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ISDA 2016 Bail-in Article 55 BRRD Protocol

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Do you need to take action?

If your fund is party to an agreement covered by the EU Bank Recovery and Resolution Directive ("BRRD") ("BRRD Covered Agreements") and the agreement is governed by the laws of a country other than an EU member state (for example, New York law), you may be required by your dealer counterparty to adhere to the ISDA 2016 Bail-in Article 55 BRRD Protocol.

An investment fund will not be directly subject to the BRRD. However, its EU-based dealer counterparty may be subject to the BRRD, in which case, to ensure its own compliance, the EU-based dealer may require adherence by its fund counterparties.

A typical BRRD Covered Agreement would include an ISDA Master Agreement, and also similar agreements covering other products/types of trades such as global master repurchase agreements and master securities lending agreements, as well as loan agreements.

Brief summary

The EU Bank Recovery and Resolution Directive (defined above as the "BRRD"), which was finalised and published in the Official Journal of the EU in June 2014, addresses "too big to fail" issues by granting powers to resolution authorities in the EU, including a power to write-down, reduce or to convert into equity (the "Bail-in Powers") debts such as net termination amounts resulting from the close-out of all transactions under agreements which fall within the ambit of the BRRD (defined above as "BRRD Covered Agreements").

A 'bail-in', as it commonly known, is a procedure imposed on a failing firm whereby an authority responsible for resolution can require that claims of unsecured creditors of the failing firm are written down and/or converted into equity in order to absorb losses and recapitalise the firm.

The Bail-in Powers are implemented through Article 55 of the BRRD ("Article 55") which requires financial institutions and financial holding companies established in the EU, such as EU banks, dealers and certain EU investment firms (each, a "BRRD Affected Party") to include a contractual recognition clause to acknowledge bail-in powers (the "Bail-in Clause") in BRRD Covered Agreements not governed by the laws of an EU member state.

A Bail-Clause may be included in a BRRD Covered Agreement via the adherence of both parties to the ISDA 2016 Bail-in Article 55 BRRD Protocol (the "Article 55 Protocol"). The Article 55 Protocol is a tool whereby BRRD Affected Parties can ensure their compliance with Article 55 by requiring their counterparties to adhere to the Article 55 Protocol. Adherence by a counterparty may be required by the BRRD Affected Party as a condition of the BRRD Affected Party agreeing to continue to trade with the counterparty.

In more detail….

Whether or not you/your fund will need to take action in respect of Article 55 will depend on answers to the following:

1. are any of your fund's dealer counterparties established in the EU and, if so, can they be classified as financial institutions, credit institutions or investment firms? For example, EU incorporated banks or large investment firms, their EU incorporated holding companies and their US subsidiaries would be considered as BRRD Affected Parties and hence subject to the BRRD requirements;
2. does your fund have any agreements covering certain financial arrangements which may give rise to liability to a BRRD Affected Party? For example, ISDA Master Agreements, as well as global master repurchase agreements, master securities lending agreements, would be classified as BRRD Covered Agreements; and
3. are any of the BRRD Covered Agreements subject to a system of laws other than the laws of an EU member state? A common example would be an ISDA Master Agreement with a BRRD Affected Party which is governed by the laws of the State of New York. This scenario is fairly common, especially when a fund's documentation is sourced out of a US office of a BRRD Affected Party.

If the answers to all of the above questions are yes, your fund may be required by a dealer counterparty (as a BRRD Affected Party) to amend the relevant BRRD Covered Agreements to include a Bail-in Clause or, more likely and more conveniently, your fund may be required by the BRRD Affected Party to adhere to the Article 55 Protocol.

What is the scope of Article 55?

Article 55 refers to BRRD Covered Agreements as agreements which "create liabilities", which appears to include a wide range of liabilities including payment liabilities. Article 55 does not provide an exhaustive list of agreements which are subject to the Bail-In Powers, but swap agreements and loan agreements would be included, as well as financing arrangements such as letters of credit and guarantees.

Article 55 also refers to liabilities which are excluded from its ambit, the most relevant exclusion being "secured liabilities", for which security is provided in respect of any actual or potential liability.
Article 44 of the BRRD provides that a resolution authority may not exercise Bail-in Powers where the BRRD Affected Party's liability is secured. The idea behind this is that whilst 'bail-in' terms may be imposed on claims of unsecured creditors (which may be written down and/or converted into equity to absorb losses), the claims of secured creditors should not be affected.

The European Banking Authority (EBA)'s December 2015 Regulatory Technical Standards (RTS) in relation to the valuation of derivatives pursuant to Article 49(4) of the BRRD refers to "the exclusion of secured liabilities to the extent that the value of the liability does not exceed the value of the collateral", which suggests that secured liabilities which are sufficiently collateralised will be excluded.

The EBA's July 2015 RTS clarify that the Bail-In Clause is required to apply to:

1. "any unsecured portion of a liability even if the liability is otherwise secured"; and
2. a liability that is "fully secured but is not governed by contractual terms that oblige the debtor to maintain the liability fully collateralised on a continuous basis in accordance with regulatory requirements specified in [EU] law or equivalent third country law".

In other words, a liability which is not fully collateralised or is collateralised not in accordance with the regulatory requirements specified in EU law will be subject to the operation of Article 55 and the BRRD Covered Agreement governing such liability will need to be amended to include a Bail-in Clause.

Another way of looking at this is to say that, in order to fall within the secured liability exception, a liability must be fully secured and governed by contractual terms which provide that the liability must be full collateralised on a continuous basis in accordance with the

relevant regulatory requirements.

The precise scope of Article 55 and the criteria whereby liabilities may be treated as excluded remain unclear, which suggests that BRRD Affected Parties are likely to act on the side of caution meaning that, in cases of doubt, they will likely require Bail-in Clauses to be included in BRRD Covered Agreements.

What do the Bail-in Powers entail?

The Bail-in Powers include powers for resolution authorities to write down or convert debt into shares or other instruments of ownership. In practice, this means that a resolution authority, in exercise of its Bail-in Powers, has the right to reduce in part or in full the outstanding early termination amount which results from the close-out of all transactions under the relevant BRRD Covered Agreement, and possibly to convert it into securities issued by the BRRD Affected Party.

What must the Bail-in Clause include?

In order to satisfy regulatory requirements, the Bail-in Clause must include the following components:

1. acknowledgement and agreement by the counterparty of the BRRD Affected Party that liabilities under the relevant BRRD Covered Agreement may be subject to the exercise of write-down and conversion powers by a resolution authority;
2. a description of the write-down and conversion powers of each resolution authority in accordance with national law; and
3. acknowledgement and agreement by the counterparty of the BRRD Affected Party to be bound by the effect of application of Bail-in Powers.

What do you need to do to adhere to the Article 55 Protocol?

In a similar way to other ISDA protocols, the Article 55 Protocol allows market participants to amend their agreements to address regulatory requirements in an efficient manner. Adherence is achieved by a party submitting an adherence letter via the Protocol Management section of ISDA's Website.

Once a party adheres to the Article 55 Protocol, the Article 55 Protocol will apply to all BRRD Covered Agreements between itself and any other party which has adhered to the Article 55 Protocol.

The effect of the Article 55 Protocol is that all BRRD Covered Agreements between adhering parties are deemed to be amended to include the Bail-in Clause.

Is adherence to the Article 55 Protocol mandatory?

No, adherence to the Article 55 Protocol is voluntary. The Article 55 Protocol is a tool whereby parties can amend all of their BRRD Covered Agreements in one go, instead of having to amend each BRRD Covered Agreement with each counterparty via written bilateral amendments. Refusal/failure by a counterparty to adhere to the Article 55 Protocol or refusal to otherwise include a Bail-in Clause in BRRD Covered Agreements is likely to result in a BRRD Affected Party refusing to trade with the counterparty, for the reason that the BRRD Affected Party will need to ensure that it is compliant with Article 55.

What is Article 55 BRRD implementation date?

EU member states are required to implement Article 55 into their national resolution regimes by 1 January 2016.

Which jurisdictions are covered by the Article 55 Protocol?

The BRRD is a directive which must be implemented by each individual EU Member state into its own national law (i.e., its own domestic resolution regime). The Protocol covers jurisdictions which have thus far implemented the BRRD, namely France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain and the United Kingdom.