Feature

KEY POINTS

- Full implementation leaves uncertainties which are unlikely to be resolved until the failure of a major bank.
- A particular problem is whether a court outside the EU would recognise a bail-in ordered by a resolution authority in another EU member state.
- The interaction between "market contracts" and bail-in powers (where, for instance, a bank acting as a clearing member is subjected to bail-in) remains unclear.

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The EU Bank Recovery and Resolution Directive: moving towards full implementation

The European Union's Directive dealing with planning for the recovery and resolution of failing banks took many years to reach political agreement. Member states should have implemented it in full by now. However, even in countries such as the UK which already have many of the key powers and regulatory controls in their law, implementation leaves uncertainties which are unlikely to be resolved until the failure of a major bank.

This article considers how implementation has been handled with particular reference to the UK, and notes some remaining legal uncertainties.

The question of how to avoid another financial crisis continues to occupy banking regulators around the world. It is in the nature of banks to take risks, and better management of those risks has become a pre-occupation of boards of directors of banks. But even the best managed banks can be subject to financial stresses that lead to potential failure and insolvency. Finding legal and regulatory tools to manage failure, either with a view to recovery or to continuation of parts of the failed business, has emerged as one of the keys to dealing with future crises.

In November 2013, when this journal last covered this subject ([2013] 10 JIBFL 641), we were still awaiting the final adopted text of the EU Recovery and Resolution Directive. During 2014 the legislative process moved on rapidly, and the Directive has been adopted with a target implementation date of 1 January 2015 for all member states.

IMPLEMENTATION PROGRESS IN THE UNITED KINGDOM

The importance of the financial services industry to the UK economy and the political attention it has received has led to the UK Government adopting an unusual approach to implementing the Directive. Usually it would wait for the finalisation of a directive and then introduce appropriate legislation to implement it, but in this case it has introduced much of the implementing legislation before the Directive was finalised.

The Directive provides for resolution authorities to have a wide range of tools and intervention mechanisms to deal with a failing bank, including early intervention powers, powers of sale over the whole bank, powers to set up a bridge bank or to separate assets and liabilities of the bank and power to "bail in" certain liabilities. Many of these powers already exist under English law. The Banking Act 2009 established a special resolution regime for banks and certain other participants in financial markets. Among other things, this includes the power for the Bank of England to arrange for the transfer of all or part of a failing bank's business to a private purchaser, or to a publicly controlled bridge bank, or to take all or part of the failing bank's business into temporary public ownership.

The Banking Act 2009 was further amended by the Financial Services (Banking Reform) Act 2013, principally to introduce a bail-in option to the tools available to the Bank of England as resolution authority. When this legislation was passed the Directive had not yet been finalised, but the UK Government believed that the bail-in powers mandated by the Directive would not be significantly different from those conferred by the UK legislation.

After finalisation of the Directive it was necessary to make further amendments to the law in the UK to reflect its final form, and this was done by four statutory instruments made under the powers conferred by the European Communities Act 1972, all of which came into force on 1 January 2015. The amendments to the existing legislation are extensive, particularly in areas such as the resolution tools and the bail-in powers. The result is that analysing the transposition of the Directive into English law requires consideration of complex amendments and re-amendments of primary legislation.

Some aspects of the Directive have been supplemented by additional rules made by the Prudential Regulation Authority (PRA). The PRA rules deal with issues such as the contents of recovery plans, the information to be provided to the PRA in the context of resolution planning, and impose certain requirements on banks in relation to bail-in and other powers.

IMPLEMENTATION AT THE EUROPEAN LEVEL

The Directive confers certain powers on the European Banking Authority (EBA), whose influence on national regulators and on the banks they regulate is increasingly felt. In the context of the Directive, the EBA's main role is to create technical standards. The technical standards contain useful guidance about how the Directive's requirements are to be implemented in practice. For example, the draft technical standard on bail-in requires

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national regulators to ensure that contractual obligations governed by the law of a country outside the EU contain a contractual provision binding the counterparty to accept the results of a bail-in (see further below).

Another technical standard relates to how shares are treated in a bail-in, and requires them to be diluted or cancelled depending on the valuation made in accordance with Art 36 of the Directive. If this shows a nil or negative net asset value, existing shares are to be cancelled or written off: if there is a positive net asset value shares will be diluted or written down. A third technical standard relates to the rate of conversion of debt to equity in a bail-in.

There is also an EBA standard on how colleges of regulators will be operated in cross-border resolution cases, and one on procedures for resolution planning. The day-to-day work of national regulators, as well as their conduct when a resolution is required, is likely to be increasingly driven by these standards made at the EBA level. Interpreting them in the context of a fast-moving situation where a bank is in financial difficulties is likely to prove a considerable challenge, and to require real-time interaction between the EBA and the national regulators involved.

CROSS-BORDER ISSUES

As with any piece of European legislation, issues can arise when the legislation is implemented and applied in all member states. The examples from the UK above illustrate how complex the implementation process can be. In the case of this Directive, which is meant to apply to banks with businesses across the whole of the European Union, the different approaches to implementation in different member states are almost bound to lead to conflicts when the legislation is tested. A key question will be whether the arrangements for resolution colleges of regulators will be robust enough to deal with these conflicts.

A particular problem arises in relation to the bail-in powers conferred on resolution authorities. Capital instruments issued into international capital markets are likely to be governed by English or New York law, while the bank issuer may be incorporated under the law of another member state. Any insolvency would most probably be handled under the law of the state of incorporation. A question then arises about whether a court adjudicating on the liabilities under the capital instruments, presumably in London or New York, would recognise a bail-in ordered by a resolution authority in another EU member state. Outside the realm of typical internationally-traded bonds and other capital instruments, it is possible to envisage even more complex problems of conflict of laws.

The UK's PRA has tried to deal with this by requiring all capital instruments to include a contractual provision in relation to bail-in powers. This will assist both in UK courts and in other courts around the world where such a contractual provision is seen as effective. It will not fully obviate the potential issue: it is possible to envisage a court somewhere in the world where such a provision might be held unenforceable, perhaps on the grounds that it unfairly deprives the holder of a right against a UK bank of his property. The problem is likely to be more acute where the conflict arises with the law of a country outside the European Union, because most countries within the European Union will be following the EBA's technical standards and their courts will be pre-disposed to give effect to an EU directive. This is the sort of problem which European legislation alone cannot solve. The Financial Stability Board has recognised this in its recent paper on cross-border recognition of resolution action.

OTHER UNCERTAINTIES

Banks are complex institutions which handle the transference of risk. It is not surprising that a regime which gives a regulator unprecedented powers, including powers to alter the normal priorities of creditors, creates legal uncertainties which will need to be resolved in the courts whenever these new powers are tested. There are many examples of this in the UK context. In its paper responding to the consultation on the UK implementation of the Directive, the Financial Markets Law Committee of the Bank of England drew attention to several examples, two of which are as follows:

- Although it is clear that bail-in powers do not apply to basic remuneration payable to employees, they do apply to bonuses or variable remuneration. The treatment of debts to pension schemes, which has given rise to complex litigation following the Lehman collapse, is not clarified by these provisions.
- Settlement of many financial contracts depends on the use of settlement systems which operate through a central counterparty and rely on security over assets given to the market. The interaction between these "market contracts" and the bail-in powers (where for instance, a bank acting as a clearing member is subject to bail-in) remains unclear.

CONCLUSION

As the 2008 financial crisis showed, financial problems within a bank can arise very quickly. Solutions which deal with immediate problems are often followed by a lengthy period of unwinding of residual liabilities and, more often than not, litigation. Litigation arising from what happened in 2008 (including actions by regulators and governments at that time) is still continuing.

The powers conferred by the Directive are now being implemented across Europe. They may well make it easier for central banks and other regulators to deal with another crisis, in that they will provide additional and powerful tools which the regulators can use. The efficacy of these tools will only really be tested when there is another crisis. In the meantime there will continue to be many aspects of the new regime where the outcome in a crisis cannot be predicted with certainty. ■

Further reading

- The EU Resolution and Recovery Directive: preventing another financial crisis [2013] 10 JIBFL 641
- Contractual recognition of resolution actions [2015] 3 JIBFL 188A
- LexisNexis RANDI blog: Three-step strategy for resolution of failed institutions