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

Response to Consultation Paper CP8/16:

The Contractual Recognition of bail-in: amendments to Prudential Regulation Authority Rules

Dana Andreicut
Prudential Regulation Authority
20 Moorgate London
EC2R 6DA

By e-mail: cp8_16@bankofengland.co.uk

Dear Madam:

Re: Response to Consultation Paper CP8/16: The Contractual Recognition of bail-in: amendments to Prudential Regulation Authority Rules

The City of London Law Society ("**CLLS**") represents approximately 17,000 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 Financial Law Committee (the "**Committee**"). The Committee is engaged in responding to consultations and also proactively raising concerns when it becomes aware of issues which it considers to be of importance in the context of financial law.

Response to Consultation Paper CP8/16

The Committee is writing to you in response to certain proposals put forward by the Prudential Regulation Authority (the "**PRA**") to amend the Contractual Recognition of Bail-in Part of the PRA Rulebook as contained in consultation paper CP8/16 ("**CP**") in connection with the Bank Recovery and Resolution Directive ("**BRRD**").

The Committee first thanks you for the extra time which you have given to it to respond to the consultation.

We will deal with each point in the proposals in turn as follows:

1. *Annex to Appendix 1 of the CP – Definition of "fully secured liability" and the draft RTS*

We refer to the draft Regulatory Technical Standards ("**RTS**") on the contractual recognition of write-down and conversion powers under Article 55(3) of BRRD prepared by the European Banking Authority ("**EBA**") as at 3 July 2015.

We would seek clarification from the PRA as to the intended interpretation of the following phrase contained at Article 2, Point 1(b) of the RTS in connection with liabilities maintained on a fully collateralised continuous basis:

"…*in compliance with regulatory requirements of Union law or of a third country law achieving effects that can be deemed equivalent to Union law."*

We note that words to a similar effect in relation to the collateralisation requirement are included in the definition of "*fully secured liability"* at the Annex to Appendix 1 of the CP, which we understand are in an effort to maintain consistency between the PRA rules and the final draft EBA RTS, as follows:

"…*in compliance with regulatory requirements of EU law or of the law of a third country achieving effects that can be deemed equivalent to Union law."*

It is our understanding that no European Union ("**EU**") law [1] exists embodying specific regulatory requirements, but rather regulatory requirements of the law of an individual member state of the EU. In any event, we would suggest that the question of whether a liability is fully collateralised on a continuous basis could be determined largely as a matter of contractual law and not by reference to regulatory requirements. We would therefore seek clarification as to the intention of this drafting as the current wording seems to create an ambiguity on this point and would otherwise suggest that the wording as set out above be deleted from each respective source.

We would seek further clarification from the PRA as to the intended interpretation of the following phrase contained at the Annex to Appendix 1 of the CP in connection with the definition of "*fully secured liability"* being:

"..*governed by contractual terms that oblige the debtor to maintain the liability fully collateralised on a continuous basis"*

Clarification is sought in respect of the above phrase as to:

a. Whether limited recourse debt would be considered to be *fully secured* for these purposes, which we would suggest is the case given that the liability can never exceed the value of the security;

b. Furthermore, whether this phrase is intended to mean that a firm has an obligation to top up the security for the otherwise limited recourse debt to maintain the security being fully secured and whether the absence of such a term is intended to mean that the liability is not "*fully secured*";

c. The meaning of the phrase "*fully collateralised on a continuous basis*" is unclear in the context of derivatives and repos. For example, liabilities under in-scope securities financing transactions which would be regarded by the relevant counterparties as "fully collateralised" would not be within scope of the exemption because there is no regulatory requirement to collateralise on a continuous basis. In addition, pending the introduction of US and EU margin rules, currently a New York law governed ISDA Master Agreement incorporating a New York law governed CSA would not be within the exemption. On the occasion of these rules coming into force, the requirement to include bail-in language in relation to these secured contracts will presumably fall away. It would be helpful if the contractual recognition rules and the margin rules were more closely aligned so that, for instance, significant resources are not devoted to obtaining Article 55 wording in contracts that will shortly become subject to the margin rules; and

d. In relation to contracts that are not subject to the new EU or US margin rules, it would be helpful to obtain guidance as to the type of margining that would allow a contract to fall within this exclusion.

Furthermore, the position in relation to client cleared derivatives remains unclear. Although it appears that non-EU CCPs may not be required to agree to Article 55 wording on the basis of impracticability, it seems

[1] Except that in relation to the collateralisation of OTC derivative transactions there is an EU regulation which has direct effect. Article 11.3 of Regulation (EU) No 648/2012 ("**EMIR**") (http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN) requires counterparties to have risk management procedures that require timely, accurate and appropriately segregated exchange of collateral. The Regulatory Technical Standards in relation to this rule are in final draft form and due to come into effect in or before September. There may be other aspects of EMIR that result in relevant EU regulatory requirements.

that the contract between the client and the clearing member will require Article 55 wording even though typically the collateral arrangement between a client and clearing member reflects the collateral arrangements between the clearing member and the CCP. It is unclear what the policy basis is for distinguishing between the client and the CCP in this context and would ask for clarification from the PRA on this issue.

2. *Impracticability*

We agree with the comments contained in the CP and specifically at clause 2.2 of Appendix 2 of the CP, recognising that the scope of the current PRA rules on contractual recognition are broad and as such there may be circumstances in which firms find compliance with the requirements impracticable. We would seek further clarification on certain matters of impracticability and particularly in respect of fully secured liabilities and the issues to be faced by firms in complying with the bail-in requirements in respect of such liabilities.

We would seek clarification as to whether the following scenarios might invoke impracticability, and as such whether the PRA may consider expanding the list of impracticability scenarios contained at clause 2.2 of Appendix 2 to the CP (or otherwise excluding such scenario(s) from the Article 55 requirement of the BRRD):

a. Trade finance agreements which are generally highly standardised, letters of credit and unilateral contracts. We would seek clarification as to whether bullet point 3 of clause 2 in Appendix 2 to the CP, namely *the creation of liabilities governed by international protocols which the BRRD firm has in practice no power to amend* might envisage and extend to such agreements;

b. Potential liabilities in damages in respect of a breach of contract including but not limited to breach of fiduciary duties and breach of trust (as well as other circumstances) and consequential liabilities associated with such breaches (for example, interest and costs);

c. Indemnities for losses suffered by others, on the basis that this would be consistent with the PRA's confirmation that it may be impracticable to include Article 55 wording where the only liability is contingent on breach of contract;

d. Financial services products requiring bail-in wording;

e. Non-contractual liabilities of all types (by their nature they are likely to be future and of unknown value and there is unlikely to be any document in which an acknowledgement could be included);

f. Contingent payment obligations under financing documentation (for example, sharing obligations under syndicated loans) on the basis that these are unlikely to arise in the ordinary course;

g. Liabilities to public bodies (for example, fines and taxes insofar as not otherwise excluded);

h. Amendments to existing contracts which require majority bank consent where the firm is unable to obtain such consent to the inclusion of a Bail-in Recognition Clause (BIRC);

i. A scenario in which a BRRD firm transfers into a facility agreement which does not contain Article 55 wording, on the basis that it will not be possible for the BRRD firm to negotiate the inclusion of Article 55 wording with the borrower and all the other lenders;

j. Obligations to act as a payment conduit (for example, a facility agent under syndicated loans) on the basis that any attempted bail-in of such liabilities would have very limited impact on resolvability; and

k. Low value contracts or liabilities, perhaps below a de minimis value. Such contracts will have little or no impact on resolvability and, thus, such an exclusion would be consistent with the PRA's aim to supervise and enforce in a "*proportionate, judgement-based and risk-based manner*".

A further point we would seek to raise on the issue of impracticability, having regard to clause 2.4 of Appendix 2 to the CP, is that the PRA should consider the definition of *liability* for the purposes of the PRA

Rulebook to ensure that it does not place UK banks at a competitive disadvantage *vis a vis* other EU banks. The reasoning behind this argument arises from an understanding that other European regulators are giving a narrower meaning to the term *liability* and as such UK banks may be held to a wider group of liabilities that could be subject to bail-in *vis a vis* their non-UK European competitors, resulting in UK banks having to consider including contractual recognition wording in a wider group of contracts. We would seek the PRA's comments on this point raised.

Broadly speaking, we would recommend that the term *liability* be redefined to relate to specific debt obligations of the type referred to by the Financial Stability Board ("**FSB**") or at the very least, be redefined to encapsulate liabilities which could reasonably be expected to be subject to bail-in procedures. Furthermore, Article 55 and the concept of Impracticability could be amended to align contractual recognition of bail-in with the scope proposed in the FSB Principles for Cross-border Effectiveness of Resolution Actions and the FSB Principles on Loss Absorbing and Recapitalisation Capacity of GSIBs in Resolution (TLAC) (Paragraph 13 of the TLAC Term Sheet). These principles, together, provide that contractual recognition of bail-in requirements should apply to relevant liabilities in order for them to be eligible for TLAC and any other "debt instruments". This would provide a much clearer scope of liabilities and significantly reduce the burden on firms while meeting the objective of ensuring resolvability.

As a final point we would suggest that the PRA and the Financial Conduct Authority collectively ensure consistency and uniformity in the approach that each body takes and wording to be adopted in relation to the inclusion of contractual recognition of bail-in language in applicable documents, for the benefit of the financial marketplace in the UK and its position internationally.

If you would prefer to discuss any of these comments, you may contact the Chair of the Committee, Dorothy Livingston, by telephone on 020 7466 2061 or by email at dorothy.livingston@hsf.com

Yours sincerely,

Dorothy Livingston
CLLS Financial Law Committee

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About CLLS Financial Law Committee

The Committee submitting this paper is made up of solicitors specialising in UK and international financial law in a number of law firms based in the City of London, who advise and act for UK and international financial institutions and businesses and for regulatory and governmental bodies on financial law matters.

The Committee Members are:

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