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Article 55 of the BRRD: contractual recognition of bail-in – what you need to do

Article 55 of the BRRD requires EU firms and other in-scope entities to include a contractual recognition of bail-in clause in a very wide range of non-EU law governed contracts. EU Member States are required to implement Article 55 into national law by 1 January 2016 and some states have already done so. With the deadline approaching, this briefing looks at the scope of Article 55 and sets out some practical steps to assist you with preparing for compliance.

The EU Bank Recovery and Resolution Directive (2014/59/EU) (the "BRRD") is part of a series of EU banking reforms made in response to the financial crisis and establishes a framework for the resolution of failing financial institutions. It gives regulators a range of tools to do this, including bail-in powers to write-down and/or convert into equity certain liabilities of a failing institution.

A key challenge for resolution authorities in cross-border scenarios is ensuring the effectiveness of special resolution powers (such as suspension of termination rights, asset transfers and bail-in) outside the home jurisdiction. The BRRD ensures that any exercise of bail-in powers by a resolution authority will automatically be effective within the EU. However, outside the EU, where the BRRD does not apply, there is a risk that a court in a non-EU country may challenge or fail to give effect to the bail-in, especially where the contract is governed by the law of the non-EU country – frustrating the resolution authority's attempts to restore the firm to viability.

Article 55 of the BRRD is designed to address this problem by requiring in-scope entities to include a contractual term in contracts governed by the law of a non-EU country which contain a relevant liability of the in-scope entity. The contractual term must include the counterparty's acknowledgement and acceptance that the in-scope entity's liability may be subject to the bail-in powers of the BRRD.

The European Banking Authority ("**EBA**") has prepared draft regulatory technical standards ("**RTS**") providing further details of the scope of the limited exclusions from Article 55 and the required minimum content for the required contractual clause. The European Commission is considering this draft and is expected to adopt the final RTS soon, although the RTS will not come into force until the European Parliament and the Council of the EU have been given an opportunity to review and object to the RTS. This briefing is prepared assuming that there is no change to the EBA's draft. The RTS will be binding and directly applicable in all EU member states.

Key issues

- EU firms and other in-scope entities need to include a contractual recognition of bail-in clause in certain contracts under Article 55 of the BBRD.
- Deadline for implementation of Article 55 is 1 January 2016, though some countries have already implemented (partially or fully).
- Affected contracts are those which are governed by the law of a country outside the EU and which include a relevant liability.
- Scope of relevant liabilities is broad, prompting likely challenges to compliance.
- Preparing for compliance, by determining which contracts are affected and establishing relevant processes, is also likely to pose a significant challenge to all in-scope entities.
- Contractual provisions will need to be tailored to the jurisdiction of each in-scope entity.

Scope of Article 55

- **What is an in-scope entity?**

Article 55 applies to EU incorporated banks and qualifying investment firms, their EU incorporated holding companies, their subsidiaries which are EU financial institutions, as well as certain affiliates. Articles 1(a) to (d) of the BRRD and associated definitions draw a wide perimeter. Non-EU incorporated firms and their EU branches are out of scope. However, firms need to consider the national implementing rules to determine which entities are in scope. For example, the UK rules exclude certain "mixed activity" holding companies and financial institution subsidiaries that are not authorised persons.

- **What are the relevant liabilities?**

A very limited set of liabilities are expressly excluded from Article 55. These exclusions cover EU insured deposits, deposits placed by individuals and small and medium sized companies (including with non-EU branches), secured liabilities (but only to the extent of the value of any security), short maturity liabilities (under 7 days) to other, unaffiliated banks/investment banks, certain liabilities to critical suppliers of goods or services, some liabilities to employees plus some other types of liability of the in-scope entity that are excluded from the scope of bail-in.

The draft RTS would further also limit the exclusion for secured liabilities to require the inclusion of a relevant clause in relation to a liability that was not fully secured at the time of its creation and, even if it was fully secured, the secured liability would only be an excluded liability if the contractual terms required full collateralisation on a continuous basis in accordance with EU regulatory requirements (or equivalent non-EU requirements).

Beyond this limited range of excluded liabilities the bail-in power under BRRD (and consequently the Article 55 obligation) applies very broadly (under Article 44 of the BRRD, bail-in applies to "all" liabilities which are not expressly excluded). Capital instruments, bonds and other instruments creating indebtedness are obviously in scope. However, Article 55 is not limited to debt liabilities. For example, the implementing rules of the UK

Practical Steps

- In-scope entities will first need to determine the range of contracts they are party to which are affected by the Article 55 requirement. This may pose a significant challenge to entities depending on how their document management systems are structured. This will be a particular challenge to in-scope entities operating through branches outside the EU as non-EU branches are likely to enter into a very wide range of contracts governed by non-EU law. Any contracts which do not contain a governing law clause, as may be the case with letters of credit, will also pose difficulties.
- In-scope entities will then need to establish processes for ensuring that (i) all affected contracts entered into after the implementation of Article 55 are compliant and (ii) existing contracts entered into prior to implementation are made compliant following a material amendment to an existing contract or if the existing contract contains a liability that is created after the implementation date. Appropriate programmes for communicating with counterparties will also need to be developed.
- In-scope entities will also need to consider how to integrate these efforts with other similar compliance programmes in relation to, for example, stays on the exercise of termination rights in resolution and their ongoing reviews to ensure that other contractual provisions (such as in service agreements) do not present impediments to resolution.
- Following implementation, in-scope entities will need to work with their counterparties to include a contractual recognition of bail-in clause in all affected contracts. In some cases, the required clause will be introduced by amending standard forms and templates or by individually negotiating changes to ensure compliance for new agreements or by adopting master agreements incorporating the relevant term into all or a class of contract with particular counterparties. In other cases, firms may consider whether they can introduce the changes through industry protocols or by unilateral amendments under standard terms or by "one way" notices to clients or counterparties where these are effective under local law.
- In-scope entities will also need to supply legal opinions from counsel in relevant non-EU countries where required by resolution authorities.
- In-scope entities will need to work with their regulators to demonstrate they have appropriate processes in place in order to achieve compliance with Article 55.

Prudential Regulation Authority ("**PRA**") make clear that the requirements cover any debt or liability, present or future, certain or contingent, ascertained or sounding only in damages. Therefore, for example, Article 55 can also apply to: (a) contingent liabilities (e.g. letters of credit, indemnities and guarantees), despite their uncertain nature; (b) operational liabilities under service contracts; and (c) liabilities to clearing and settlement systems outside the EU.

In banking transactions, a loan facility (from an accounting perspective) constitutes an asset of the lending bank rather than a liability but Article 55 will still be relevant to a bank's commitment to extend credit under a loan and its potential liabilities to other syndicate members in a loan or an inter-creditor arrangement.

- **When does Article 55 apply?**

The deadline for EU member states to adopt Article 55 and publish implementing legislation and regulations is 1 January 2016. Some member states will implement Article 55 in advance of 1 January 2016 (for example, Germany implemented Article 55 in full with effect from 1 January 2015). In the UK, Article 55 applies to debt securities of PRA regulated firms and their UK holding companies from 19 February 2015 (and so Article 55 is already a feature in the capital markets for UK bank issuers) and all other relevant liabilities from 1 January 2016.

Each member state may implement Article 55 at different times and on different terms so the status and details of implementation will need to be checked in the member state of each in-scope entity.

Once implemented in the relevant jurisdiction of an in-scope entity, an Article 55 clause will need to be included in all new affected contracts of that in-scope entity. In addition, the draft RTS provide that any material amendment of a contract (where the contract was entered into before implementation) will need to include an Article 55 clause regardless of when the liability is created. Finally, the draft RTS provide that the Article 55 requirement will also apply to liabilities created after implementation even if the relevant contract creating the liability is entered into before the implementation date. Even so, the requirement should still not apply to a loan agreement entered into by an in-scope entity as lender before implementation even though it contains a commitment to lend or the other typical contingent liabilities of lenders.

- **Exclusions?**

Even if the party and contract is within the scope of Article 55 it may not be necessary to include the contractual recognition of bail-in clause in contracts governed by the law of a non-EU jurisdiction where bail-in is recognised, either under its law or under a binding agreement with the relevant EU country of the in-scope entity. However, the draft RTS set stringent conditions that must be satisfied in order to rely on this exemption and it seems unlikely that currently any non-EU states would meet those conditions. In addition, in the UK, in-scope entities would also need to seek a waiver of the rules before they could rely on this exemption.

How to comply?

- **Include the clause**

The BRRD does not provide a prescribed form of the contractual clause but the RTS will set out the elements that must be included in a contractual recognition of bail-in clause (see summary in the *Contractual recognition clause* box above). Due to the nature of these requirements, it is not possible for a single form of clause to be suitable for use by all in-scope entities but template clauses can provide a useful starting point. A number of industry associations are currently developing standard terms to address the requirements of Article 55. Clifford Chance can also provide bespoke assistance with drafting appropriate clauses (see our *Contacts* at the end of this briefing).

For more on preparation, see the *Practical Steps* box on the previous page.

Contractual recognition clause:

The draft RTS states that the contractual recognition of bail-in clause must include a description of the relevant bail-in powers and must include an acknowledgment and acceptance by the counterparty that:

- The liability may be subject to the exercise of write-down and conversion powers;
- The counterparty is bound by the effect of an application of those powers;
- The terms of the agreement may be varied as necessary to give effect to such exercise; and
- Ordinary shares or other ownership instruments may be issued to the counterparty as a result of such exercise.

- **Get a legal opinion from non-EU counsel**

Article 55 also provides that an EU resolution authority can require an in-scope entity to provide it with a legal opinion on the enforceability and effectiveness of an Article 55 clause from counsel in the relevant non-EU country. It is not yet clear which resolution authorities will request such legal opinions and, if they do, if they will do so in relation to each affected contract, each type of transaction or simply in relation to each relevant non-EU country.

Even if a formal legal opinion is not required, in-scope entities should still seek appropriate local advice. For example, depending on the type of contract, inclusion of these clauses may raise issues under local consumer, employment or investor protection laws or other local regulations.

To be able to count a relevant liability towards its "minimum requirement for own funds and eligible liabilities" ("**MREL**") under Article 45 of the BRRD, an in-scope entity will need to comply with Article 55 and is likely to need an opinion as to the effectiveness of the contractual recognition of bail-in clause from counsel in the relevant non-EU country. For more information on MREL, see the Bank finance – TLAC and MREL Topic Guide on the Financial Markets Toolkit.

Consequences of breach?

- **Penalty**

The consequences of breaching Article 55 will depend on the national implementation by each member state. In the UK, the penalty for breach of the Article 55 requirement includes public censure and a potentially unlimited fine, though the validity of the contract itself should not be affected. Resolution authorities may also take compliance with Article 55 into account when considering the resolvability of an in-scope entity.

- **Effect on bail-in**

It is worth noting that Article 55(2) of the BRRD states that a failure to include an Article 55 clause does not preclude a bail-in. Conversely, the inclusion of an Article 55 clause is not a guarantee that a bail-in of the liabilities of the in-scope entity under the contract will be fully immune from challenge under the laws of the non-EU country. Ultimately, whether the bail-in is enforceable in the non-EU country is a question for the laws of that non-EU country and Article 55 simply aims to reduce the likelihood of a creditor successfully challenging the effect of the bail in. However, irrespective of its likely effectiveness in a non-EU country, compliance with Article 55 will be a legislative requirement for all in-scope entities.

- **Regulatory response**

To date there has been no guidance issued by regulators regarding compliance with Article 55, though such guidance may be produced in the future. We can assume that regulators will expect in-scope entities to establish processes and appropriate systems and controls for ensuring compliance even if they are not able to be fully compliant by the implementation deadline. Following implementation, there will need to be an open dialogue between in-scope entities and their regulators as to the measures that are taken to ensure compliance and the obstacles they face in being fully compliant.

What if the counterparty refuses to agree to include the clause?

If a counterparty cannot be persuaded to include an Article 55 clause, an alternative is to remove one or more of Article 55's applicability criteria, such as changing the governing law of the contract to the law of an EU country, removing the relevant liability from the contract, or substituting the in-scope entity for an entity that is not in-scope. The requirements of Article 55 present particular challenges where a firm is required to contract on a particular set of terms which are not open to amendment, for example where an in-scope entity participates in non-EU clearing or settlement systems or provides performance bonds that have to be in a specified form.

Conclusion

The broad scope of Article 55, as well as the difficulties with compliance (for example, when faced with non-negotiable standard terms), has attracted much criticism from commentators. Fears have been expressed as to whether the requirements of Article 55 will harm the competitiveness of in-scope entities contracting outside the EU. However, no significant changes are expected to be made to the Article 55 requirement before the implementation deadline of 1 January 2016.

In the absence of changes to Article 55 or official guidance from legislators or regulators, all in-scope entities will need to work with their advisors and regulators to ensure that processes are in place to facilitate compliance with the Article 55 requirement.

For more information on the BRRD, see the BRRD Topic Guide on the Financial Markets Toolkit.

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