Update: More options for financial institutions

Paul Durban and Sabina Khan report on the further expansion of reorganisation and winding-up measures for financial institutions through the EU Bank Recovery and Resolution Directive (BRRD) and other potential reforms

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In the Summer 2014 edition of eurofenix (in an article entitled "A New Regime for Bank Crisis Management"), we reported on the EU Bank Recovery and Resolution Directive 2014/59/EU (the "BRRD"), a minimum harmonisation directive which aims to establish a common framework for the recovery and resolution of failing credit institutions and larger investment firms in the European Economic Area (EEA).

The BRRD complements the EC Directive on the Reorganisation and Winding-Up of Credit Institutions (2001/24/EC), the "Directive", implemented in the UK in 2004, which is broadly aimed at determining the state within the EEA that should oversee insolvency proceedings for certain financial entities and determining the extent to which that state's laws govern the administration of the financial entity's interests in other EEA states.

While the objective and status of the Directive remain the same, the implementation of the BRRD has led to certain aspects of the Directive being amended to ensure harmonisation with the new legal framework.

Recap on main features of BRRD

By way of reminder, our previous article summarised the tools and powers that EEA Member States must now equip themselves with as a minimum pursuant to the BRRD. The BRRD makes significant changes to the operation of certain credit and investment firms and the extent to which regulatory authorities will have powers to intervene when certain conditions have been met. These include:

Prevention: The BRRD requires institutions to develop robust recovery plans or "living wills" at both individual entity level and group level. These plans can be used by resolution authorities to construct credible resolution plans.

Early intervention: Resolution authorities will be able to appoint "special managers" to help restore failing institutions as a form of early supervisory intervention. Special managers will have far-reaching powers including corporate reorganisations, increasing capital and considering potential takeover options.

Resolution: Subject to certain conditions being met, resolution authorities will be able to adopt certain "resolution tools" such as the sale of all or part of the business, the transfer of all or part of the business to a temporary publically controlled entity (bridge bank), the transfer of 'bad' assets to an asset management vehicle and the more controversial bail-in tool, which enables resolution authorities to restructure the liabilities of a distressed institution by writing down debt or converting it to equity.

Expansion in the scope of the Directive

As mentioned above, the Directive sets out an EEA regime whereby the administrative or judicial authorities of the home Member State of a credit institution are empowered to decide on the implementation of reorganisation measures and winding-up proceedings for the credit institution and its branches in other EEA Member States. Such reorganisation measures and winding-up proceedings will be recognised and effective across the

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EEA and are governed, subject to certain exceptions, by the law of the home Member State. While the general purpose and operation of the regime created by the Directive has not been affected by the BRRD, the BRRD has necessitated certain significant amendments being made to the Directive. *Key changes include:*

Enhanced Scope

1. The Directive now not only applies to credit institutions but also to "investment firms". "Investment firms" means "*any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis*". Significantly, firms having less than €730,000 of capital are expressly excluded from the definition of investment firms. This recognises that the BRRD is aimed at the mid-high end of the market, so as to address institutions whose financial difficulties or insolvency could cause systemic risk.

2. Further, the Directive has also been extended to apply to financial institutions, firms and parent undertakings within the scope of BRRD. This change reflects the fact that the BRRD contemplates measures being taken in respect of groups of companies with their head offices in the EEA. Accordingly, proceedings for such groups of companies will fall within the scope of the Directive and will be recognised and effective in all EEA Member States. This is a significant development in cross-border insolvency as although pan-European legislation has historically been well equipped to deal with single entities in self-contained proceedings, it often fell short when dealing with more complex group structures operating in multiple jurisdictions. This sometimes gave rise to inconsistent decisions being handed down with respect to different entities within the same group company. The aim is that these inconsistencies should now be minimised.

3. The definition of "reorganisation measure" has been revised so that it is clear that the application of the resolution tools and the exercise of the resolution powers in BRRD will be "reorganisation measures" for the purpose of the Directive. Such an amendment should be welcomed as the types of resolution actions which fell within "reorganisation measures" were not always previously clear (for example there has been debate about whether certain types of good bank/bad bank splits were reorganisation measures) giving rise to uncertainty as to whether such an action would be automatically recognised and effective across the EEA. The revision to the definition of "reorganisation measure", so that it refers specifically to those actions available under the BRRD, should go some way to removing these uncertainties for future financial institution rescues.

Applicable law

The exceptions to the general choice of law rule which provide protection for netting agreements and repurchase agreements have been amended so that the provisions in the BRRD which give the home Member State resolution authority the power to suspend termination rights and impose temporary stays (for a limited period of 48 hours) should override netting and repurchase agreements that are governed by the laws of other EEA Member States. The exceptions to the general choice of law rule which provide protection for set-off and third party rights *in rem* have not been similarly amended, presumably on the basis that such rights benefit from the general safeguards, and would be dealt with in due course under the resolution process.

Domestic implementation of BRRD

On the domestic front, the implementation of the BRRD raises the issue of how the UK's existing regime for the resolution and recovery of financial institutions should be adapted to ensure compliance with the BRRD.

Large parts of BRRD formally came into force in the UK on 1 January 2015 via the Bank Recovery and Resolution Order 2014 (the "Order"). The

Order amends the Banking Act 2009 (the "Act") in order to bring the UK's own special resolution regime ("SRR"), which applies to banks, building societies, systemically important investment firms, recognised central counterparties (CCPs) and banking group companies) into alignment with the BRRD.

Overview of the main amendments to the SRR

Some of the principal amendments to the SRR resulting from the implementation of the BRRD include:

Asset separation tool: The asset separation tool embodied in the BRRD has been added to the stabilisation options available to the UK authorities pursuant to the SRR. Broadly, it enables the Bank of England (which is the entity responsible for the operation of the SRR, including the decision of which SRR tool to use and the mechanism for that tool's implementation) to use property transfer powers to transfer assets, rights and liabilities of a failing bank to asset management vehicles.

Government stabilisation options: The BRRD sets out two government stabilisation tools: the public equity support tool and the temporary public ownership ("TPO") tool. The TPO was already available as part of the SRR, however, the public equity support tool is a new addition to the Act. The Act has also been amended to reflect the BRRD requirement that government stabilisation options can only be used once there has been a contribution to loss absorption and recapitalisation of at least 8% of the total liabilities of the institution under resolution.

Write down of capital instruments: New provisions have been inserted into the Act to reflect the BRRD requirement that before any resolution tools can be used (i) capital must be used to absorb losses, and (ii) relevant capital instruments should be written down or converted (this may be done by way of cancelling shares and other instruments of ownership, transfers made to bailed-in creditors or substantial share dilution).

Bail-in: The Financial Services (Banking Reform) Act 2013 has amended the Act to introduce the controversial bail-in tool. Indeed, the amendments have established the bail-in option as a new stabilisation option available to the Bank of England as lead resolution authority under the SRR. This option is available in respect of failing banks and investment firms and will also be made available, with modifications, to building societies using secondary legislation. It should be noted that it is still not clear when these particular amendments will take full effect and, given their nature, these particular reforms are still subject to some ongoing consultation.

What next?

By setting out a common framework for a pan-European bank recovery and resolution regime, the EEA authorities have sought to facilitate a more orderly and concrete legal framework aimed at reducing the potential public costs of future bank failures. While the BRRD (and its consequential amendments to the Directive) has on paper created a new, flexible regime for dealing with the rehabilitation of failing banks, it also carries elements of legal uncertainty, including fundamental concerns about loss of proprietary rights.

Moreover, while the BRRD in tandem with the Directive may go some way to resolve certain of the harmonisation issues relating to cross-border insolvencies of credit/financial institutions in the EU, it is likely that a more international approach will need to be adopted with respect to institutions with an increasingly global presence and this will likely need to be addressed at an international level, not just at an EEA level.

Consequently, whether the BBRD (and the harmonisation of the Directive) results in a safer and more disciplined European banking system remains to be seen. It is likely that the BRRD's success will ultimately depend on whether interaction between the relevant authorities (and statutory instruments) proves to be effective and most importantly, whether the measures prove to be sufficiently robust to allay the fears of creditors of a failing bank and to mitigate the potential risks of non-recovery.

Other proposed pan-European reforms

European Union finance ministers also very recently agreed on a new draft law aimed at tackling the problem of "too-big-to-fail" banks and shielding taxpayers from having to bail out large lenders. The planned legislation would apply to banks whose trading activities exceed €100 billion (approximately 30 of the biggest banks in Europe would be within this scope) and could force these banks to rein in proprietary trading and give national regulators the power to split off risky trading activities from safer lending operations.

The planned reforms seek to harmonise laws that have already been adopted in several EU countries to deal with "too-big-to-fail" institutions but the law would exempt countries if they already have similar legislation in place. This would exempt the United Kingdom who has its own rules (the Vickers reforms) which call for UK retail banks to ring-fence their retail banking businesses from investment-banking activities and cushion them with additional capital.

Even though it has the backing of the 28 EU countries, the European Parliament still has to approve the final version of the law and further changes are possible as many banks are concerned that any radical move to break them up might harm their ability to support Europe's economic recovery, and spark an exodus of business toward more favourable jurisdictions. It therefore could take several months before the new law is formally adopted. ■

THE PLANNED REFORMS SEEK TO HARMONISE LAWS THAT HAVE ALREADY BEEN ADOPTED IN SEVERAL EU COUNTRIES TO DEAL WITH "TOO-BIG-TO-FAIL" INSTITUTIONS

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