The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA
United Kingdom

7 January 2015

Dear Sirs

EBA/CP/2014/33 Consultation Paper – Draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the **"Committee"**). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

Context

The BRRD requires (at article 55(1)) Members States to mandate the inclusion of appropriate contractual terms, governing eligible liabilities for 'bail-in' purposes, that would be binding on creditors of banks and other entities falling within the scope of the BRRD so that the contract recognises that the relevant liability may be subject to the write-down and conversion powers (under article 59(2) and in points (e) to (i) of Article 63(1) of the BRRD) and contemplates specifically the possibility of a reduction in principal or outstanding amount, conversion to equity or cancellation of eligible liabilities resulting from the exercise of such powers by an EU resolution authority.

Article 55(1) contains a list of exclusions from the requirement set out above. Such exclusions include, amongst others, all agreements governed by the laws of an EU Member State and those eligible liabilities which are issued or entered into before the transposition date of the 'bail-in' tool in a relevant Member State (whose laws govern the terms of any eligible liability).

Article 55(3) requires the EBA to develop regulatory technical standards (**RTS**) in order to further determine the list of liabilities to which the exclusions set out in article 55(1) applies.

The EBA is presently consulting on a draft of that required RTS.

The draft RTS (referred to below as the **draft Regulation**) is significant for banks and certain large investment firms (and some holding companies in their group, in respect of which BRRD derived resolution powers may be exercised) and will have impact on a whole host of liabilities including derivatives, loans and debt securities where such liabilities are governed by non EU laws.

Issue 1

The EBA has correctly interpreted its mandate as clarificatory as to the scope of excluded liabilities rather as giving it free rein to determine new categories of liabilities that are excluded. This means that the EBA has not proposed any new grounds for a liability to be excluded *per se*.

In taking such approach, the EBA has specified in article 3(3) of the draft Regulation a non exhaustive list of those liabilities that it considers to fall within the scope of article 55(1)(d) by way of interpretation or clarification of that provision. Given the breadth of the four heads of liabilities that are specified by the EBA it is unclear why such categories form a non exhaustive list and what other types of liabilities could conceivably fall within scope. We suggest that there are no other liabilities that could fall within scope of article 55(1)(d) and that the word "include" at the end of the first paragraph of article 3(3) is deleted so as to make the list an exhaustive one (or failing that, that article 3(3) of the RTS be expanded so as to explain more clearly the scope of other liabilities that are in scope).

Issue 2

Article 3(2) of the draft Regulation provides that a liability shall not be excluded "*to the extent that it is, or **may** become, unsecured in part or in full even if the liability was at the point of its creation fully secured*".

The EBA expressly anticipates that respondents may wish to comment on the reference to "may". It is not inconceivable that almost any security package "may" become devalued to the point where it ceases fully to cover the liability. Without further qualification, this language could result in all secured liabilities governed by a third country's laws including the contractual recognition term.

It may be that, as a policy matter, this is the EBA's preference (in order to ensure that the unsecured portion of initially secured liabilities will be subject to the write down and conversion powers even in the event that remote circumstances arise).

An alternative proposal would be that a secured liability need not contain the contractual recognition term if both (i) it is fully secured at the time of creation and (ii) judged at that time, it is reasonable for the entity to consider that the security will continue to fully cover that liability to its maturity.

Issue 3

Article 3(3)(a) of the draft Regulation captures:

"Liabilities created after [the transposition date] under agreements entered into before [the transposition date]"

We believe that this broad drafting presents real practical problems for impacted EU entities.

<u>Derivatives</u> – derivative transactions are undertaken primarily under standardised master agreements (such as the ISDA Master Agreement) (each a **Master Agreement**) which govern both the terms of each relevant transaction entered into between the parties and the aggregate relationship having regard to all transactions undertaken under such Master Agreement. In particular, the Master Agreement provides for a close-out netting between the parties on the occurrence of certain specified events.

Article 49 of the BRRD provides that liabilities arising from a derivative can only be bailed in upon or following close-out. It is therefore understood that only a net liability resulting from close- out may be subject to bail-in.

The impact of the proposed wording in the Regulation on a Master Agreement would be to bring liabilities 'created' after the date of the Master Agreement (and subsequent to the transposition date) within the scope of the obligation to accommodate 'bail-in'. This raises the question whether the draft Regulation intends to capture liabilities arising from individual derivative transactions (which are not themselves bail-inable), or only any net liability that may result from close-out.

We would submit that the latter is the only sensible approach given the restriction under article 49 (see further below). In addition, it is clear that there can be liabilities (to pay or otherwise) arising under a Master Agreement which arise by operation of the provisions of the Master Agreement and occur through no action by the parties and without the initiation of a new transaction. For example, an obligation to pay a particular amount and which is crystallised after the relevant transposition date or a liability arising when the value of a pre-existing transaction (or the net amount under the Master Agreement) moves against the entity in resolution.

Given that some liabilities arising after transposition would occur automatically by operation of the provisions of the Master Agreement, these are beyond the control of the EU entity that will be subject to the obligation to modify the contract. Additionally, given the respective bargaining position of the parties, it is naïve to expect counterparties to be sympathetic to a suggestion by the relevant EU entity that the Master Agreement is required to be modified to accommodate 'bail-in' powers and which will work to the clear disadvantage of the counterparty. Consequently, a proposed amendment may be either turned down outright or the counterparty may command a premium in order to agree to it. Both outcomes would be negative for the EU entity as it either has to cease the counterparty relationship (with potential substantial costs) or agree to the payment of a premium in order to continue in existing relationships.

As regards new transactions under an existing Master Agreement, it is arguable that those transactions are within the gift of the EU entity to enter into consensually and therefore the imposition of a contractual accommodation of 'bail-in' could practically be achieved. However, this would give rise to differential treatment of pre-transposition and post-transposition transactions raising the question of how this might impact on netting under the Master Agreement. Additionally, in order to properly give effect the proposed Regulation (given that bail-in powers will only apply to the close out net liability), the Master Agreement must be amended not just individual confirmed transactions. It is highly unlikely that counterparties to Master Agreements would consent to that given the substantial volume of pre-existing transactions.

A possible solution here will be to carve out liabilities which arise by operation of provisions enshrined in a prior agreement. A clarification is due here as the creation of any new liability (e.g. a close out net amount arising post transposition) may relate solely or predominantly to transactions entered prior to transposition time. The only practical solution here appears to be one that captures liabilities arising under new Master Agreements created after transposition.

Bank finance – a similar issue arises in connection with loan facilities and particularly revolving and term facilities. The draft Regulation could subject a drawdown that is made after the transposition date but is under a facility entered into before the transposition date to the requirement to contractually accommodate 'bail-in'. It is widely expected that no lender would wish to entertain the proposed amendment absent an opportunity to negotiate a risk premium. Should the EU entity be unwilling to agree to such a premium, it would effectively have to cease drawing under the said facility or draw down under an unmodified facility and face being in breach of the draft Regulation.

A possible solution here could be to differentiate between liabilities which have been committed to by the relevant lender/counterparty prior to the date of transposition, as would be the case under any revolving or term loan, and those which are committed to after the date of transposition. Whilst this necessarily involves an examination of the level of commitment on inception, it would produce a more just and reasonable outcome for the EU entities involved.

Capital markets – generally speaking, outside the context of derivatives which form part of a capital markets transaction (in which respect the concerns raised above remain relevant), the provisions of Article 3(3)(a) should not cause substantive difficulties in the context of bond issues or debt issue programmes such as Euro Medium Term Note (EMTN) programmes. Whilst the programme specifies a master set of terms, each new bond issue under the programme would usually constitute a separate and distinct liability. Programmes tend to be regularly updated and maintained (usually on an annual basis) and accordingly the contractual recognition term could be included in the master terms (for future bond issues) as part of that normal update process. In addition, such an amendment may be contractually required to be made in respect of all issuances within the relevant class of securities even where there are pre-existing tranches within that class.

The exception (which would apply to bonds whether issued under a programme or on a standalone basis) would be 'tap' issues – i.e. further new bonds intended to be fungible with an existing series, which must therefore be issued on terms identical to the existing series. Accordingly, where an issuer has issued a bond governed by a third country law prior to the relevant transposition date without including the contractual recognition term, it would be unable to tap that series after the relevant transposition date (unless obtaining consent from the bondholders of the existing bonds to amend the terms of the existing bonds to include that contractual term –which, as described above in the bank finance context, would likely be rejected by the bondholders or be accepted only at a significant cost to the issuer). As a commercial matter, it should be considered whether the inability to tap existing series will have a significant impact on issuers.

Further, the terms and conditions of bonds often provide for (or bondholders may agree to) the substitution of the issuer (and/or any guarantor). As currently drafted, any of Articles

3(3)(a), (b), (c) or (d) could be interpreted in such a manner that a substitution of the issuer would require insertion of the contractual recognition term, notwithstanding that the liability is not otherwise varied. It should be clarified that where an existing liability is assumed by a new obligor (whether by operation of law, pursuant to the terms and conditions or by agreement with the bondholders) after the relevant transposition date but is not otherwise subject to material amendment (see further below), that substitution of the obligor does constitute a *liability issued or entered into after the relevant transposition date* for the purposes of any part of Article 3(3).

<u>Issue 4</u>

Article 3(3)(b) of the draft Regulation provides that any 'amendment' to agreements under which an eligible liability to be 'bailed-in' arises under the BRRD, would act as a trigger to the EU entity having to impose contractual accommodation of 'bail-in' powers.

The current proposed language does not impose any materiality or qualitative test regarding the proposed change to the original agreement.

Given this broad language of 'amended', there are real practical concerns:

<u>Derivatives</u>

Master Agreements and individual confirmations may be varied in many different ways in order to, for example, increase the amount of collateral exchanged between the parties, modify delivery obligations, alter designated individuals who are authorised to provide trading instructions.

The draft Regulation would appear to capture each of the instances set out above as triggering an obligation on the EU entity to insert contractual accommodation of 'bail-in' powers. At one level, this approach is disproportionate and unnecessary. Viewed from a different perspective, it is potentially hugely disruptive to the counterparty relationships during the transitional stage of all liabilities coming into line with the BRRD 'bail-in' regime and may have significant negative consequences for the business of EU entities.

Further, in light of the view that only the net liability is bail-inable, does the EBA intend that only an amendment to the terms of the Master Agreement would constitute an amendment to the agreement, or (more broadly) that the addition of a new transaction would constitute a relevant amendment? We would submit that the former is the only appropriate policy approach.

<u>Bank finance</u>

Bank finance documentation contemplates and indeed is frequently subject to amendments, waivers and modifications during their life. The imposition of a requirement that any amendment would trigger a regulatory requirement for the affected EU entity to negotiate in contractual accommodation of 'bail-in' appears unrealistic given the relative bargaining powers between the parties.

In order to avoid the potentially punitive costs of adding the contractual recognition language, EU entities may seek to avoid amending their borrowing in any way. This could have the counterintuitive result that EU entities would be unable to agree necessary amendments such as, for example, a waiver to a breach of covenant or a modification of the covenant package altogether, and which would ensure the continuity of a stable funding profile moving forward. This could be a sizeable issue for the large European banks who have substantial stock of liabilities that are potentially impacted.

Capital markets

Bond documentation (whether the bonds are issued under a programme or on a standalone basis) usually contemplates amendments in the following circumstances:

- amendments which can be made without bondholder consent, such as minor or technical changes, changes to correct manifest errors or, if there is a trustee, changes which the trustee considers are not materially prejudicial to the interests of the bondholders;
- substitution of the issuer and/or any guarantor (in which regard, see earlier discussion);
- more substantive amendments that can be made only with the consent of specified majorities of the bondholders; and
- in a regulatory capital bond context, changes which (in certain circumstances) the issuer may implement in order to cure a technical non-compliance with the prudential rules so that the bonds may continue to be recognised as regulatory capital.

Without a materiality qualifier, Article 3(3)(b) would result in the issuer being unable to implement minor, technical or corrective amendments to the terms, on the grounds that even a minor amendment (e.g. correcting an incorrect cross-reference to another clause) would, of itself, require insertion of the contractual recognition term, which in turn renders the proposed amendments something more than a minor or technical change, and one that is likely to be construed as materially prejudicial to bondholders. In such case, the change could only be made if the bondholders consent to inclusion of the contractual term. As noted above, the bondholders would likely reject that change or consent only at a significant cost to the issuer.

A proposed solution to the issues raised above could be to limit the application of Article 3(3)(b) to amendments that are sufficiently material to render the amended liability effectively a newly created liability that substantially replaces a preceding liability. In the debt capital markets, this ‘new security’ concept is precedented, and has for example been adopted under US securities and tax laws in certain circumstances (e.g. FATCA).

In addition, if a materiality qualifier is accepted, it should also be made clear that Article 3(3)(c) does not then inadvertently capture a scenario addressed by that materiality qualifier. For example, the terms of a bond constituted by a trust deed will be formally amended by way of execution of a supplemental trust deed. In that case, it should be clear that those amended bonds, whilst constituted by the trust deed as so amended after the relevant transposition date, are not liabilities within Article 3(3)(c). A possible solution is to amend Article 3(3)(c) to read: “*liabilities* ***created*** *under agreements entered into after that date*”.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact either Peter Richards Carpenter by telephone on +44 (0) 20 3400 4178 or by email at peter.richards-carpenter@blplaw.com, or Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours faithfully

Karen Anderson
Co-chair, CLLS Regulatory Law Committee

Peter Richards-Carpenter
Co-chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Karen Anderson (Herbert Smith Freehills LLP) (Co-chair)
Peter Richards-Carpenter (Berwin Leighton Paisner LLP) (Co-chair)
David Berman (Macfarlanes LLP)
Peter Bevan (Linklaters LLP)
Margaret Chamberlain (Travers Smith LLP)
Simon Crown (Clifford Chance LLP)
Richard Everett (Travers Smith LLP)
Robert Finney (Holman Fenwick Willan LLP)
Angela Hayes (King & Spalding LLP)
Jonathan Herbst (Norton Rose LLP)
Mark Kalderon (Freshfields Bruckhaus Deringer LLP)
Etay Katz (Allen & Overy LLP)
Ben Kingsley (Slaughter and May)
Tamasin Little (King & Wood Mallesons LLP)
Simon Morris (CMS Cameron McKenna LLP)
Rob Moulton (Ashurst LLP)
James Perry (Ashurst LLP)
Stuart Willey (White & Case LLP)