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Dear Ms Andreicut,

The contractual recognition of bail-in: amendments to Prudential Regulation Authority rules

This is the British Bankers' Association ('BBA') and International Capital Market Association ('ICMA') response to the above consultation. We welcome the opportunity to provide our views.

Key messages

In summary, the response makes the following points:

- The recognition of the challenges the industry faces in implementing the requirements of Article 55 of the Bank Recovery & Resolution Directive ('BRRD') and the subsequent pragmatic steps which have been taken to mitigate these are welcome. The proposal to move the existing modification by consent issued in November 2015 onto a formal footing will address a number of the most pressing concerns to the industry.
- The proposed changes to the PRA Rulebook ('Rulebook') do, however, stop someway short of addressing the fundamental and acknowledged shortcomings which arise from the scope of Article 55. Ultimately, pragmatic implementation cannot act as a long-term

substitute to an appropriately scoped requirement. As such, it remains our view that the European authorities must amend the scope of Article 55 to provide a clear and consistent framework which can be applied across Member States. The overarching policy goal of promoting effective cross-border resolution could be met by limiting the contractual recognition of bail-in requirement to debt and other instruments used to meet loss absorbing capacity requirements. This would be proportionate and consistent with the Principles for Cross-border Effectiveness of Resolution Actions and Principles on Loss Absorbing and Recapitalisation Capacity of GSIBs in Resolution adopted by the Financial Stability Board ('FSB').

- The need to align the UK rules with the final draft RTS is understood. It is unfortunate, however, that the definition of secured liabilities adopted by the final draft Regulatory Technical Standard ('RTS') is unduly restrictive and will place an onerous requirement on BRRD firms to include contractual recognition terms in liabilities which the market effectively treats as being fully and continuously collateralised irrespective of regulatory requirements. Notwithstanding this, our response identifies the need for clarity over the interpretation of secured liabilities for the purposes of the UK rules.
- Although it is encouraging that the PRA will supervise the contractual recognition requirement on a proportionate basis, there is a risk that BRRD firms will face considerable uncertainty which will manifest itself in the market as confusion as some BRRD firms seek to impose contractual recognition provisions on counterparties whereas others do not. A broader, more flexible approach to the definition of impracticability will reduce this risk and assist BRRD firms in their implementation.

Introductory comments

The BBA and ICMA support the development of credible and effective regimes for the orderly resolution of failed financial institutions, without resort to public solvency support. As the consultation paper notes, contractual recognition has a role to play in promoting the effectiveness of the bail-in tool and supporting equitable treatment between EU and third country liability holders. It is unfortunate therefore that the Article 55 BRRD requirement goes inadvertently beyond what is necessary to achieve this policy objective. The unintended consequences of the drafting of Article 55 are now well-known and the decision of the UK authorities to seek a pragmatic solution is appreciated. In particular, BBA and ICMA members welcomed the modification by consent which disapplied the rules in relation to those liabilities where it is impracticable for BRRD firms to comply. In this context, the BBA and ICMA support the PRA's proposal to amend its rules in a way which will place this helpful temporary regime onto a formal footing from the expiry of the modification on 30 June 2016. We note that a similar amendment is required to the equivalent FCA Rules.

The proposed changes to the UK rules, however, stop someway short of addressing the fundamental shortcomings with Article 55 and leave considerable uncertainty as to the expectations on BRRD firms subject to PRA – and FCA – rules. This is driven principally by uncertainty over the interpretation of impracticability and, in this context, the extent to which BRRD firms can achieve sufficient legal certainty from the PRA's approach to supervision.

For these reasons, the BBA and ICMA believe that the only realistic permanent solution to the challenges of Article 55 is for the European authorities to amend the scope of the requirement. Aligning the contractual recognition requirement with the FSB's Principles for Cross-Border Effectiveness of Resolution Actions would deliver the policy objective of ensuring debt instruments absorb loss in resolution and would promote a consistent approach across Member States.

The Regulatory Technical Standard

The need to align the Contractual Recognition Part of the Rulebook with the draft final RTS is understood. It is nevertheless disappointing that the European Commission has chosen to adopt the draft final RTS, notwithstanding the serious reservations with Article 55 that were identified by a wide range of stakeholders in response to the European Commission's recent "Call for Evidence on the EU regulatory framework for financial services"[1].

<u>Secured liabilities</u>

The proposed amendment to the definition of secured liabilities looks to conform to the draft final RTS. It does, however, give rise to a number of questions.

RTS definition

The RTS requirement is for liabilities to be governed by contractual terms that oblige the debtor to maintain the liability fully collateralised on a continuous basis in compliance with regulatory requirements of EU law or equivalent third country law. We are concerned that this could be construed narrowly so that an exposure can only be treated as a secured liability if EU regulation specifically requires the debtor to maintain the liability fully collateralised on a continuous basis and, as a consequence, will result in a large number of liabilities which are fully collateralised by the terms of their contracts, being treated as if they were unsecured. For

[1] http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/index_en.htm

example, the market would traditionally see securities financing transactions, repo and stock lending as collateralised on a continuous basis (subject to intraday and Minimum Transfer Amounts or Thresholds). Likewise, with secured asset finance transactions. They are not, however, collateralised in compliance with regulatory requirements and therefore cannot be treated as secured liabilities for the purposes of Article 55. A better and less onerous approach would be to treat a liability as fully secured if the contract requires full and continuous collateralisation so long as it does so in a manner which is not inconsistent with any applicable regulatory requirements. This could be subject to a requirement that any renegotiation of the contract which created an uncollateralised exposure would necessitate the inclusion of a contractual recognition of bail-in provision.

PRA Rulebook definition

Consistent with the RTS, the definition proposed for inclusion in Part 1.2 of the Rulebook requires that the liability be governed by terms which oblige the debtor to maintain the liability fully collateralised on a continuous basis in compliance with regulatory requirements of EU law or the law of a third country achieving effects that can be deemed equivalent to EU law. Notwithstanding our concerns with the shortcomings of this definition, it would be useful to have clarity that this provision applies to any EU regulatory provisions regarding secured exposures and is not limited to, for example, the European Market Infrastructure Regulation (‘EMIR’). In this context, we highlight that the Capital Requirements Regulation (‘CRR’) considers certain exposures fully and completely secured when they are secured on residential and commercial property collateral without a requirement to collateralise on a continuous basis if the collateral has a specific loan to value.

Second, it is noted that the phase in of the margin requirements under EMIR will leave a gap between the time at which the contractual recognition rules apply and the point at which banks can be considered to be in full compliance with EU law. As such, we recommend that Part 2.1A of the final Rulebook be amended so that a BRRD firm may consider it impracticable to include contractual recognition terms into a fully secured liability until such time as the EU regulatory requirements come in to effect. Not taking this approach will require BRRD firms to seek the inclusion of contractual recognition provisions, even though these contracts will fall out of scope just a few months later.

Moreover, a similar challenge exists in relation to third country law and the extent to which this can be said to be equivalent to EU law. It is not clear whether the draft Rulebook requires that a formal equivalence determination by the European authorities be in place or whether BRRD firms may rely on their judgement as to whether equivalent rules are in place in the third country. If it is the case that a formal European equivalence assessment must be in place, then the final rules should also allow for appropriate transitional arrangements. These should permit BRRD firms to regard it as impracticable to include contractual recognition provisions in liabilities that would otherwise have been deemed fully secured until such time as the European Commission has concluded its equivalence negotiations with individual third country markets.

Material amendments

As above, the proposed amendment to the definition of material amendment looks to conform to the RTS.

Automatic amendment

Further clarity could be provided over how 'automatic amendment' should be interpreted. For example, it is not clear whether this should include all embedded optionality within the life cycle of a transaction. In particular, we would not expect parties to have to sign an amendment introducing a contractual recognition clause where the triggering material amendment was 'automatic' (and did not itself require a written amendment).

Created

We agree that the proposal to replace the reference to liabilities arising after a certain date with liabilities created after the respective date provides greater clarity.

Impracticability

Examples of impracticability

Comments on proposed examples

The BBA and ICMA welcome the decision to identify a non-exhaustive list of examples of where the inclusion of contractual recognition language might be considered impracticable. The drafting of the first four examples, which focus on the characteristics of the liability, does, however, set a high bar for compliance. The examples are also limited in scope which may therefore inadvertently prevent BRRD firms from reaching a determination of impracticability even if this appears to be consistent with the policy intent.

Paragraph 2.2 of the draft supervisory statement, for example, states that a BRRD firm could take the view that the inclusion of contractual recognition language is impracticable if a third country authority has informed the BRRD firm that they will not allow it to include contractual recognition language in agreements or instruments creating liabilities governed by the law of that third country. In the first instance, the requirement that the notification be 'in writing' is unduly restrictive. Moreover, in certain contexts, such as contracts entered into by BRRD firms with an issuer of securities when they are acting as underwriters for that issue of securities, a third country authority may have informed the BRRD firm's <u>counterparty</u> to the contract creating the liability, rather than the BRRD firm itself, that it is not possible to include contractual recognition language in agreements creating liabilities governed by the law of that third country. In these circumstances it would seem equally impracticable for the BRRD firm to include a contractual recognition of bail-in in the relevant agreement(s).

It would be helpful if the first bullet point in paragraph 2.2 of the supervisory statement could refer to third country authorities informing the BRRD firm <u>*or the BRRD firm's counterparty*</u> that they will not allow contractual recognition language to be included in agreements or instruments creating liabilities governed by the law of that third country.

Further, there are counterparties which share characteristics of a 'third country authority' in that they are sovereign, quasi-sovereign or officially supported organisations but in respect of which it is unclear whether they would constitute a 'third country authority'. Examples include official export credit agencies, multilateral development banks and/or international organisations as these terms are used in the CRR.

The fifth example focuses on the nature of the liability itself. This is a very welcome approach which will be vital to enabling firms to comply with the contractual recognition requirements and must therefore be retained in the final Supervisory Statement.

Additional examples

In addition to the above, there is a case to expand the list of non-exhaustive examples of where it is impracticable to include contractual recognition provisions to also include:

- contracts under which the sole obligation of the BRRD firm is to distribute proceeds of enforcement;
- contracts the BRRD firm must enter into but which are in a statutory form or over which it has no control or power to amend (such as shipping guarantees or mortgages);

- contracts entered into by a BRRD firm in connection with an asset or project finance but over which it has no control or power to amend (such as equipment warranties given by manufacturers, direct agreements and offtake agreements);
- liabilities owed to official export credit agencies, multilateral development banks and/or international organisations (as these terms are used in the CRR) where that counterparty has informed the relevant BRRD firm that they will not allow it to include contractual recognition language in agreements or instruments to which they are a party;
- contracts where the sole potential liability of the BRRD firm is non-contractual; and
- non deposit, operational or vendor contracts with low resolution value.

Furthermore, in the example of amendments to existing contracts, there is a strong case for the final Supervisory Statement to acknowledge that it may be impracticable for a BRRD firm to require a contractual recognition clause where it does not constitute the required majority to insist on the same. For example, it is not uncommon for secondary loan trading desks to hold relatively small positions where they are not in a position to amend existing contracts to include a contractual recognition clause without the support of all of the other parties to the loan agreement (which can be a very substantial number of third parties).

The impracticability is exacerbated in the context of acquiring an initial position in a non-EEA law governed loan position where the BRRD firm will not even have a contractual nexus with the borrower or agent bank at the point of committing to the acquisition that would entitle it to request that the amendment be made.

Material amendments to debt instruments issued before 19th February 2015

There is a further question as to the practicality of making material amendments to debt instruments which were issued before 19 February 2015. Part 2.3(4) of the draft Rulebook would require the inclusion of contractual recognition provisions in debt instruments subject to material amendment after 30 June 2016. This may mean that amendments which would have been possible without debtholder consent will require a consent solicitation to include the clause. Such changes are likely to require qualified majority consent, thereby making the amendment impracticable if, otherwise, the restructure would be possible without such a qualified majority or without debtholder consent at all.

Definition of debt instrument

Part 1.2 of the draft Rulebook proposes a definition of debt instrument which includes bills of exchange and banker's acceptances. It would be helpful for this to be amended so that it is clear that bills of exchange and banker's acceptances in the context of trade finance are not unintentionally treated as phase 1 liabilities. This should be consistent with the wider policy intent and the fact that as trade finance instruments they are not entered into for purposes of raising debt by BRRD firms but rather for the facilitation of international trade.

<u>Policy intent</u>

The proposed UK rules for contractual recognition of bail-in are much broader in their scope than the FSB Principles, cited in paragraph 2.7, which focus very specifically on debt and capital instruments. For example, FSB principle 9 reads[2]:

> 'Capital or debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity should include legally enforceable provisions recognising a write-down, cancellation or conversion of debt instruments in resolution ('bail-in') by the relevant resolution authority if the entity enters resolution'.

Whilst it is fully understood that this difference in scope derives from the BRRD requirement, it is difficult to reconcile the ensuing administrative and competitive costs with the development of a proportionate regime. As detailed above, there is a clear case for the BRRD requirement to be revised so that it is consistent with the FSB Principles and the policy objective of removing impediments to effective resolution and providing legal clarity.

As a final point, it would be useful for the PRA to provide guidance over the approach that will be taken by the Bank in respect of the penultimate subparagraph of Article 55(1) and the development of statutory bail-in regimes in third countries. Equally, the UK authorities should seek to promote the development of formal agreements and statutory recognition regimes such as those provided for by Articles 93 and 94 of the BRRD.

[2] Principles for Cross-Border Effectiveness of Resolution Actions, FSB, 3 November 2015: http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf

Approach to supervision

The proposed approach to supervision gives rise to a number of uncertainties for BRRD firms, which reinforce our view that it is essential for the BRRD to be amended to revise the scope of the contractual recognition requirement.

At one level, it is encouraging that the PRA will enforce and supervise the contractual recognition requirement in a proportionate, judgement and risk-based manner (paragraph 4.2). That said, when viewed in the context of recent initiatives to enhance individual accountability for decisions, a proportionate approach to supervision implies a degree of risk of technical non-compliance which leaves considerable uncertainty for BRRD firms. This will be compounded by the fact that neither the Bank nor the PRA will approve firms' judgements (paragraph 4.4). Overall, this may add to uncertainty and confusion in the market as some BRRD firms seek to impose contractual recognition provisions on counterparties whereas others do not. These problems could be addressed if the PRA was to take a broader and more flexible approach to impracticability as a concept. For example, the PRA could:

- acknowledge that the assessment of impracticability may not be a simple point in time assessment;
- elaborate the list of examples of impracticability (as proposed above, although we welcome the PRA's non-exhaustive list approach); and
- explain the factors set out in paragraph 4.3 which will be used to assess the impact of non-compliance on resolvability. To date, members have understood the assessment of the impact of non-compliance to be approached from a balance sheet value and no-creditor worse off perspective and so are unclear what is intended to be implied by the inclusion of the 'legal nature of the liability' as a factor for consideration.

Separately, this uncertainty for BRRD firms is also likely to work against the objective of providing market transparency with regard to which liabilities can be subject to bail-in and thereby improving risk pricing and credit risk management, which are cited as benefits of the policy approach in the cost-benefit analysis (paragraph 5.11). This issue could be magnified by differing interpretations of Article 55 adopted by supervisors in other Member States.

Impact assessment

The cost-benefit analysis notes that the benefits of contractual recognition are likely to include greater transparency that will in turn improve risk pricing and facilitate better credit risk management (paragraph 5.11). Paragraph 5.16 goes on to argue that BRRD firms could experience an increase in funding costs as a result of the requirements but that the PRA would regard this as a benefit of the policy, to the extent that it reflected the probability of bail-in and therefore better risk pricing in the market. It should be noted, however, that a change in funding costs to reflect the true probability of bail-in would not necessarily be the most likely client reaction, at least not in markets where the concepts are not well understood. Similarly, even where local regulators do not object to the adoption of contractual recognition terms, it is unlikely that counterparties will be anticipating the inclusion of contractual recognition language to phase 2 liabilities as is assumed by paragraph 5.17.

Please do not hesitate to contact us should you require further clarification of any of the points raised above or if we can provide any further assistance.

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