under the SRM it does not have any other legal consequences than going to the third phase. Therefore, this decision is not open for appeal. However, when the ECB, or SRB, decide(s) the bank is not failing or likely to fail, the resolution powers and authorities do not become available, and one could argue that this is a legal effect. This is the case under Dutch administrative law. When the situation is less serious, the ECB can take early intervention measures. These measures entail, *inter alia*, imposing higher capital requirements or the removal of members of the management body. The ECB has to notify the SRB if any of these measures are taken. The SRB has, subsequently, the power to require the group or entity to contract potential purchasers in order to prepare for the resolution of the group or entity. This seems to be a requirement with legal effect, but the decision is not mentioned as a decision open for appeal.

In the following phases, there are several consecutive decisions ultimately leading to the adoption of the resolution scheme. First, if a bank is likely to fail, and the SRB determines, in the second phase, that there are no prospects for alternative private sector solutions and resolution action is in the public interest, the SRB adopts a resolution plan. These decisions are not open for appeal. Hereafter, the European Commission has to endorse or object to the resolution scheme within 24 hours. The Council can also, within 12 hours, approve or object to a material modification of the amount of Fund provided for the resolution. Both decisions of the European institutions are not open for appeal. This results in uncertainties because this, for example, might be different when the Commission does not endorse or object to the scheme in time. In the fourth phase, the SRB will, within 8 hours, modify the adopted resolution scheme in accordance with the objections of the European Commission or in accordance with the approved material modifications of the amount of the Resolution Fund provided. Here again, there is uncertainty whether one is legally protected against these modifications.

In the fifth phase, the resolution scheme enters into force after its endorsement by the Commission and approval of the Council. The measures described in the resolution scheme can be applied by the national resolution authority, but only after a valuation of the assets and liabilities of an entity or group. This valuation, however, is an integral part of the decision on the application of a resolution tool, and therefore there is no legal protection concerning this valuation *per se*.

In the sixth and last phase, the resolution scheme is addressed to the national resolution authority, and this authority has to implement this scheme by using its own resolution powers. Therefore, national legal protection is available for the involved banks or other involved persons. The national resolution authority, however, may use as a defence that it is obliged to follow the instructions from the SRB. Therefore, the national courts can and often must in this procedure request a preliminary ruling from the Court of Justice

on the decision of the SRB to adopt the resolution scheme. The SRB also monitors the execution of the scheme and may give instructions to the national authorities. These instructions, however, will not have legal effect until they are implemented by the national authorities. Then again, national legal protection is available. Here again, the instruction of the SRB can be judged by the national court by requesting a preliminary ruling from the Court of Justice. Furthermore, if the national authority does not comply with the instructions from the SRB, the SRB may issue executive orders to the involved bank. These orders have legal consequences and are, therefore, open for appeal to the Appeal Panel. During all these phases, the SRB can use supervisory and enforcement powers. For instance, it can decide to conduct a general investigation. The decisions to investigative powers are not directly open for appeal, but it is likely that an appeal to the Court of Justice is possible because of the obligation to comply with these decisions. If a bank or involved person does not comply, the SRB may impose a fine or a periodic penalty payment and, in the opinion of Nuijten, these sanctions are quite convincing. For example, the basic amount of a fine for non-compliance with a general investigation can have a maximum of 0.15% of the total annual net turnover.

Nuijten concluded that there is very little protection against actions from the SRB because most of these actions will result in decisions of DNB, and these decisions are open for legal protection according Dutch national rules. The decisions of the SRB can be judged in these procedures by preliminary rulings from the Court of Justice. The consequence is that many important decisions cannot be contested in an early phase. Furthermore, it is likely that these early decisions have contractual consequences before the national resolution can take actions. The question will be whether the available legal protection will come in time or only after passing a real point of no return.

3 RALUCA PAINTER

The second presentation by Raluca Painter concerned the European Framework for Bank Recovery and Resolution. Her presentation consisted of two parts. The first part related to the BRRD, its main features and novelties and the second part to some difficult points that the EC has encountered during the negotiations, while highlighting the divergent opinions at times between the co-legislators or between the original proposal and the position of the co-legislators.

The BRRD has the objectives of (1) maintaining financial stability; (2) minimising costs for taxpayers in case banks are failing; and (3) avoiding disorderly insolvency. In order to achieve these objectives, the BRRD provides supervisors and resolution authorities with a set of powers to strengthen their grasp of the structure of all banks as well as an ability to plan and respond to the failure of the banks. Furthermore, the authorities will be granted

powers to return a bank in financial distress back to viability or to resolve a non-viable bank in the public interest. Under the BRRD, every Member State is obliged to put in place a national resolution authority. Some Member States decided to create completely new authorities, whereas other ones have decided to create special departments within supervisors to deal with resolution matters. The only condition for such organisational structure is that within the supervisory authority, the supervisory and resolution functions are separated in order to ensure that decisions are taken by the resolution authorities with significant objectivity compared to the decisions taken by supervisors.

The BRRD is the outcome of negotiations that took about 19 months, and during these negotiations delicate balances had to be struck on, for instance, the treatment of home and host authorities when agreeing actions on planning, prevention and resolution of cross-border banks and on the parameters of a credible and usable bail-in tool. The result was a comprehensive and flexible framework that consists of four pillars, namely (1) planning and prevention; (2) early intervention; (3) resolution; and (4) cooperation and coordination. Flexibility is preserved as the national resolution authorities are able to use a range of tools and powers in a proportionate manner based on an institution's business model, risk and size and different types of crises. Because it is a directive that is to be transposed by the Member States into their national laws, these Member States are also given sufficient flexibility in order to implement the different provisions that are set up in the Directive.

Painter focused extensively on the bail-in mechanism that builds upon the idea that from now banks would be saved not by public money, but by asking shareholders and creditors to contribute to the loss that has occurred. She also addressed the different bail-in mechanism thresholds. Once a bank is put into resolution, there has to be an 8% bail-in of the total liabilities. If other resources are necessary, the resolution financing arrangement may provide a capital injection of up to 5% of total liabilities. When these funds do not provide to be sufficient, the BRRD allows, in case of a systemic crisis, for the use of state stabilisation tools, although the EC will have to approve this use.

Painter also dealt with the cross-border cooperation within the EU and with third countries in her presentation. With regard to the former, resolution colleges are established that are to facilitate cooperation and coordination among authorities for the resolution of cross-border banks. These authorities must come to joint decisions, and the European Banking Authority (EBA) is given mediation powers in this respect. The BRRD also prescribes some detailed principles on cross-border resolution within the EU, namely that, *inter alia*, the resolution process should be transparent and efficient, and timely action has to be taken. With regard to the cross-border cooperation with third countries, the Commission is authorised to negotiate binding agreements with third countries on the basis of a framework developed by the EBA, but before this is done the Member States may enter into bilateral arrangements.

After elaboration on the four pillars of the BRD, the focus of her presentation shifted to the SRM. Under this system, there is a division of tasks between the SRB and the national resolution authorities, but the SRB will ultimately be responsible for all banks and for the use of the Single Resolution Fund (SRF). In the remainder of her presentation, Painter focused on two important issues on which the co-legislators had divergent opinions, namely the tasks of the plenary and executive sessions within the SRB and (the contributions to) the SRF.

With regard to the former, the EC proposed a system whereby the executive session would take all the individual resolution decisions by a simple majority rule. However, the European Parliament (EP) and the Council had divergent views on how these decisions should be taken. The outcome of their lengthy negotiations was the following. As a rule, the Executive Board decides in specific resolution cases, but the Plenary Board decides whether (1) a specific case requires more than five billion euros from the SRF; and (2) whether the net accumulated use of the Fund in the prior consecutive 12 months reaches five billion euros. In both latter cases, the decision should be taken by simple majority representing at least 30% of the contributions.

The last issue discussed was the SRF. This single fund, sourced from the banking sector, is thought to create economies of scale, to boost credibility and to be instrumental in breaking the link between bank debt and sovereign debt. The Commission originally proposed a single fund fully mutualised as of day 1, and it would be built up during a 10-year period. Here again, the EP and the Council had divergent opinions. The outcome of these negotiations was that, during a transitional period of 8 years, the Fund comprises national compartments corresponding to each participating Member State in the SRM, and these Member States agreed upon an intergovernmental agreement on the transfer and mutualisation of the contributions. The individual contributions of the banks are calculated at the European level but are collected at national level pursuant to the aforementioned intergovernmental agreement.

4 DISCUSSION

After these presentations, the chair opened the floor for interventions from the audience. The discussion was opened by Boudewijn Berger, who reacted on the presentation of Raluca Painter. He asked her whether the Member States that are part of the Euro Area still have the discretion to use stabilisation tools, because these tools are not mentioned in the SRM. The reaction of Painter was short and clear: These government stabilisation tools are not applicable in the Banking Union. This was the outcome of the negotiations concerning the SRM.

Roelf de Weijs continued with another question for Painter concerning the effects of the exclusion of depositors from the bail-in tool and the preferred status of these depositors, which he considered as being a novelty of the BRRD next to the introduction of the bail-in tool. He wondered whether this whole plan would not backfire to the deposit holders. These deposit holders will be receiving less interest even to such extent that the interest will be negative. He referred to the situation in Germany at that time. Painter answered that this question is quite difficult to answer, but as choices have to be made, the protection of depositors was placed on the forefront. Besides that, Painter was doubtful that the current situation is so negative as De Weijs seems to experience it. Boudewijn Berger added that the current negative interest has more to do with the overall low-yield/interest environment and that the negative interest rate is not related to the higher protection of depositors.

Thomas van Rijn reacted to the presentation of Saskia Nuijten, and he wondered whether her conclusion was justified. The focus of Nuijten's presentation was, in his opinion, on the formal criteria with regard to legal protection either on the European or national level. Van Rijn agreed that from a formal perspective, there might be some *lacunae*, but he wondered whether those could not be overcome by focusing on more substantial criteria. He exemplified this by stating that in case the SRB gives very clear instructions to a national resolution authority, this national authority cannot do anything else than to follow these instructions. In such a case, it would be logical that there would be legal protection against the decision of the SRB before the Court of Justice. In his opinion, case law of the Court of Justice offers all kind of examples in which the Court of Justice applies such a material or substantial approach to legal protection, because one of the main concerns of this Court of Justice is that there is always effective legal protection.

Nuijten agreed with van Rijn that she focused on the formal criteria and that there might be another way of looking at it, but her main point was that the legal protection under the SRM is currently uncertain as it does not explicitly state which lawyer you should have to address. Moreover, the instructions of the SRB regarding the implementation of its decisions are not binding. Therefore, the regulation directs to the national courts, but it would be better, in her opinion, to have legal protection at the European level. She then reiterated that her main issue is that it should be clear at what level the legal protection will be, and this should not be dependent on case law.

Van Rijn disagreed and argued that the regulation provides the legal protection where the formal decisions are taken. He then made a last remark with regard to the legal basis of the SRF. In her paper, Nuijten stated that the SRF could not be based on Article 114 TFEU and that for that reason, an additional legal basis was chosen in the form of an intergovernmental agreement. But in his opinion, the intergovernmental agreement was the result of a political compromise to put the legal basis of the SRF outside of the treaties, but not because Article 114 TFEU could not be the basis for the SRF. Painter agreed with

this statement because she also saw the intergovernmental agreement as an outcome of the negotiations concerning the SRM.

5 BART JOOSEN

After the break, Matthias Haentjens introduced the third presenter, Bart Joosen, and said that his contribution would focus on the bail-in mechanisms in the BRRD, a mechanism that is considered by many to be the most controversial topic of the directive. Joosen started his presentation with the consideration that the last few years many new legal regimes have been introduced all over the world, based on the global standards of the Basel Committee and the Financial Stability Board. Joosen mentioned that at this moment, the Basel III standards are applied in almost all countries. He fully agreed with the introductory remark of professor Bob Wessels that one would hope that we would be able to create harmonised rules as regards the recognition of recovery and resolution measures. According to Joosen, it is a lost opportunity that the European legislator was not able to put the BRRD in the form of a regulation. Joosen warned that this may result in a patchwork of national laws addressing the recovery and resolution of credit institutions and investment firms, whereas many banking groups operate cross border. The recovery and resolution of those internationally organised and operating institutions may again depend on different national regimes.

The BRRD closes one gap that was left by the European Capital Requirements Regulation (CRR) in 2013. It establishes a contingent capital mechanism as regards Tier 2 capital instruments. Yet some of the BRRD provisions are duplicative as compared to the existing CRR regime. According to Joosen, the provisions already dealt with in the CRR should not be included in the BRRD because this may give rise to conflicting rules and confusion. Based on the Basel III regime, the CRR requires that contingent capital mechanisms should be incorporated in the terms and conditions for Additional Tier 1 capital instruments. Consequently, when a so-called “trigger event” occurs, the debt obligations are either converted in equity capital or wholly or partly written off. The BRRD also introduces a write-down and conversion regime, that is, the bail-in tool, which can be applied as regards a wide range of debt obligations, except for a list of liabilities that are excluded from the scope of the tool.

The last few years’ contingent capital instruments have been issued by many institutions with great success, as the results of the Asset Quality Review of the European Central Bank recently showed. Credit institutions even introduced Tier 2 capital instruments containing contingent capital features with a high trigger, although this was not required in the CRR. The issued instruments will be converted into equity capital when the capital ratio of the institution drops, for instance, below 7%. According to Joosen, these mechanisms are

particularly applied in circumstances where the operations of the institution are still going concern. Therefore, these mechanisms may enable that we will never end up in the resolution regime of the BRRD. Joosen concluded that this shows that the market is wiser than the regulator.

In many studies and reports, the bail-in tool has been placed in the context of a penalisation and punishment of creditors and shareholders, who should pay much more attention to the well-being and management of the institution beforehand. However, according to Joosen, creditors and shareholders are restricted in their rights as a result of the capital requirements and the prudential supervision imposed on institutions. Creditors and shareholders can therefore hardly contribute to the management of the institution.

Finally, the BRRD works on the hypothesis that the bail-in tool can be enforced by means of a statutory basis. Only with regard to the contractual relationships that are governed by the law of a third country, contractual provisions about the enforceability of the measures in the third country are required. Joosen recommended that this contractual addition should always be put in the various contracts governing bail-in-able debt, as an extra contractual emphasis on the restriction of rights of creditors once the bail-in mechanism is being applied.

6 PATRICK CLANCY

Patrick Clancy started his presentation by mentioning that he wanted to look to bank recovery and resolution “... from the other side of the telescope.” He highlighted the consequences of the resolution measures for the position of counterparties, especially in repos and derivatives contracts. Before the financial crisis, which Clancy referred to as “the regulatory revolution”, many counterparties traded in derivatives without security from the institution, while big positions and exposures were built up. Where collateral arrangements were in place, in particular for derivatives, very high initial thresholds were often used. This resulted in a so-called “credit cliff”. Since the financial crisis, a lot has changed in financial regulation. There are now, for instance, more capital requirements and rules as regards recovery and resolution planning and as regards clearing.

Clancy argued that the resolution measures will not, per se, improve the behaviour of institutions, unless you provide some information to the shareholders and the potentially bail-in-able creditors that allows them to assess what the financial situation of the institution is. This is, however, not required by the BRRD.

The BRRD provides for four resolution tools: the sale of business, the transfer to a bridge institution, the transfer to an asset management entity and the bail-in tool. The bail-in tool is, however, only available where the business is to be continued. In some cases, the business has to be wound up under normal insolvency law. Where the resolution tools

are applied, counterparties may suddenly face a replacement or a substitute institution or may find their contract suddenly terminated. Yet these measures are not provided for in the contractual documentation and do not provide protection for their wishes, credit lines and rating requirements. Moreover, the bail-in tool can result in the write-down of liabilities of the institution or the conversion of the creditor's claim into equity. Secured liabilities are exempted from bail-in, including all repos and collateralised derivatives, but only to the extent of the coverage. Clancy argued that there is, therefore, absolutely no reason for a counterparty anymore to deal with an institution on a non-collateralised basis.

When a derivative position is terminated by the resolution authority and the liability resulted from the termination is bailed in, it is not clear how the value of the position is to be determined. According to Clancy, special rules need to be developed for the valuation of derivatives. Under the BRRD, the EBA has to develop regulatory technical standards specifying the methodologies and the processes for the valuation exercise and has a wide discretion to do this. Clancy was worried about how the methodologies and the timetable for the valuation will look like. Moreover, Clancy was not sure that the bail-in tool "... is the end of our story". In case the bail-in tool is applied, the resolution authorities will determine how much need to be bailed in to restore the required Common Equity Tier 1 capital ratio of the institution. There is, however, no BRRD mechanism that requires the use of any further liabilities of the institution in order to create an increased quantity of capital and which provides that the institution is genuinely credible to survive and continue its business.

How may counterparties react and respond to the new resolution regime? Clancy advised that they should always deal on a collateralised basis. Moreover, the clearing of repos and derivatives contracts may prevent certain issues, and counterparties may turn to entities that are not subject to the BRRD or to only the biggest institutions in the relevant market, rather than the smaller ones, because the big institutions may be seen as more certain not to be subjected to the BRRD resolution regime.

Clancy concluded that because the resolution authorities now have the resolution tools at their disposal, it seems that when an institution fails, it is the fault of the authorities. However, the authorities cannot use the resolution tools until they conclude that the institution is actually failing, which will be at a very late stage.

7 DISCUSSION

After Clancy's presentation, the chair opened the floor for discussion. In reaction to the presentation of Bart Joosen, Aartie Hoeblal asked how exactly the link between the contingent capital mechanisms in both the CRR and the BRRD will work out in practice. Bart Joosen explained that the CRR provisions about the contingent capital mechanism continue

to apply, even as the bail-in tool under the BRRD exists. Before the institution is failing or likely to fail, the application of the CRR mechanisms can result in the replacement or dilution of the regulatory capital providers. When the institution is subsequently moved into resolution, the resolution authorities can apply the bail-in tool in respect of a wider range of capital holders.

Rolef de Weijs asked whether the new resolution regime is only applicable when there is a systemic risk. Patrick Clancy explained that the BRRD determines that the resolution tools can only be used under certain circumstances and that certain objectives need to be taken into account, such as the protection of depositors. When the collapse of a very small credit institution is not likely to cause a systemic risk, the resolution authorities will not be allowed to use the resolution tools. In such instance, the normal insolvency regime will apply. Matthias Haentjens added that when a bad bank is created in the application of the sale of business tool, the bridge bank tool or the asset separation tool, that bad bank has to be wound up under normal insolvency law as well. According to Bart Joosen, it is, however, not the case that the resolution regime of the BRRD will only be applicable to large institutions because small institutions can also have important functions and can be of systemic relevance.

Thomas van Rijn finally emphasised that the Single Resolution Mechanism is put in the form of a regulation and that a patchwork of national laws addressing the resolution of institutions, as mentioned by Bart Joosen, is therefore less likely to develop in the Euro Area. Bart Joosen stated that Europe is, however, bigger than the Euro Area, and the financial markets are certainly bigger than the Euro Area. The effect of the BRRD is, therefore, still relevant.