Briefing Note: Banking Resolution

Monte die Paschi has put banking resolution back in the news. But what is the EU Bank Recovery and Resolution Directive (BRRD), and what if anything does it mean for derivative end-users?

Introduction

As with much financial regulation, legislation covering bank resolution can be traced back to the G20 summit in Pittsburg in 2009. Based on the broad agreement reached there the Financial Stability Board (FSB) produced guidelines in 2011, and in turn the European implementation of these is contained in the EU Bank Recovery and Resolution Directive[1] which entered into force on 1st January, 2015, with the applicability of bail-in provisions delayed until 1st January 2016.

BRRD

The general aim of the directive is to provide "adequate tools at European Union level to effectively deal with unsound or failing credit institutions". To achieve this the directive requires each member state to appoint a resolution authority, outlines how in-scope institutions and this authority should co-operate to develop resolution planning, imbues the authority with various powers, and specifies tools it should have at its disposal:

Resolution can be triggered before actual failure of an institution when such failure appears inevitable, private sector solutions have been exhausted, and avoidance of failure is in the public interest. The aim of resolution is then to sustain critical functions of the institution and protect preferred clients and investors. It is not to be used if the normal insolvency process would meet the same goals, nor are any creditors to be worse off than they would have been through normal insolvency.

Four tools are placed at the disposal of resolution authorities, allowing them to sell assets, install a state bridge institution, transfer assets to separate vehicles, and apply a bail-in. As a consequence derivative counterparties of the institution under resolution may find themselves facing a different entity, or having their exposure including in the bailed-in liabilities.[2]

The concept of bail-in is familiar from the failure of Cypriot banks, and from the contingent convertible (CoCo) bonds issued by banks, which convert from debt to equity under certain distressed conditions, however the inclusion of derivatives in the list of liabilities potentially subject to bail-in has attracted less attention.

[1] BRRD - Directive 2014/59/EU

[2] In this note we only consider derivative contracts with the instution under resolution as counterparty. There are also potential consequences for CDS contracts with the institution under resolution as the reference entity.

Bail-in of Derivatives

There are a number of noteworthy points in the legislation which help give a more detailed picture of the likely impact of the bail-in tool on derivative liabilities.

- The BRRD bail-in conditions automatically apply to derivative agreements with EU institutions which are governed by the law of an EU member state.
- Exclusion from bail-in is possible if the resolution timescale does not permit processing of the liability
- Institutions are required to maintain a minimum ratio of eligible (for bail-in) liabilities to total liabilities, with derivative liabilities counting towards the latter but not the former.
- Eligible liabilities shall be written-down to maintain solvency, then converted to shares until the required capital levels are re-established, with liabilities being included in accordance with the hierarchy of claims in normal insolvency proceedings
- Write-down or conversion will only occur after close-out of derivatives, which the resolution has full power to apply.
- The resolution authority can suspend activity under the terms of the derivative for a day following announcement of resolution.
- Bail-in does not apply to secured liabilities, such as repos or collateralised derivatives. However, any unsecured component of such a transaction is eligible.
- Article 55 of the BRRD has attracted particular attention as it requires that for any agreement governed by the law of non-EU state an EU institution is obliged to include a clause detailing the applicability of the BRRD. Note that the absence of a clause does not exempt the agreement from the BRRD, the article is intended more to avoid legal procedures in the non-EU country.

Caveats

The following should also be taken into consideration:

- Although the BRRD is in force it has not yet been fully used in anger. The debate around Deutsche Bank called into question whether there would be the political will to enforce the directive's less palatable measures, although the prospect has been averted for the time being. And recent events regarding Monte de Paschi have seen the Italian government invoke a BRRD option to provide a precautionary recapitalisation[3], thus avoiding resolution itself, while deploying creative means to mitigate the effects on certain creditors. It is debatable whether these are within the spirit of the agreement, and only increase the risk that the directive becomes a dead letter, or perhaps worse, is divisively applied differently in different member states.
- Furthermore, there is some discussion of whether any regulator applying bail-ins would extend this to derivatives giving the complexity of doing so in comparison with other products.

[3]https://www.bankingsupervision.europa.eu/about/ssmexplained/html/precautionary_recapitalisation.en.html

- Even if the derivatives bail-in conditions were applied there is some mitigation provided in the BRRD itself, both in applying netting in any calculation, and ensuring that any bail-in shouldn't create replacement costs exceeding the amount bailed in.

Conclusion

The requirement that resolution should not render a creditor worse off than under normal insolvency proceedings is highly significant, and should provide comfort to counterparties of institutions under resolution, creating as it does a certain equivalence with the pre-existing situation. However, even though this minimizes the impact of BRRD for derivative end-users, there are still some effects to consider:

- Any such 'equivalence' is dependent on the sound judgement of the resolution authority in only applying resolution to institutions which would indeed have become insolvent otherwise. If their judgement is off then losses may be incurred which would not have been otherwise.

- Successful application of resolution and maintenance of contracts may often be preferable to the often protracted recovery of funds under insolvency proceedings.

- The unilateral powers of the resolution authority mean that the evaluation, substitute entity, or equity replacement of derivative contracts are outwith the control of a counterparty and may breach their internal policies or disrupt their regulatory compliance.

- Banks are obliged to abide by Article 55, and include the relevant clause in any documentation governed by the law of a non-EU state.