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The Atypical Creditor: How EU Bail-In Provisions Impact Borrowers

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On January 1, 2016, the European Union's "bail-in" provisions went into effect. The bail-in provisions, authorized under the Bank Recovery and Resolution Directive (BRRD) and implemented by the Single Resolution Mechanism (SRM), provide for financial resolution of covered institutions by cancelling or reducing liabilities of a failing bank, or converting debt to equity, as a means of restoring a financial institution's capital position. The bail-in provisions apply to obligations incurred as of January 1, 2016, and as such when covered institutions enter into transactions governed by non-European law, their contracts need to include a "contractual recognition provision" which gives notice of the bail-in liabilities and obtains acknowledgment by the other parties to the transaction. While borrowers may not readily identify themselves as creditors of their lenders, the liabilities to which the bail-in provisions apply include obligations of lenders to a borrower which might arise under typical loan agreements, including undrawn commitments. On April 10, 2016, HETA became the European Union's first bank to be bailed-in pursuant to these provisions.

Brief Overview

Following the financial crisis, the European Union passed broad sweeping banking regulation known as the Single Rule Book. Among other things, the Single Rule Book establishes capital requirements for banks, ensures protection for depositors, and regulates the prevention and management of bank failures, through regulations and directives including the Bank Recovery and Resolution Directive. The Single Rule Book also serves as the foundation of the formation of a "Banking Union" for Eurozone member states and

for other participating EU member states. The Banking Union is composed of: 1) the Single Supervisory Mechanism (SSM), which places the European Central Bank (ECB) as the central prudential supervisor of financial institutions in the euro area, 2) the Single Resolution Mechanism, whose purpose is to ensure an orderly mechanism for resolution with minimal cost to taxpayers, and 3) the European Deposit Insurance Scheme (EDIS), designed to provide uniform insurance coverage for all retail depositors in the Banking Union with an eye toward ensuring equal protection of deposits throughout the Banking Union regardless of the Member State where the deposit is located.

In the context of the Banking Union, the BRRD and the SRM are complementary; the BRRD provides uniform rules across the EU single market and the SRM sets out the institutional and funding architecture for applying those rules in Member States participating in the Banking Union. One of the primary goals of the BRRD (implemented through the SRM) is the orderly resolution of banks such that their critical functions are preserved, while the non-critical parts of the failed institution are wound down.

The main aims of bank resolution under the BRRD are to: 1) safeguard the continuity of essential banking operations, 2) protect depositors, client assets and public funds, 3) minimize risks to financial stability, and 4) avoid unnecessary destruction of value.

Under the BRRD, resolution authorities are able to exercise clear-cut measures when a bank meets the conditions for resolution: 1) it has reached a point of distress such that there are no realistic prospects of recovery over an appropriate timeframe, 2) all other private sector or supervisory intervention measures have proved insufficient to restore the bank to viability, and 3) winding up the institution under normal insolvency proceedings would risk prolonged uncertainty or financial instability and therefore resolving the bank would be better from a public interest perspective.

Bail-In

Under the BRRD, resolution authorities are granted broad power to: (i) effect private sector acquisitions (parts of the bank can be sold to one or more purchasers without the consent of shareholders); (ii) transfer business to a temporary structure (such as a "bridge bank") to preserve essential banking functions or facilitate continuous access to deposits; (iii) separate clean and toxic assets between “good” and “bad” banks through a partial transfer of assets and liabilities; and/or (iv) ***bail-in*** creditors.

The main aim of bail-in is to stabilize a failing bank so that its essential services can continue, without the need for a bail-out using public funds. A bail-in can take one of two forms.

Open Bank Resolution
In an “open bank resolution,” authorities seek to recapitalize a failing bank through the write-down of liabilities and/or converting liabilities to equity so that the bank can continue as a going concern. In theory, this gives authorities time to reorganize the bank or wind down parts of its business in an orderly manner. In the process, shareholders would be severely diluted or wiped out and management would be replaced. Meanwhile, creditors would endure a haircut as a result of the write-down or alternatively become shareholders of the failing bank.

Closed Bank Resolution
In a “closed bank resolution,” the bank is split in two, a good bank (or bridge bank) and a bad bank. The good bank-bridge bank is a newly created legal entity which continues to operate, while the old bad bank gets liquidated. Bank creditors that are not determined to be systemic are either left with the old bank and undergo losses as part of the liquidation or are transferred to the new

bank either reducing their claims or converting them into equity. Shareholders and holders of other instruments of ownership may have their shares canceled, transferred, diluted, or partially canceled/transferred (a situation in which dilution is combined with cancellation or transfer without cancelling or transferring the instruments in full).

In exceptional circumstances of systemic stress, authorities may also provide public support instead of imposing losses in full on private creditors. However, such measures would only become available after the bank's shareholders and creditors bear losses equivalent to 8% of the bank's liabilities and would be subject to the applicable rules on State aid.

To which liabilities does bail-in apply?

The BRRD applies to all EU credit institutions and large investment firms (i.e. firms with initial capital greater than 730.000 EUR), all EU-based parent and intermediate financial holding companies, and subsidiaries of EU parent credit institutions or the investment firm of financial holding companies. Although the exact degree of burden-sharing depends on the bank in question (its systemic footprint determining minimum maintenance levels subject to bail-in), the amount of losses that need to be covered, and the wider economic situation.

Generally speaking, bail-in applies to any liability of a covered institution which is not fully backed by assets or collateral other than liabilities which are expressly excluded. Thus, bail-in will potentially not apply to deposits protected by a deposit guarantee scheme, short-term inter-bank lending or claims of clearing houses and payment and settlement systems (that have a remaining maturity of seven days), client assets, or liabilities such as salaries, pensions, or taxes. In exceptional circumstances, authorities can choose to exclude other liabilities on a case-by-case basis, if strictly necessary to ensure the continuity of critical services or to prevent widespread and disruptive contagion to other parts of the financial system, or if they cannot be bailed-in in a reasonable timeframe.

What does bail-in mean for borrowers?

While borrowers may not readily identify themselves as creditors of their lenders, the liabilities to which the bail-in provisions apply would include: (i) lending commitments, (ii) any indemnities (limited as they may be) running from the lenders to the borrower and (iii) any other obligations of the lenders to a borrower which might arise under a loan agreement. Accordingly, the ability of a borrower to draw on a line of credit or revolver may be affected, as to a specific lender, by the bail-In. (Other lenders in a syndicated loan facility may also be affected, such as obligations of lenders running to agents in connection with the funding of a loan or letter of credit issuing bank. Additionally, requirements to share or turnover recoveries made from the borrower are similarly applicable "liabilities.") Because these obligations apply to both contractual and non-contractual obligations, they may also include: requirements to obtain borrower consents or consultations prior to assignments of loans from an affected covered institution; certain contractual restrictions typically found in inter-creditor documentation; certain administrative obligations, such as notifications of tax status or requirements to make other notifications or to supply and forward tax related information; and potential claims under loan market documentation such as potential claims in negligence or misrepresentation.[1]

[1] Loan Market Association Bail-In User Guide, Section 1.3(b)(v). See also http://lsta.org/news-and-resources/news/1/the-lsta-publishes-a-form-of-eu-bail-in-contractual-recognition-provision.

When covered institutions enter into transactions governed by non-European law, their contracts (which includes loan and other credit agreements and other typical loan market documentation governed by any U.S. state law) must include a "contractual recognition provision" which gives notice of the bail-in liabilities and obtains acknowledgment by the other parties to the transaction. Failure by a covered institution to include a contractual recognition clause in a contract may lead to considerable fines and regulatory sanctions. Accordingly, borrowers are being required to agree to these "contractual recognition provisions."

Under the BRRD, bail-in applies to obligations incurred after January 1, 2016. However, bail-in may also apply to preexisting agreements if they are amended or new liabilities otherwise arise under the document after January 1, 2016.[2] Accordingly, both new facilities and existing facilities which are being amended may need to have the contractual recognition provisions included.

On April 10, 2016, Austrian regulators became the first to use the European Union's new bail-in process for the resolution of failed banks. With its application, Austrian regulators will force senior creditors of HETA to take a 54 percent haircut on the value of their debts, while all subordinated liabilities endure a 100% bail-in. While the full legal and practical impact remains to be seen, Austrian regulators' use of the new European recovery and resolution framework for banks marks the first step into the uncharted legal and practical world of bail-in provisions.

If you have any questions about the content of this alert please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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[2] According to the Loan Market Association, the obligation to add the "contractual recognition provision" to documentation governed by the law of a non-European country applies if the European financial institution has any potential liability under the document (whether contractual or non-contractual and regardless of its capacity as a party to the document) and if after January 1, 2016, (i) the financial institution becomes a party to the document (either as an original or as a transferee lender), (ii) the document is materially amended, or (iii) new liabilities arise under the document. Loan Market Association Bail-In User Guide, Section 1.1(c).