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C H A N C E

Sea of change

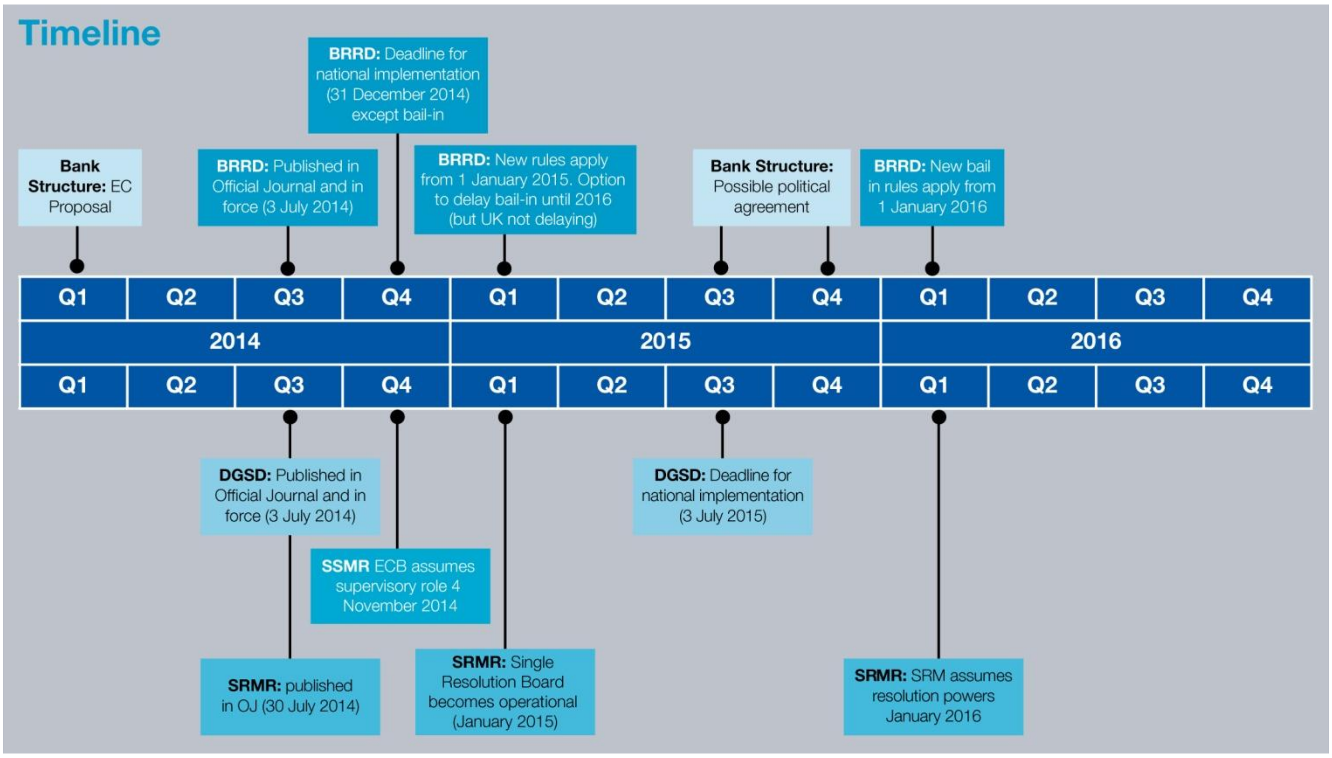
Regulatory reforms – reaching new shores

Briefing note

January 2015

UK implementation of the EU Bank Recovery and Resolution Directive: What you need to know

1 January 2015 marks a major implementation deadline for the EU Bank Recovery and Resolution Directive (the **Directive**). Adopted in June 2014, the Directive aims to harmonise Member States' bank resolution frameworks. Although the focus is on managing the failure of an institution in an orderly fashion, the legislation has important implications for banks and firms during their normal 'life'. These range from the day to day compliance burden of recovery and resolution planning, through to fundamental changes to bank capital structure driven by new bail-in and loss absorbency requirements. The Directive also opens the door to resolution authorities forcing changes to group structure in their efforts to improve the resolution prospects for firms. Part 1 of this briefing note provides an overview of the Directive itself while Part 2 briefly examines the latest UK transposition measures, and includes an explanation of the impact of the UK's new bail-in regime for netting, set-off and collateral arrangements.



Directive– Key features

Scope

- Banks
- Investment firms

Crisis prevention

- Individual institutions and groups required to prepare recovery plans and to take steps to improve resolvability
- Resolution authorities to prepare resolution plans and to conduct resolvability assessments of institutions

Early intervention

- Powers for regulators to intervene pre-resolution to require institutions to take remedial steps (e.g. change management, restructure debt, effect legal and operational changes) to avert need for resolution

Crisis management – resolution

- Regulatory intervention threshold that permits resolution action before balance sheet or cash flow insolvency
- Key resolution tools: sale of business, bridge institution, asset separation and bail-in
- Main resolution objectives: protect financial stability, preserve critical functions, avoid taxpayer losses
- Key resolution principles: losses fall in line with ordinary insolvency hierarchy (shareholders and junior debt bear losses first)
- Measures for resolving groups and third country entities

Resolution financing

- National resolution funds, financed via *ex ante* industry contributions
- Limits on use of resolution funds to absorb losses
- Depositor preference reduces risk to Deposit Guarantee Scheme
- 'No creditor worse off' principle limits application of resolution tools *ex ante* and sets *ex post* benchmark for creditor compensation

Part 1: The Directive

The Directive is a key component of European efforts to end the "too big to fail" problem and should be set in the context of a number of related pieces of legislation, including the new Deposit Guarantee Scheme Directive (the **DGSD**, which aims to harmonize the protection offered by national deposit guarantee schemes in all Member States), the Single Supervisory Mechanism (**SSM**) and the Single Resolution Mechanism (**SRM**) (which together form the twin pillars of a eurozone banking union) as well as proposed measures relating to bank structural reform. The European Banking Authority (**EBA**) is consulting on a wide range of draft Guidelines and technical standards required under the Directive, most of which have to be submitted to the Commission for adoption by 3 July 2015.

Scope and objectives

The Directive is not concerned exclusively with bank resolution. It creates a harmonised EU framework for the recovery and resolution of EU banks and investment firms and their holding companies (and their respective subsidiary financial institutions), as well as for the EU branches of non-EU banks and investment firms. The Directive maintains a conceptual distinction between "recovery" or "crisis prevention" on the one hand, and "resolution" or "crisis management" on the other. The provisions on recovery are designed to minimise the likelihood of firm failure and to ensure that if a firm's situation does deteriorate to the point of non-viability, its resolution can be completed with as little systemic disruption as possible. The "resolution" elements of the Directive aim to permit intervention in a failing firm before it has reached balance sheet or cash flow insolvency and before its equity has been wiped out entirely, giving resolution authorities a range of practical and legal "tools" that can be used to maintain an institution's critical functions and avert systemic disruption.

Preparation

Recovery and resolution planning

The Directive establishes obligations to prepare (and update annually, or following material events) recovery plans both for individual firms and groups. The purpose of the recovery plan is to provide an outline of the steps a firm would take to restore its financial position following a significant deterioration. The plans must analyse how the institution would respond to a range of severe systemic and idiosyncratic financial stresses. The plans must also analyse how, when and against what collateral a bank or firm would access central bank liquidity but cannot assume access to or receipt of any publicly funded solvency support.

Group recovery plans must have as their objective the stabilisation of the group as a whole and should include arrangements to ensure consistency of action amongst parent and subsidiary undertakings. Where regulators require it, group plans might be supplemented by distinct plans for individual subsidiaries. Details of intra-group financial support should also be disclosed in group recovery plans.

Recovery plans are to be assessed by national regulators. A group recovery plan must be submitted to the consolidating supervisor for the EU group headed by the EU parent undertaking. Group recovery plans are to be reviewed and assessed by the consolidating supervisor for the group, as well as the competent authorities of the subsidiaries (after consultation with the competent authorities which form the college for the purposes of consolidated supervision under the revised Capital Requirements Directive (**CRD 4**) and the competent authorities of any significant EU branches). The EBA may also assist in this review, if the competent authorities request this.

The Directive requires authorities to assess whether the recovery plan: (i) is reasonably likely to maintain or restore a firm or group's financial position; and (ii) is likely to be implemented quickly and effectively in stress scenarios. Where authorities identify material deficiencies in a plan, they may require the institution to submit a revised plan. If the institution fails to submit a revised plan or if the authorities determine the plan revisions to be inadequate, the Directive contemplates that competent authorities should have powers to direct an institution to make changes to its business (including in relation to its capital and liquidity resources, its risk profile and its governance arrangements) to remedy the identified deficiency.

Whilst recovery plans are for the firm to draw up, the Directive separately requires national resolution authorities (in consultation with national regulators) to prepare resolution plans for firms and groups. Resolution plans are required to outline the options for applying the different resolution tools to an institution and to analyse how those tools could preserve critical business lines to ensure their continuity in resolution. As part of the resolution plan, resolution authorities are also required to conduct a "resolvability assessment" to analyse the extent to which an entity is resolvable without extraordinary public financial support or emergency central bank liquidity. The Directive also empowers resolution authorities to address or remove impediments to resolvability by imposing requirements on entities, *inter alia*, to limit exposures, divest assets and change legal or operational structures. Firms will be required to give resolution authorities extensive information to assist the authorities in their planning.

Both the form and content of recovery and resolution plans and the criteria for resolvability assessments are subject to technical standards, to be prepared by EBA after consultation with the European Systemic Risk Board (**ESRB**).

Intra-group financial support

The Directive establishes a framework under which financial support may be transferred among entities of a cross border group with the objective of ensuring the financial stability of the group as a whole without jeopardising the liquidity or solvency of the entity providing the support. Specifically, the Directive allows group entities to enter financial support agreements to set out the basis on which they may assist one another in circumstances where they might otherwise be subject to early intervention (see below).

The Directive requires Member States to remove any national laws that might act as barriers to transactions under such financial support agreements. However the Directive also sets several conditions for the application of intra-group financial support, including (*inter alia*), that there is a reasonable prospect that the support provided significantly redresses the financial difficulties of the recipient, would not jeopardise the liquidity or solvency of the provider and that there is a reasonable prospect that the consideration for the support will be paid and, if the support is given in the form of a loan, that the loan will be reimbursed by the recipient. If the support is given in the form of a guarantee or any form of security, a similar condition applies to the liability arising for the recipient if the guarantee or the security is enforced.

Early intervention

Title III of the Directive establishes an early intervention framework that shares some similarities with the US' 'prompt corrective action' regime. The triggers for early intervention are broadly tied to breaches of prudential requirements under CRD 4 although calibration of triggers will be determined via technical standards. The early intervention powers in the Directive allow national regulators to require firm management to implement measures outlined in the recovery plan; convene shareholder meetings; draw up debt restructuring plans; change business strategy and make legal or operational changes to an institution's structure, all prior to formal resolution. In situations of significant financial deterioration, the Directive's early intervention regime also permits regulators to dismiss senior management and to appoint a temporary administrator to take charge of an institution. Regulators' powers under the Title III early intervention framework share some similarities with but are distinct from their powers to remove obstacles to resolution under the resolution planning framework.

Resolution

The Directive establishes a regulatory or "prudential" threshold for resolution action. This is designed to permit resolution action in a situation where a troubled institution is technically solvent but in breach of regulatory requirements (particularly – although not exclusively - regulatory capital requirements).

Conditions

Under the Directive, resolution action depends on fulfilment of the following three cumulative conditions:

- The national competent authority determines that the institution is failing or likely to fail;
- There is no reasonable prospect that alternative private sector measures or supervisory intervention would prevent failure within a reasonable time frame; and
- The resolution is necessary in the public interest.

The Directive deems the first requirement to be fulfilled when an institution is in breach of requirements for regulatory authorisation (including regulatory capital requirements) in a way that would justify the withdrawal of authorisation (or that there are objective elements to support a determination that this will be the case in the near future). The commencement of resolution action operates to exclude the ability to initiate normal insolvency proceedings (except at the initiative of the resolution authority itself). The Directive seeks to limit procedural obstacles to the commencement of resolution by requiring that any prior judicial approval of any resolution authority be made expeditiously.

Objectives

Resolution actions are to be treated as in the public interest where they are necessary to achieve and are proportionate to one or more of the following resolution "objectives":

- To ensure the continuity of critical functions;
- To avoid significant adverse effects on financial stability;
- To protect public funds;
- To protect insured depositors; and
- To protect client funds and client assets.

Principles

When applying resolution "tools" and exercising resolution "powers" (described below) the Directive requires resolution authorities to "take all appropriate measures" to ensure compliance with a wide range of resolution "principles". Amongst the most significant of these principles is the requirement that no creditor should be left "worse off" in resolution than they would have been in an ordinary liquidation. Inclusion of the "no creditor worse off" (**NCWO**) requirement amongst the resolution principles appears to indicate that the safeguard is not merely a benchmark for post resolution compensation for those creditors who are left worse off in a resolution than in ordinary insolvency but also, potentially, a limit on the application of resolution tools and powers when they are used.

In the context of bail-in, *ex ante* adherence to the NCWO principle presents some specific legal and operational difficulties, particularly as regards respecting set-off arrangements that would survive an ordinary insolvency. Although certain liabilities are expressly excluded from bail-in, it seems possible that resolution authorities may not know, at the point of resolution, which of an institution's liabilities would be reduced by set-off in insolvency, making it difficult for resolution authorities to make an accurate assessment of the true quantum of liabilities that should properly be susceptible to bail-in.

Principles

- Shareholders bear first losses in resolution
- Creditors bear losses next, following the order of priority that would apply in an ordinary insolvency proceeding
- Board and senior management are replaced in resolution (unless their retention is necessary to achieve a resolution objective)
- Board and senior management to provide assistance necessary to achieve resolution objectives
- Natural and legal persons responsible for institution's failure liable under national civil and criminal laws
- Creditors of the same class are treated in an equitable manner
- No creditor incurs greater losses than they would have done in ordinary insolvency
- Insured deposits are fully protected
- Resolution action adheres to safeguards

Tools

The Directive provides resolution authorities with four main resolution "tools". Effective deployment of these tools is dependent on authorities possessing the necessary legal "powers" – which are outlined separately in the Directive. The tools are not mutually exclusive and can be used in any combination, although the asset separation tool cannot be used in isolation and must be used in conjunction with another resolution tool.

The sale of business tool

This tool allows resolution authorities to change the legal ownership of an entity itself (i.e. a share sale) by a transfer of equity to a third party or private sector purchaser. As an alternative to a share sale, the tool can also be used to effect a business sale, by mandatory transfer of the assets and/or liabilities of an institution. Whether the share sale or business sale route is taken, there is no requirement to obtain the consent of the institution's shareholders or any third party other than the transferee. Transfers are required to be made on commercial terms and in accordance with EU State aid rules.

The bridge institution tool

The bridge institution tool is similar in scope to the sale of business tool, except that the transferee of bank shares or property is a specially incorporated bridge institution wholly or partially owned by public entities – which may include the resolution authority. The purpose of a bridge institution resolution is to provide a temporary 'home' within which to preserve a failing bank's critical functions prior to its merger with or sale of its business to a private sector buyer or, where none can be found, its wind down. Newly incorporated bridge institutions can be given a short exemption from usual prudential requirements. The Directive also requires them to enjoy continued access to financial market infrastructure and to deposit guarantee schemes in which the institution under resolution participated.

The asset separation tool

This tool, to be used in conjunction with other tools allows resolution authorities to 'carve up' the balance sheet of a failing bank by moving rights, assets and liabilities of the bank or firm in resolution to an asset management vehicle that would house assets with a view to maximizing their value in an eventual sale. The tool is designed to facilitate 'good bank – bad bank' splits in conjunction with other tools.

The bail-in tool

While the other three tools occupy a mere six Articles of the text between them, the Section of the Directive dealing with bail-in comprises well over a dozen Articles spread across four separate subsections in Chapter IV of Title IV of the Directive. Additionally, the bail-in provisions need to be read alongside the provisions of Chapter V, which regulate the write-down and conversion of capital instruments. Together the provisions are designed to ensure, first that an institution's most loss absorbent capital is written off in a bid to restore its solvency and secondly, to bail-in creditors to cover any remaining losses and to recapitalize the institution and ensure it is not merely solvent but also complies with regulatory capital requirements and has a strong enough balance sheet to continue as a viable operation. The EBA is currently consulting on guidelines to clarify the interrelationship between the sequence in which liabilities are converted or written down under the Directive's bail-in power and the hierarchy of capital instruments under CRD4 and the CRR.

Bail in summary

- Apart from certain excluded categories of claim (secured claims, insured deposits etc), potentially all other liabilities are be susceptible to bail-in, regardless of seniority
- Resolution authorities have a discretion to extend the scope of exclusions but the bar for doing so is set high (e.g. exclusion is necessary to maintain a core business line or to avoid contagion)
- If the resolution authority excludes certain liabilities, then to the extent losses that would otherwise have been borne by the excluded creditors have not otherwise been borne by other creditors, the resolution fund can contribute to the recapitalization - although shareholders and other creditors must have absorbed losses and made a recapitalization worth at least 8% of the entity's total liabilities before any contribution from the resolution fund can be made (for institutions with assets below EUR 900 billion the resolution fund may be able to contribute on more flexible terms)
- Any resolution fund contribution must not exceed 5% of the value of the institution's liabilities
- Regarding derivatives, only the net sum (after close out and application of collateral) can be bailed in
- The "principles" for resolution apply to any bail-in, so creditors of the same class must be treated equitably and no creditor should be left worse off following bail-in than they would have been in an ordinary insolvency proceeding
- Reduction of principal or outstanding amount due, conversion or cancellation is immediately binding on shareholders and creditors
- Resolution authorities empowered to take all necessary steps to effect bail-in including register amendment, delisting/relisting etc
- Institutions required to include contractual provision in debt contracts whereby the creditor agrees to be subject to bail in (including contracts governed by non-EU Member State laws)

The following liabilities (whether governed by the law of a Member State or a third country) are excluded from bail-in under the Directive:

- Covered deposits
- Secured liabilities including covered bonds and liabilities in the form of financial instruments used for hedging purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to covered bonds
- Any liability that arises by virtue of the holding by the institution in resolution of client assets or client money including client assets or client money held on behalf of UCITS or of AIFs, provided that such client is protected under the applicable insolvency law
- Any liability that arises by virtue of a fiduciary relationship between the institution or entity in resolution (as fiduciary) and another person (as beneficiary) provided that such beneficiary is protected under the applicable insolvency or civil law
- Liabilities to institutions, excluding entities that are part of the same group, with an original maturity of less than seven days
- Liabilities with a remaining maturity of less than seven days, owed to systems or operators of systems designated according to Directive 98/26/EC or their participants and arising from the participation in such a system
- A liability to any one of the following:
  - i. an employee, in relation to accrued salary, pension benefits or other fixed remuneration, except for the variable component of remuneration that is not regulated by a collective bargaining agreement;
  - ii. a commercial or trade creditor arising from the provision to the institution in resolution of goods or services that are critical to the daily functioning of its operations, including IT services, utilities and the rental, servicing and upkeep of premises;
  - iii tax and social security authorities, provided that those liabilities are preferred under the applicable law;
  - iv. deposit guarantee schemes arising from contributions due under the DGSD

Powers

The Directive requires resolution authorities to have powers to:

- Compel information required for resolution
- Take control of an institution, exercising all rights and powers of shareholders and management
- Transfer shares of the institution
- Transfer to a transferee (with its consent) rights, assets or liabilities of an institution in resolution
- Reduce (including to zero) the principal amount of or outstanding amount due in respect of eligible liabilities (being all the liabilities of an institution which don't qualify for regulatory capital purposes and which are not otherwise excluded from the scope of bail in e.g. insured deposits)
- Convert eligible liabilities into shares (i.e. a debt to equity conversion)
- Cancel debt instruments (other than certain secured liabilities)
- Reduce (including to zero) the nominal amount of shares and to cancel shares
- Require an institution or its parent to issue new shares (including preference shares and contingent convertible instruments
- Amend or alter the maturity of or interest payable on debt instruments and other eligible liabilities (including temporary suspensions of payment) – except for unsecured liabilities
- Close out and terminate financial contracts or derivatives (so that bail-in can be applied to the resulting net sum)
- Remove or replace the management body and senior management of an institution in resolution

Powers

In order to apply the different resolution tools effectively, the Directive mandates that Member States ensure that resolution authorities have available to them a wide range of legal powers which may be used individually or in combination with one another. Importantly, all share and property transfer powers are expressly exempt from ordinary operation of company and securities law – facilitating transfers without the need to obtain shareholder or other third party consents. Together these powers are backed up by various ancillary powers such as the ability to have an institution's securities de-listed or suspended from trading. In addition, resolution authorities must have powers to appoint a special manager of an institution under resolution to replace existing management.

Cross-border recognition

Importantly, the Directive establishes a requirement for Member States to recognise and enforce resolution measures taken by authorities in other Member States and gives primacy to the home state authority, excluding the possibility of multiple resolution proceedings in branch states. The Directive also amends the Winding up (Credit Institutions) Directive (2001/24/EC) (**WUD**) so that the exercise of resolution measures and powers under the Directive are treated as "reorganisation measures" for the purposes of the WUD. The provisions of the Directive which give the home state resolution authority the power to suspend termination rights and impose temporary stays should override netting and repurchase agreements that are governed by the laws of other Member States.

Within the EU, these cross-border provisions tackle a major difficulty of effective cross-border bank resolution, viz. how an executive body in one jurisdiction can legally perfect the transfer of property located in a different jurisdiction. As far as third countries are concerned, the Directive obliges resolution authorities to take all necessary steps to ensure that resolution action which they take in respect of claims or property governed by the laws of a third country is recognised in that third country.

Effect on derivatives and other contracts

In order to facilitate resolution, the Directive provides that crisis prevention and crisis management measures taken in accordance with the Directive may not constitute an enforcement event or an insolvency proceeding that might otherwise permit a contractual termination or acceleration - provided that the institution concerned is continuing to perform its payment and delivery obligations. This limitation also applies to contracts entered into by the subsidiary of an entity in resolution whose obligations have been guaranteed by a parent or other member of the group and operates to exclude the effect of cross-default provisions. An important effect of providing that resolution does not *per se* constitute insolvency proceedings, is to preserve an entity's participation in systemically important payment, clearing and settlement systems whose operators might otherwise look to terminate a member on commencement of resolution.

The Directive also enables resolution authorities temporarily to suspend an institution's payment and delivery obligations under any contract until midnight at the end of the business day following the resolution authority's announcement of resolution action. The power does not extend to obligations in relation to eligible deposits or to payment and delivery obligations within payment and settlement systems that are designated under the Settlement Finality Directive. The purpose of the power is to facilitate the application of resolution tools by providing the bank or firm in resolution with a temporary and limited suspension of its obligations.

The Directive enables resolution authorities temporarily to limit security enforcement and to suspend contractual termination rights provided the institution in resolution continues to make payments and deliveries and perform obligations relating to collateral under the affected contracts. This power allows the resolution authorities to prevent derivatives counterparties from closing out until midnight at the end of the business day following the resolution authority's announcement of resolution action.

The purpose of these suspension powers is to facilitate the transfer of derivatives and other financial contracts to solvent transferees. Where an affected contract has been transferred, the contractual counterparty may, at the expiry of the suspension period, exercise close out rights vis-a-vis the transferee for any new default of the transferee (but not due to the fact of the transfer itself).

Safeguards

The Directive establishes a safeguards regime that is intended first to ensure that shareholders and creditors who are affected by resolution do not make a worse recovery in resolution than they would have done in ordinary insolvency proceedings and secondly to control the application of partial property transfer powers in order to preserve the effect of certain netting, set-off and collateral arrangements.

No creditor worse off

The no creditor worse of safeguard is predicated on a counter-factual calculation which requires an independent valuer to carry out, as soon as possible after resolution actions have been taken, a valuation that compares the actual treatment of shareholders and creditors in resolution with the treatment that they would have received in ordinary insolvency proceedings. Where this valuation identifies any difference between the two treatments, the Directive entitles shareholders and creditors to receive compensation from the resolution financing arrangements.

Protections against partial transfers

The Directive provides that in the case of a partial transfer of assets and/or liabilities to a transferee, the resolution authority must ensure the protection of: security arrangements; title transfer financial collateral arrangements; set-off and netting arrangements; covered bonds and structured finance arrangements (including securitizations). In particular, the Directive requires that partial property transfer powers may not be used: to transfer some but not all of the rights and liabilities protected under title transfer financial collateral arrangements, set-off and netting arrangements; to separate assets that constitute collateral from the liability that those assets secure; or to break up asset pools in structured finance arrangements and covered bond transactions. Further, the Directive includes express provisions that require resolution authorities to ensure that the application of partial transfer powers and suspension of contractual termination powers does not interfere with the operation of systems that are designated pursuant to the Settlement Finality Directive.

MREL

The Directive requires both banks and investment banks to maintain a "minimum requirement for own funds and eligible liabilities" (**MREL**). The purpose of MREL –which is calculated as a percentage of the total liabilities and own funds of an institution – is to ensure that institutions maintain enough capital capable of being written down and/or bailed-in, so as to facilitate resolution. MREL can be met using own funds (i.e. Tier 1 and Tier 2 capital) or eligible liabilities (i.e. liabilities and capital instruments that do not qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments for regulatory capital purposes).

For an eligible liability to count towards MREL it must:

- be issued and fully paid up;
- not be owed to, secured by or guaranteed by the institution itself;
- not have been funded directly or indirectly by the institution itself;

- have a remaining maturity of at least one year;
- not arise from a derivative;
- not arise from a preferred deposit (see depositor preference, below).

If a liability is governed by the laws of a third country, it cannot count towards MREL unless the resolution authority is satisfied that any write down or bail-in of the instrument under the law of a Member State would be effective under the law of the third country.

The quantum of MREL per institution is to be determined by resolution authorities, following consultation with competent authorities and taking into account various criteria such as the size and funding model of the institution and the extent to which its failure would impact financial stability.

Under the Directive the MREL requirements apply to institutions on a solo basis and to parent undertakings on a consolidated basis, as determined by the group level resolution authority following a consultation with the consolidated supervisor (the solo requirement can be waived in limited circumstances).

The EBA is required to report to the Commission by 31 October 2016 on a range of issues relating to MREL including how MREL requirements have been implemented nationally and whether there have been divergences in the levels set for comparable institutions in different Member States. Based on the EBA's report, the Directive contemplates that the Commission may (by 31 December 2016) submit a legislative proposal designed further to harmonize the application of MREL requirements. In the meantime, the setting of MREL requirements is likely to be a focus of industry advocacy initiatives. Until the EBA and the Commission have completed their work on Level 2 measures, the calculation methodologies for requirements and precise impact of the requirements on individual firms is likely to remain a matter of some uncertainty. It is also unclear whether the recent proposals by the Financial Stability Board for a new international standard on total loss absorbing capacity (**TLAC**) for globally systemically important banks (**G-SIBs**) will affect the way in which the authorities implement the MREL regime, although it is likely that there will at some point be proposals to align the EU regime with the eventual international standard.

Contractual recognition of bail-in

Member States must ensure that firms within the scope of the Directive which enter into any contracts governed by the law of a state other than a Member State must include in those contracts provisions under which the other contracting party recognises that any resulting liability is subject to EU bail-in powers. The contractual clause must comply with conditions to be set out in technical standards being drafted by the EBA. There are limited exceptions for some existing contracts, deposits benefitting from depositor preference (see below) and liabilities that are excluded from bail-in powers altogether and where the resolution authority is satisfied that the bail-in powers can be given effect under the relevant local law in the non-Member State or a binding agreement with the authorities. This provision raises significant compliance implications particularly for banks with branches outside the EU because of the large range of potentially affected contracts or which participate in non-EU financial infrastructures, or other arrangements where there may be limited flexibility to negotiate terms.

Third country entities

The Directive contemplates three methods for resolving a third country institution. Third country firms (particularly US institutions) already subject to non-EU resolution planning requirements will need to analyse the impact of the Directive on their existing resolution plans.

1. **Co-operation agreements**
   The Directive permits the adoption of binding international co-operation agreements between the EU and third country authorities to establish processes and arrangements for cooperation, including through information sharing in selected cases. As a practical matter though, binding co-operation arrangements are unlikely to be as important as less formal frameworks for cooperation.

2. **Recognition and enforcement of third country resolution proceedings**
   Unless and until the EU has concluded a binding international co-operation agreement with a non-EU jurisdiction, the relevant EU resolution college has responsibility for deciding whether or not to recognise any non-EU resolution proceedings and give effect to those resolution proceedings under national law. If there is no EU resolution college, individual resolution authorities may make this decision. Once the EU has concluded a binding international cooperation agreement, the decision on recognition should be covered by this co-operation

agreement and will not be left to the discretion of individual resolution authorities.

3. **Exercise of domestic resolution powers**

   If there is no third country resolution proceeding ongoing, or if the relevant local resolution authority elects not to recognize/enforce a third country resolution proceeding for one of the permitted reasons, then the Directive allows such authority to apply the general resolution tools granted under the Directive to an EU branch of a third country firm provided that the action is necessary and in the public interest and one or more of the following conditions is satisfied: (a) the EU branch of the third country firm no longer meets or is likely not to meet the conditions for authorisation and there is no prospect of a private sector rescue within a reasonable time frame; (b) the third country institution is in the opinion of the resolution authority, unable or unwilling or likely to be unable to pay its obligations to EU creditors or obligations booked to the EU branch and the authority is satisfied that no third country resolution proceeding or insolvency proceeding has been or will be initiated in the third country within a reasonable time frame; or (c) third country resolution proceedings have been initiated or the resolution authority has been notified of the intention to initiate such proceedings.

Resolution financing

Whilst acknowledging the crucial role of central bank emergency liquidity in any resolution, the principle that taxpayers should not be on the hook for solvency support to banks underpins the Directive, although the Directive does not completely exclude the possibility of public financial support and even contemplates temporary public ownership as a resolution option in sufficiently extreme scenarios. The Directive requires each Member State to establish a national resolution financing arrangement, which may use the same administrative structure as national bank deposit guarantee schemes – i.e. an organized and dedicated fund. Such resolution financing arrangements are to be empowered to levy *ex ante* industry contributions from institutions authorised in the Member State and from local branches of third country firms.

The Directive permits a derogation from the requirement to establish a national dedicated fund controlled by the resolution authority. The Directive instead permits Member States to satisfy the requirement to establish financing arrangements through general industry contributions (subject to certain requirements including that the amount raised be equal to the amount that a dedicated fund would raise and that the resolution authority be entitled to access the contributions for resolution purposes). In effect, this derogation should enable jurisdictions (such as the UK) that already collect a bank levy whose proceeds are paid into the general exchequer to side step the Directive’s requirements for a separate, pre-funded arrangement.

The Directive sets a number of purposes for which resolution financing may be used, including (but not limited to) funding NCWO compensation payments, lending to or buying assets from, an institution in resolution, guaranteeing assets or liabilities of an institution, contributing (in lieu of write down or conversion) where the carve out from bail-in has been extended to exclude the bail-in of certain creditors otherwise susceptible to bail-in.

Critically, the Directive expressly prohibits the use of the resolution financing arrangement directly to absorb losses or recapitalize a failing institution. This express prohibition may be problematic when weighed against the idea that ‘no creditor worse off’ acts as an *ex ante* limitation in the Directive. In jurisdictions where set-off rights enjoy strong protection in insolvency, respect for the no creditor worse off principle should mean respect for every set-off that would survive ordinary insolvency (whether contractual or statutory in origin). This means that resolution authorities may face an extremely difficult (if not impossible) task in gauging the quantum of ‘bail-inable’ liabilities, due to the unknown impact of insolvency set-offs. There may be categories of claim that would normally be reduced by statutory insolvency set-off or which rely on contractual set-off to achieve credit risk mitigation but which appear to fall outside the scope of the categories of liability that are excluded from bail-in; in such instances, it seems possible that recourse might ultimately need to be made to the resolution financing arrangement to compensate creditors whose set-off rights were not respected in a bail-in due to the resolution authorities' less than perfect information on the quantum of liabilities properly susceptible to bail in.

The Directive sets a resolution fund ‘target level’ of at least 1% of the value of insured deposits of all authorised institutions in a Member State. The Directive aims to reach this minimum level, through industry contributions, by 31 December 2024 (with scope to extend that deadline where payouts have been made in the meantime and with a mechanism to maintain that target level beyond the deadline date on an ongoing basis). The Directive also requires the EBA to report to the Commission by 31 October 2016 with an analysis as to whether total liabilities would be a more appropriate reference point for setting resolution financing arrangements than insured deposits.

In addition to annual industry contributions, the Directive also establishes a framework for extraordinary industry contributions to be levied in resolutions where existing resources are inadequate. Such top-up contributions are capped at three times the normal annual contributions.

Depositor preference and the use of the DGS

The Directive establishes a preference in the ordinary insolvency hierarchy for both insured depositors (or a DGS subrogating to the depositors' rights having made a payout to depositors or otherwise contributed to the costs of resolution) and for all other deposits of individuals and micro, small and medium sized enterprises held in both EEA and non-EEA branches of an EEA bank.

The above requirement needs to be considered alongside the DGSD, which will increase the volume of deposits that are insured (and thus preferred) to include all deposits, including all corporate deposits (unless the depositor is a public sector body or financial institution) plus some temporary high value deposits. These changes to the insolvency hierarchy may have important practical and commercial implications, potentially impacting the cost of senior unsecured debt. Firms and banks will need to consider whether to address the issue as a disclosure matter in prospectuses for senior bond documentation, as the preference amounts to a partial subordination of the claims of senior bond holders. Institutions will also need to assess whether there are *pari passu* or other provisions in existing or standard form documentation which might be contravened by the change in law.

Under the Directive, a deposit guarantee scheme can be used to contribute to resolution to the extent that it would have suffered loss on paying out bank depositors if the bank had gone into ordinary insolvency proceedings. The preference for insured depositors in winding up means that it is very unlikely that there will be an absolute loss to depositors, except in exceptional cases. However, the pre-funding of the deposit guarantee scheme may act as a source of liquidity to help meet the target of 7 days for paying out insured deposits under the DGSD in the event that a bank is not placed into resolution but instead enters ordinary insolvency proceedings.

Part 2: UK implementation

The Directive is a minimum harmonization measure, so some Member States may 'gold plate' some of the Directive's requirements subject to limitations set out in the Directive. The UK authorities consulted on transposition during the course of Q2 and Q3 2014. 1 January 2015 marks the transposition deadline. Provisions relating to bail-in may be transposed by 1 January 2016 although the UK will not take advantage of this extension and has implemented its bail-in powers on 1 January 2015, although it is deferring implementation of the MREL regime.

Even before the Directive had been finalized at a European level, the UK had amended the Banking Act through Schedule 2 of the 2013 Banking Reform Act to introduce a bail-in tool. (These changes in the 2013 legislation followed changes made via the 2012 Financial Services Act commencing in August 2014 to expand the range of types of entity covered by the UK special resolution regime). However, the key bail in related provisions of Schedule 2 to the 2013 Banking Reform Act did not commence until 31 December 2014 and were then subject to almost immediate modification and addition pursuant to the various orders which the UK has also now made to transpose most provisions of the Directive into UK law.

The Bank Recovery and Resolution Order 2014 (SI 2014 No. 3329)

This is the key UK transposition instrument. It entered into force on 1 January 2015. It reconfigures slightly the statutory objectives and resolution triggers of the special resolution regime so that they conform with the Directive's requirements. The Order also gives the UK authorities new, pre resolution powers and imposes obligations on the UK authorities to write down or convert capital instruments before using stabilisation options. While a bail-in power is technically introduced into the UK special resolution regime via certain provisions of Schedule 2 of the 2013 Banking Reform Act commencing on 31 December 2014, the Order immediately amended those provisions to bring them into line with the requirements of the Directive on 1 January 2015.

The Order alters the procedural rules for the use of stabilization powers and add new provisions to: (a) grant a 2 day grace period on payments and deliveries for firms in resolution; (b) temporarily suspend secured creditors' enforcement rights; and (c) temporarily suspend parties' termination rights. These new provisions accompany the existing provisions of the special resolution regime relating to the disapplication of termination rights in resolution.

The provisions of the Order do not apply to recognised central counterparties. Thus, anyone concerned to understand the impact of the UK special resolution regime on recognised central counterparties will need to consult an old version of the statute not reflecting the changes made by this Order.

The Banks and Building Societies (Depositor Preference and Priorities) Order 2014 (SI 2014 No. 3486)

This Order implements the obligation in the Directive to establish depositor preference via amendments to the Insolvency Act 1986, the Insolvent Partnerships Order 1994 and equivalent Scottish and Northern Irish legislation. It entered into force on 1 January 2015. Insured deposits will rank alongside existing preferred claims as "ordinary" preferred claims. These ordinary preferred claims must be satisfied before the claims of "secondary" preferred creditors are met (secondary claims would comprise relevant deposits over the insured limits and relevant deposits made outside the EU).

The Banking Act (Restriction of Special Bail-in Provision, etc.) Order 2014 (SI 2014 No. 3350)

This Order protects certain categories of claim from the effects of bail-in. It entered into force 1 January 2015. See text box on next page.

The Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations (SI 2014 No. 3330)

This Order sets out provisions to be included in compensation orders where post resolution valuation determines that creditors or shareholders have made a worse recovery than they would have done in ordinary insolvency and are entitled to compensation for the difference. It entered into force on 1 January 2015.

The Bank Recovery and Resolution (No. 2) Order 2014 (SI 2014 No. 3348)

The Order establishes procedural requirements relating to resolution planning and group resolution plans, together with measures to restore the financial position of distressed entities. It enters into force on 10 January 2015. It also modifies the 2003 Financial Collateral Regulations and the 2004 Credit Institutions (Reorganisation and Winding up) Regulations in order to ensure that resolution action prevails over protections to netting and set-off (see text box on next page).

The Building Societies (Bail-in) Order 2014 (SI 2014 No. 3344)

This Order modifies the UK special resolution regime to facilitate application of bail-in tools to the resolution of a failing building society and enters into force on 10 January 2015.

Changes to FCA and PRA Rules

In addition to this wave of new secondary legislation both the PRA and the FCA will assume new powers and responsibilities following the Directive's transposition and their rules will be updated accordingly. Both regulators issued consultation drafts of their revised rules in Q3 2014. These included amendments to the IFPRU and SUP sections of the FCA Handbook and several new sections of the PRA Rulebook covering recovery plans, resolution packs, group financial support, notifications, contractual recognition of bail-in and transitional rules, together with an updated PRA supervisory statement. The PRA has indicated that with regard to provisions on contractual recognition of bail-in two alternatives were being considered: (1) deferred application for certain liabilities until 2016; and (2) full application of Article 55 requirements for all liabilities from January 2015. Unfortunately though, it does not appear that clarity will be obtained as to which of the two alternatives are preferred before the PRA publishes its final rules, which is expected to happen in mid January 2015. The FCA had indicated that it would likely follow the PRA's approach for the sake of consistency. There is a risk therefore that firms face an early and immediate compliance challenge in January 2015 once the timetable for implementation has been determined in the PRA's and FCA's final rules.

Bail-in: what does UK transposition mean for netting, set-off and collateral?

The Directive's bail-in power is expansive and potentially impacts any liability that is not explicitly protected. Unless a liability that is subject to a netting or set-off right enjoys protection from bail-in the value of any netting or set-off could be reduced or eliminated commensurately with any bail-in.

Under the UK transposition, various categories of claim constitute "excluded" liabilities under section 48B(8) of the Banking Act. These include any liability that is "secured" (section 48B(8)(a)). The relevant statutory definition of "secured" is broad and would cover not only typical in rem security rights but is also expressed to extend to title transfer arrangements. Accordingly, liabilities covered by a security interest or title transfer collateral should be immune from bail-in. Section 48B(8)(d) also establishes an exclusion for unsecured liabilities with an original maturity of less than 7 days owed to a credit institution or investment firm. In its feedback on the transposition consultations HM Treasury has said that this exclusion would extend to liabilities with no fixed maturity and so it should operate to protect many demand deposits and overdraft lines.

For claims not otherwise covered by the exclusions from bail-in set out in section 48B of the Act, the Banking Act (Restriction of Special Bail-in Provision, etc.) Order provides an additional layer of protection. The protections of this order will be especially important for liabilities connected with "derivatives, financial contracts and qualifying master agreements". However, the safeguard is expressly *disapplied* to the following categories of claim:

(a) liabilities in relation to an unsecured debt instrument which is a transferable security;
(b) liabilities in relation to a capital instrument;
(c) liabilities owed in relation to subordinated debt;
(d) unsecured liabilities in relation to any instrument or contract which (i) at the date on which it was issued or made, had a maturity period of 12 months or more, and (ii) is not a derivative, financial contract or qualifying master agreement;
(e) unsecured liabilities owed to another member of the same group as the relevant banking institution which are not owed in relation to derivatives, financial contracts or qualifying master agreements;
(f) liabilities which relate to a claim for damages or an award of damages or a claim under an indemnity

These carve outs indicate that some liabilities that are not otherwise shielded from bail-in by the primary legislation but which may rely on netting or set off for credit risk mitigation (such as intra-group on balance sheet loan / deposit liabilities) are potentially susceptible to bail-in (although the "no creditor worse off" standard would suggest that they ought not to be where netting and set-off rights would survive insolvency.) Finally, even where explicit protection from bail-in is made in either the primary or secondary legislation, this is no guarantee that mistakes will never be made. Gaining an accurate picture of what liabilities are subject to netting and set-off may not be easy for resolution authorities acting under time pressure in a crisis situation. Compensation against a "no creditor worse off" benchmark might offer some comfort but in commercial terms, compensation which might be paid months in the future is not the same as being "net today".

Resolution Glossary

Legislation and instruments	Institutions
BRRD Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms	**Board** Single Resolution Board established pursuant to SRMR
SSMR Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions	**ECB** European Central Bank
SRMR Regulation 806/2014 establishing a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund	**ESRB** European Systemic Risk Board
WUD Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions	**EBA** European Banking Authority
Key Attributes Key Attributes of Effective Resolution Regimes for Financial Institutions 2011	**FSB** Financial Stability Board
	Fund National resolution financing arrangement established pursuant to BRRD
	SSM Single supervisory mechanism for financial supervision in eurozone composed of the ECB and national competent authorities of participating Member States
	Other
	TLAC Total Loss Absorbing Capacity
	MREL Minimum Requirement for Own Funds and Eligible Liabilities
	NCWO No creditor worse off
	PONV Point of non-viability

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