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# **The impact of Brexit on "bail-inable" liabilities under English law**

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**Title of the paper:**

*The impact of Brexit on “bail-inable” liabilities under English law*

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**Abstract**

*Over three years have passed since 29 March 2017, the date when the United Kingdom (UK) triggered Article 50 of the Treaty on European Union (TEU). This date has become well-known, for paving the way to multiple legal issues, which mostly depend on the finalisation of an agreement setting the conditions for the future relations between the European Union (EU) and the UK. Despite recent political declarations, the Brexit outcome is now clear, and a transitional period has just begun. As a result, for the resolution of credit institutions established in the EU, the bail-in of liabilities previously established under English law could become problematic. To date, the EU framework for the resolution of credit institutions (namely, the Bank Recovery and Resolution Directive – BRRD) lacks a provision for the direct recognition of liabilities governed under third-country law. However, through its Article 55, the BRRD leaves to the EU Member State (MS) the duty to require entities to include “resolution-proof” clauses or, alternatively, to conclude a binding agreement with the relevant third country. This leaves a legislative gap concerning this direct recognition.*

*By analysing the current EU legal framework for the bail-in of liabilities established with contracts governed by third-country law, with a view to identify its weaknesses, this paper aims at addressing possible practical solutions. The purpose is to ease the resolution process for the relevant administrative authority of the EU MS in charge of the resolution procedure, without the need of an immediate intervention of the legislator. Indeed, a solution for such gap in the BRRD might be disentangled outside the Brexit withdrawal agreement, or with specific arrangements between the EU/EU MS and the UK administrative authorities.*

## Introduction

Since the 29 March 2017,<sup>1</sup> date in which the UK triggered Article 50 of the TEU,<sup>2</sup> EU and UK negotiators have been working towards reaching an agreement for the departure of the UK from the “bloc”<sup>3</sup> (i.e. the EU). At the same time, the public and private sector of the “remaining” EU Member States have been preparing (with different degrees of success)<sup>4</sup> to manage the imminent consequences of the unprecedented withdrawal of a Member State from the EU.

Chiefly, a smooth resolution procedure for banks established in the European Union and, at the same time, having subsidiaries and/or branches in the UK<sup>5</sup> is uncertain due to Brexit,<sup>6</sup> especially concerning regulatory issues, which will be discussed in this paper. The resolution of a bank actually means the “restructuring of a bank by a resolution authority [i.e. the Single Resolution Board – SRB<sup>7</sup> – or the National Resolution Authority – NRA<sup>8</sup> – of each of the nineteen euro area Member States]<sup>9</sup> through the use of resolution tools in order to safeguard public interests, including the continuity of the bank's critical functions, financial stability and minimal costs to taxpayers.”<sup>10</sup> The Bank Recovery and Resolution Directive (BRRD)<sup>11</sup> was introduced by EU lawmakers, following the euro area sovereign debt crisis,<sup>12</sup> as a measure to reduce negative spillover effects on the economic system and to avoid the cost of serious bailouts<sup>13</sup> on taxpayers. Among the tools provided by the BRRD, the bail-in

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<sup>1</sup> The decision to trigger Article 50 TEU was taken following the vote of the referendum on the 23 June 2016 in the United Kingdom, where the majority of the voters opted to leave the European Union. For the complete Brexit timeline, see **Walker (2020)**.

<sup>2</sup> OJ C 202, 7.6.2016, p. 43.

<sup>3</sup> The term “bloc” means a trading bloc. **Schott (1991)** explains that a trading bloc is “an association of countries that reduces intra-regional barriers to trade in goods (and sometimes services [...] and capital as well).”

<sup>4</sup> This statement concerns the banking sector as, in August 2009, following the Council decision for the extension of the withdrawal period until the 31 October 2019, the European Central Bank (ECB) warned the euro area entities that “as a result of the delays observed, banks will not be able to fully implement their target operating models within the timelines agreed with their supervisors”, with the consequence that, euro area bank’s negligence in preparing for Brexit “could have [had] a negative impact on banks’ profitability”. On the topic, see **European Central Bank (2019)**.

<sup>5</sup> Or for an EU subsidiary of a group headquartered in the UK.

<sup>6</sup> In 2018 the European Commission released a document addressed to stakeholders in order to warn them about the upcoming risks to be potentially caused by Brexit in the field of banking and payment services. See **European Commission (2018)**, pp. 3-4.

<sup>7</sup> See **Iglesias-Rodríguez (2019)**, pp. 192-199.

<sup>8</sup> Article 3(1)(3) of the Single Resolution Mechanism Regulation (SRMR) provides a definition of NRA, see OJ L 225, 30.7.2014, p. 22. Moreover, in the Banking Union (BU), the relevant NRA of each of the participating Member States is responsible for banks other than those under the mandate of the SRB as stated in Article 7(2), (4)(b) and (5) SRMR, see OJ L 225, 30.7.2014, pp. 26-27.

<sup>9</sup> Please note that the BRRD applies to all the EU Member States, while the administrative authority responsible to lead the resolution procedure differs from the BU, where the dualism SRB/NRAs – Significant Institutions (SIs)/Less Significant Institutions (LSIs) is absent and each non-participating (i.e. non-BU) Member State has its own (administrative) resolution authority which is not part of the Single Resolution Mechanism (SRM). On the topic, see **Alexander (2015)**, p. 155.

<sup>10</sup> See **Single Resolution Board**.

<sup>11</sup> OJ L 173, 12.6.2014, pp. 190-348.

<sup>12</sup> The sovereign debt crisis in the euro area, according to **Kräussl, Lehnert and Stefanova (2017)**, was caused by “the subprime mortgage market in the U.S [which] ignited the 2008 banking crisis [turning] into a global recession. A series of financial sector bailouts in 2008 sparked a full-blown sovereign debt crisis in Europe.”

<sup>13</sup> A bailout is a procedure aimed at providing financial support to a distressed financial institution through public funding.

instrument<sup>14</sup> facilitates the absorption of losses and the recapitalisation of an entity through the write down<sup>15</sup> and conversion<sup>16</sup> of liabilities. In the framework of this instrument, Article 55 BRRD<sup>17</sup> sets the rules for the “contractual recognition of bail-in”,<sup>18</sup> being thus one of the key features ensuring the proper functioning of the bail-in tool.

The advent of Brexit has opened up the possibility of a future disapplication of EU law in the UK and subsequently the potential repeal of relevant EU directives.<sup>19</sup> Consequently, the condition of contractual agreements establishing liabilities as per the English law has suddenly become burdensome. Due to the lack of entrenchment of EU law, there is the risk that the automatic recognition of liabilities between the UK and the “remaining” EU MS might no longer apply. In fact, the risk of the no longer automatic recognition of contractual liabilities could have unexpected negative consequences directly on the amount of the liabilities which could be subject to conversion or write down when applying the bail-in tool, an issue under analysis in the section concerning this specific resolution tool.<sup>20</sup> Moreover, as flagged by the EBA, a Court of a third country may decide not to recognise the effect of the decision of an EU resolution authority.<sup>21</sup>

As a result, this could adversely impact the success of the whole resolution procedure by weakening the effectiveness of the application of the bail-in tool. Accordingly, this paper seeks to answer to the question on how Brexit will impact the write down or conversion of liabilities and the related instruments governed under English law. This will be achieved assessing the impact of Brexit on a future framework in which contracts governed by English law, which an EU financial institution is a party to, will have to be compliant with Article 55,<sup>22</sup> as the UK became *de iure*<sup>23</sup> and *de facto* a third country.<sup>24</sup>

The current legal framework for the resolution of credit institutions which applies to both the BU<sup>25</sup> and the remaining non-participating EU Member States<sup>26</sup> requires banks to have “resolution-proof” clauses in their contracts establishing liabilities.<sup>27</sup> Contracts which fall under the scope of this paper

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<sup>14</sup> See the “bail-in tool” section below.

<sup>15</sup> Reduction of the value of an asset to offset a loss or expense.

<sup>16</sup> This modification entails the conversion of debt (liability) into equity.

<sup>17</sup> OJ L 173, 12.6.2014, p. 286.

<sup>18</sup> *Ibid.*

<sup>19</sup> Including the BRRD.

<sup>20</sup> See the “bail-in tool” section below.

<sup>21</sup> On the topic, see EBA/CP/2014/33, p. 19.

<sup>22</sup> Starting from 1 January 2016, Article 55 BRRD requires entities under its remit to include contractual terms for the recognition of the bail-in tool for agreements governed by the law of third-country Member States.

<sup>23</sup> Since 1 February 2020.

<sup>24</sup> In the sense linked to this article, a “third country” is a State which is not part of the European Union. Such denomination is regularly used in the EU legislation. In addition, the use of the conditional form is due to the fact that the UK could still be part of EEA or other forms of closer relationship with the EU.

<sup>25</sup> The BU was born as a response to the financial crisis with the aim of establishing deeper integration and lowering risks for the European economy. Despite not having reached yet full completion (lack of a BU wide Deposit Insurance Scheme), the first two pillars of the BU (supervision and resolution) are operational. On the future steps in order to complete the BU, see COM(2017) 592 final, pp. 1-20.

<sup>26</sup> See note 12 above.

<sup>27</sup> During the resolution phase, it is important to maintain the operational continuity and to deliver the critical functions to the economy where an entity operates. As a firm enters resolution, there is a concrete risk that some parties could opt to avoid risks through the termination of the contracts they have in place with the concerned entity. This is a clear example

are those governed by the law of a EU Member State or the law of a third country, only if “the resolution authority of a Member State determines that the liabilities or instruments referred to in the first subparagraph [of Article 55 BRRD] can be subject to write down and conversion powers by the resolution authority of a Member State pursuant to the law of the third country or to a binding agreement concluded with that third country.”<sup>28</sup> Such determination from the resolution authority serves as a safeguard so that, in case of a resolution decision which applies the bail-in tool as preferred resolution strategy,<sup>29</sup> liabilities established with contracts under third-country law could be equally subject to the write down and conversion as those under EU law<sup>30</sup> For example, this could help the enforcement of a cross-border resolution action.<sup>31</sup>

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of a barrier to resolvability that can be removed by making contracts able to “survive” in case of resolution, and therefore, become “resolution-proof”. For a broader explanation of the UK resolution regime, see **Bank of England (2017)**.

<sup>28</sup> See OJ L 173, 12.6.2014, p. 286.

<sup>29</sup> In line with Article 10 BRRD, resolution strategies followed by the relevant resolution authority are those detailed in the resolution plan, see OJ L 173, 12.6.2014, p. 228. It is important to specify that the solution in the plan is a preferred resolution strategy, meaning that all the authorities involved in the resolution procedure (e.g. for the BU, the European Commission or the Council) can modify the strategy to be implemented. On the topic, see **Single Resolution Board (2016b)**.

<sup>30</sup> These specific liabilities under EU law are governed by the BRRD.

<sup>31</sup> See **Financial Stability Board (2015a)**, p. 6.

## The bail-in tool

The bail-in tool,<sup>32</sup> together with the sale of business tool, the bridge bank tool and the asset separation tool, was initially established with the guiding principles for an effective bank resolution, namely the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions.<sup>33</sup> According to the Financial Stability Board's Key Attributes Assessment Methodology for the Banking Sector, the bail-in tool is a restructuring mechanism "that enable[s] loss absorption and the recapitalisation of a bank in resolution or the effective capitalisation of a bridge institution through the cancellation, write-down or termination of equity, debt instruments and other senior or subordinated unsecured liabilities of the bank in resolution, and the conversion or exchange of all or part of such instruments or liabilities (or claims thereon) into or for equity in or other instruments issued by that bank, a successor (including a bridge institution) or a parent company of that bank."<sup>34</sup>

Consequently, EU legislators decided to include in the directive the requirement for EU credit institutions to introduce a clause stating the recognition of the bail-in tool in their contracts with third-country parties. This choice was made in the interest of an efficient application of the bail-in tool and it was already present in the FSB's principles. Despite not ensuring absolute certainty about a Court enforcement of such contracts, the FSB highlights the need of bail-in recognition clauses for strengthening the "cross-border enforceability of bail-in actions".<sup>35</sup> This instrument also plays a crucial part for a successful resolution procedure, allowing the concerned party to the contract to be aware that the liabilities agreed upon, even if subject to the jurisdiction of third-country law, could be subject to a write down or conversion. Accordingly, the bail-in tool aims at recovering the losses faced by the credit institution put under resolution. More specifically, the provision of Article 55 BRRD clearly sets that "[EU] Member States shall require institutions and entities [...] to include a contractual term by which the creditor or party to the agreement creating the liability recognises that liability may be subject to the write down and conversion powers and agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority, provided that such liability is: [...] (c) governed by the law of a third country."<sup>36</sup> This Article combines, at the same time, principles of information and transparency for the party who subscribes the contract which establishes the liability and, it also makes the application of the bail-in tool less burdensome for the relevant resolution authority.<sup>37</sup> Additionally, Article 55 BRRD<sup>38</sup> foresees the possibility for the resolution authority to request for legal opinions with a view to ensuring the recognition of the bail-in clause in the third-country jurisdiction.

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<sup>32</sup> For an early analysis of the bail-in tool, which includes an explanation of what is meant for "bail-inable" liability, see **Armour (2015)** pp. 474-475.

<sup>33</sup> See **Financial Stability Board (2014)**, p. 9. For a critical view on bail-in and the risks that could arise from its application, including a parallel with bailouts, see **Avgouleas and Goodhart (2015)**, pp. 3-29.

<sup>34</sup> See **Financial Stability Board (2016)**.

<sup>35</sup> See **Financial Stability Board (2015a)**, pp. 6-7.

<sup>36</sup> OJ L 173, 12.6.2014, p. 286.

<sup>37</sup> Including the successive valuation procedure described in Article 36 BRRD. On the topic, see OJ L 173, 12.6.2014, p. 253 and **de Groen (2018)**, pp. 8-9.

<sup>38</sup> OJ L 173, 12.6.2014, p. 286. This Article became Article 55(3) with the adoption of the BRRD2, see OJ L 150, 7.6.2019, p. 337, but the text of the Article was left as before. In **Single Resolution Board (2020b)**, p. 32, the SRB detailed several elements which should constitute "a satisfactory legal opinion".

Furthermore, Article 44 of the Commission Delegated Regulation 2016/1075<sup>39</sup> specifies in detail the content that the contractual recognition clause has to include.<sup>40</sup> Among other elements, it shall include a clear “acknowledgement and acceptance by the counterparty of an institution or entity [...] that the liability may be subject to the exercise of write-down and conversion powers by a resolution authority”<sup>41</sup> and “a description of the write-down and conversion powers of each resolution authority in accordance with the national law”.<sup>42</sup>

While the BRRD2<sup>43</sup> left unaltered the previously mentioned requirements of Article 44, it changed substantially the core rules concerning bail-inable liabilities, namely Articles 45 and 55 BRRD.

Article 45 BRRD<sup>44</sup> allowed the concerned resolution authority to disregard certain liabilities in case that it would not be possible to demonstrate the effectiveness of the bail-in. This was modified with the adoption of the BRRD2, in particular by Article 55(2).<sup>45</sup> This Article introduced a more restricted circumstance, ruling out the discretion of the resolution authority and determining the exclusion of the liability under two conditions only, namely the absence of a cross-border framework agreement for its recognition or the lack of a recognition clause.<sup>46</sup> However, these principles do not apply to liabilities established before the transposition of the original BRRD text on 31 December 2014,<sup>47</sup> which includes the liabilities governed under English law established until the above deadline.

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<sup>39</sup> OJ L 184, 8.7.2016, pp. 35-36.

<sup>40</sup> It refers to Article 55(1) BRRD.

<sup>41</sup> OJ L 184, 8.7.2016, p. 35.

<sup>42</sup> OJ L 184, 8.7.2016, p. 36.

<sup>43</sup> OJ L 150, 7.6.2019, pp. 296–344.

<sup>44</sup> OJ L 173, 12.6.2014, p. 272.

<sup>45</sup> OJ L 150, 7.6.2019, p. 337. See also **Single Resolution Board (2020b)**, p. 31.

<sup>46</sup> Such clause should follow Article 55(1) BRRD2 (OJ L 150, 7.6.2019, p. 336).

<sup>47</sup> It must be signaled that, by the date of the transposition deadline, only two EU MS were compliant. Cfr. COM(2019) 213 final, p. 2.

## The MREL requirement

The missing element of the puzzle, which allows to draw the full picture showing the importance of the protection of “bail-inable” liabilities, is the Minimum requirement for own funds and eligible liabilities (MREL). Indeed, Article 55 BRRD eases the formation of the MREL by the EU credit institution, including its determination by the responsible resolution authority. According to Article 12(1) and (2) SRMR, the MREL is a requirement determined by SRB<sup>48</sup> and NRA(s)<sup>49</sup> towards banks under the scope of the Regulation.<sup>50</sup> The MREL secures a minimum amount of a specific type of liabilities,<sup>51</sup> which can be used to “ensure that banks at all times have enough capital and eligible liabilities to facilitate”<sup>52</sup> the absorption of the losses and recapitalisation (in case an application of the bail-in tool), thus favouring the continuation of its critical functions.<sup>53</sup> Resolution authorities in the European Union are in charge of the MREL determination,<sup>54</sup> hence they have to assess whether the liabilities to be count as MREL are suitable and qualify for such amount. Consequently to the main issue of this paper, a number of liabilities established with contracts governed by English law, which were already deemed eligible for the MREL requirement of EU credit institutions,<sup>55</sup> would require the concerned EU resolution authorities to recalculate such amount in the case that (after the UK would have definitely left the EU)<sup>56</sup> the UK would decide not to apply the BRRD (or not to align to its standards) any longer. This paper argues that, even in the event of the repeal of the BRRD by the UK, it might (most probably) still follow and apply the Total Loss-Absorbing Capacity (TLAC) standards for its Global Systemically Important Banks (G-SIBs), which have the same purpose of the MREL. Although TLAC and MREL are quite similar in scope, TLAC applies only to G-SIBs, while MREL applies to all European banks. This means that all UK banks are included in the scope of the MREL, that is why the UK might decide to reduce those requirements back to only its G-SIBs, thus following the US approach.<sup>57</sup>

In order to prevent such adverse scenario, the issue concerning “bail-inable” liabilities was already flagged in late 2017 in an Opinion by the European Banking Authority (EBA).<sup>58</sup> The EBA specified that, in the post-Brexit scenario, “English law instruments should be treated no differently from any

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<sup>48</sup> With the consultation of the ECB and other competent authorities. See OJ L 225, 30.7.2014, p. 35.

<sup>49</sup> *Ibid.*

<sup>50</sup> Meaning that the determination of MREL for banks established within the BU is a duty of (respectively) the SRB and NRA(s). However, it should be clear that MREL requirements arising from the BRRD as from Article 45 BRRD apply to all banks established in the European Union. See OJ L 173, 12.6.2014, p. 271.

<sup>51</sup> Liabilities which count for the MREL are calculated based on the requirements of Articles 92 and 500 CRR and Articles 104 and 128 CRD. For the methodology developed by the SRB, which is based on the criteria outlined in the BRRD, see **Single Resolution Board (2016a)**, pp. 14-16. For the legal texts, see OJ L 176, 27.6.2013, pp. 64-65, 285-286 and OJ L 176, 27.6.2013 pp. 70 and 83.

<sup>52</sup> See **Single Resolution Board (2016a)**, p. 8.

<sup>53</sup> Critical functions are those “activities performed by a bank for third parties, where failure would lead to disruption of services critical to the functioning of the real economy and for preserving financial stability” as lending to Small and medium-sized enterprises (SMEs), see **Binder (2016)**, pp. 13-14, **Financial Stability Board (2016)** and specifically for the identification of critical functions, **Financial Stability Board (2013)**. For the SRB’s approach about Critical Functions, see **Single Resolution Board (2017)**.

<sup>54</sup> As stated in Article 12(1) SRMR.

<sup>55</sup> MREL determinations are being made by resolution authorities since 2016.

<sup>56</sup> Following the end of the transition period.

<sup>57</sup> See **Financial Stability Board (2015b)**.

<sup>58</sup> In 2018, the ECB set supervisory expectations based on this EBA Opinion. See **European Central Bank (2018)**, p. 3.



other non-EU [i.e. third-country] instruments, in the absence of an agreement to the contrary.”<sup>59</sup> The Opinion of the EBA was not just serving as a warning about the treatment of post-Brexit English law liabilities. On the other hand, it already advised resolution authorities of the EU to instruct credit institutions under their remit. Specifically, to include the Article 55 BRRD clause as to safeguard the eligibility of their newly “issue[d] MREL-eligible instruments under English law”<sup>60</sup> or otherwise opt to issue the same instruments under the law of any of the other EU-27 Member States. The EBA also suggests renegotiating those contracts which issue this type of instruments lacking a “resolution-proof” clause. However, it will be mentioned also later in this paper<sup>61</sup> that, the renegotiation of such contracts would be possibly taken as the last option by EU credit institutions. In fact, it is a costly operation and increases the risk of concluding a more costly contract, also due to the new safeguards which will have to be included.<sup>62</sup> Apart from MREL concerns, EBA suggests that EU resolution authorities should still ensure that those English law liabilities will be subject to a bail-in procedure.<sup>63</sup> In this paper are reflected the consequences of Brexit for the MREL of all the European Union’s credit institutions, included those of the BU. Therefore, it is important to mention an additional duty of resolution authorities of the participating MS of the BU arising from Article 12(17) SRMR. In the circumstance covered by this Article, which is the situation of a third-country law liability, the SRB can instruct the relevant NRA(s) to “require the institution to demonstrate that any decision of the (SRB) Board to write down or convert that liability would be effected under the law of that jurisdiction.”<sup>64</sup> The SRMR suggests (in quite broad terms) that the NRA(s) should verify the compliance of the concerned liabilities with bail-in powers through the contractual terms of the liability or “international agreements on the recognition of resolution proceedings.”<sup>65</sup> This last requirement (also examined in the following section) would be preferable for the post-Brexit scenario as the Parties [i.e. EU-UK] will have to handle the issue of the recognition of “bail-inable” liabilities – preferably – within the transitional period.

In the interest of the safeguard of the resolution powers in the BU, the SRB issued a position paper drawing the attention to key areas that could be affected by Brexit, including MREL. The SRB reiterated the need to include bail-in recognition clauses in contracts issuing MREL and “governed by the laws of the UK or third countries”.<sup>66</sup> At the same time, with the aim of achieving legal certainty, the SRB suggested to banks to issue MREL instruments “under the governing law of one of the EU27 Member States”.<sup>67</sup> The SRB acknowledged that possible MREL shortfalls could arise because of Brexit and some MREL issuances under English law could become not eligible. As a result, these instruments could “rank *pari passu* with MREL eligible liabilities negatively impacting the no creditor worse-off risk”.<sup>68</sup> In other words, having in force contracts which are not “resolution-proof” represents a concrete risk of complicating a future resolution procedure. If the contractual provisions

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<sup>59</sup> See EBA/Op/2017/12, p. 18.

<sup>60</sup> *Ibid.*

<sup>61</sup> See the last paragraph of the next section.

<sup>62</sup> The Prudential Regulation Authority (PRA) advised that the modification would require “contract renegotiation costs.” See **Bank of England (2016a)**, p. 10.

<sup>63</sup> EBA/Op/2017/12, p. 19.

<sup>64</sup> OJ L 225, 30.7.2014, p. 37.

<sup>65</sup> *Ibid.*

<sup>66</sup> See **Single Resolution Board (2018)**, p. 3.

<sup>67</sup> *Ibid.*

<sup>68</sup> *Ibid.*

would not be adopted to all the third-country law bail-inable liabilities, there could be the risk that the creditors with similar claims will not be treated fairly, breaking the no creditor worse off (NCWO) principle.<sup>69</sup>

This SRB approach was confirmed in its latest policy concerning MREL issuances under the new Banking Package.<sup>70</sup> The SRB dedicated an entire section to liabilities issued under third-country law, which proves the growing interest and concern for this matter. The relevance of the topic is directly associated with the changes introduced by the BRRD2 in favour of Article 55.<sup>71</sup> In this document, the SRB confirmed the willingness to exclude certain liabilities from the MREL amount whether they would put the “effective exercise of the write-down and conversion powers at risk”,<sup>72</sup> notwithstanding the governing law of these same instruments. Moreover, it stated that the responsibility to ensure the eligibility of such instruments lies within the banks,<sup>73</sup> an interpretation already affirmed in 2018.<sup>74</sup> Lastly, for the sake of clarity and for guiding the banks in their path to achievement of resolvability, in its Expectations for Banks the SRB stressed the need for them to include “contractual bail-in recognition clauses for eligible liabilities governed by the law of third countries by which holders explicitly recognise that the liability may be subject to the write-down and conversion powers and other relevant powers of EU resolution authorities, and be prepared to demonstrate that any decision of a resolution authority would be effective”.<sup>75</sup>

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<sup>69</sup> See **Schelo, S. (2015)**, pp. 82-84.

<sup>70</sup> See **Single Resolution Board (2020b)** and the previous section concerning the bail-in tool.

<sup>71</sup> OJ L 150, 7.6.2019, pp. 336-338.

<sup>72</sup> See **Single Resolution Board (2020b)**, p. 33.

<sup>73</sup> *Ibid.*

<sup>74</sup> Cfr. **Single Resolution Board (2018)**.

<sup>75</sup> See **Single Resolution Board (2020a)**, pp. 20-21.

## ***Bail-inable liabilities in the English law***

In this section, this paper examines how the protection of these liabilities is established under English law. In the UK, the Financial Services (Banking Reform) Act 2013 included the above requirement in its legislation through the Bail-In Recognition Clause (BIRC). The BIRC sets out the implementation of the powers arising from the BRRD through the Bail-in stabilisation option.<sup>76</sup> This includes, among others, the competence of the Bank of England to write down and convert liabilities. In parallel, this power is mandated by the SRMR to (administrative) resolution authorities in the BU.<sup>77</sup> Article 55 BRRD is also incorporated in the Policy Statement (PS) 17/16 of the PRA Rulebook,<sup>78</sup> which has the function of providing feedback to the Consultation Paper 8/16<sup>79</sup> on the amendments to PRA rules concerning the contractual recognition of bail-in.<sup>80</sup> PS 17/16 states that “Article 55 requires firms to include in certain non-EU law contracts governing liabilities a term by which the relevant creditor or party to the contract recognises that the liability may be bailed in by the Bank of England as resolution authority”<sup>81</sup> For this reason, Policy Statement 17/16 “is relevant to BRRD undertakings to which the Contractual Recognition Part of the PRA Rulebook applies.”<sup>82</sup> Moreover, the stability of liabilities created within the EU is compounded by the fact that “for EU law governed contracts, the BRRD will automatically apply and no explicit clause is required”,<sup>83</sup> exposing vulnerabilities for future contracts under post-Brexit English law. Precisely, in the case that EU law would no longer be applicable in the UK, as no clause was previously required in contracts establishing liabilities governed by English law (or having a Party to the contract subject to the UK legislation), in the absence of an explicit recognition explained below, the write down or conversion of such liabilities would result highly problematic. In point of fact, the Article 55 requirement presupposes that “the creditor or party [from a third country] creating the liability [on or after 1<sup>st</sup> January 2016] is expected to recognise that [it] may be written down or converted [...] in the event of an EU bank rescue situation.”<sup>84</sup> This condition protects third-country contractual parties and informs them of their possible exposure to the losses of a failing financial entity.

The choice of the European legislator to avoid direct recognition is most probably linked to the need to leave a certain degree of discretion to the national authorities in the application of the bail-in tool against liabilities established with contracts under the law of a third country, which seems legitimate. However, the decision of the inclusion of a contractual clause for the recognition of the liabilities under third-country law, as valid for write down or conversion in case of the application of the bail-in tool, has been put on the shoulders of the EU MS resolution authorities. Indeed, under Article 45(5) BRRD, any resolution authority of the BU may request an entity to prove that any decision to write

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<sup>76</sup> **Financial Services (Banking Reform) Act 2013**, Chapter 33, Part 3(17).

<sup>77</sup> For example, Article 21(1) SRMR gives the powers to write down or convert liabilities to the SRB, which (according to Article 22 SRMR) instructs the NRAs to exercise those powers. See OJ L 225, 30.7.2014, pp. 48-49.

<sup>78</sup> For the full statement, see **Bank of England (2016b)**.

<sup>79</sup> **Bank of England (2016a)**.

<sup>80</sup> **Bank of England (2016b)**.

<sup>81</sup> According to the **Banking Act 2009**, Chapter 1, the Bank of England is the designated authority for exercising resolution powers, which are called “stabilisation powers”.

<sup>82</sup> *Ibid.*

<sup>83</sup> See **Hingley and Prowse (2016)**.

<sup>84</sup> See **Labbé (2016)**.

down or convert liabilities coming from one of the resolution authorities will be recognised under the law of the third country.<sup>85</sup> In such case, a preferable solution would be the conclusion of an *ad-hoc* binding agreement between the EU resolution authority of a specific Member State and the third-country party to the contract (i.e. the UK in the case of Brexit) on the recognition of the concerned liabilities. The inclusion of BIRCs in contracts governed by third-country law, where EU credit institutions are one of the parties, might (internally) force them not to comply immediately with the Article 55 requirement. In fact, credit institutions could be reluctant to proceed with the renegotiation of such contracts to protect themselves from additional costs. This can be explained with the fact that after the gradual adoption of the contractual recognition of the bail-in requirement by the PRA,<sup>86</sup> the same authority introduces the possibility of a waiver. By means of this waiver, the PRA allowed concerned institutions to do not apply the requirement for phase 2 liabilities as from 1 January 2016, delaying it to 30 June 2016. This waiver could have been granted for reasons related to the “impracticability”<sup>87</sup> of its application, which proves the previously mentioned renegotiation issues.

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<sup>85</sup> See OJ L 173, 12.6.2014, p. 272. However, as it was explained in the last paragraph of the above section on the bail-in tool, such requirement was modified with the adoption of the BRRD2, including the new Article 55(3).

<sup>86</sup> The PRA calls this graduality as a “phased approach”. It differentiates between phase 1 and phase 2 liabilities. Phase 1 liabilities include unsecured debt instruments, additional tier 1 (AT1) and tier 2 instruments. On the other hand, phase 2 liabilities consist of “unsecured liabilities which are not debt instruments”. See **Bank of England (2016a)**, p.6.

<sup>87</sup> **Bank of England (2016a)**, pp. 6-7. For PRA conditions to determine impracticability, see **Bank of England (2016c)**.

## Recent Brexit Developments

The definitive departure of the UK from the EU started in late 2019 with a statement by the Prime Minister Boris Johnson,<sup>88</sup> in which he declared that his mandate was to “get Brexit done”<sup>89</sup> by 31 January 2020. Few weeks earlier, with the draft Decision of the Council On 28 October 2019 the Council announced a new “Brexit date” with a draft Decision<sup>90</sup>, and voted the related official Decision<sup>91</sup> on 30 October 2019. On the same day, the UK voted the “Exit Day” amendment.<sup>92</sup> On 19 December 2019, the UK Government published the European Union (Withdrawal Agreement) Bill<sup>93</sup> which, after receiving the Royal Assent by the Queen,<sup>94</sup> became officially an Act of the Parliament, namely the European Union (Withdrawal Agreement) Act 2020.<sup>95</sup> After the approval by the European Parliament<sup>96</sup> and the subsequent final vote by the Council,<sup>97</sup> as of the 31 January 2020 the Agreement on the withdrawal of the UK from the EU is in force.<sup>98</sup> Concerning this study, upon the official withdrawal from the EU, starting from 1 February 2020 the UK has entered a transitional period. This means that (for the moment) even if Article 50(3) TEU states that “the Treaties shall cease to apply to the State in question [i.e. the UK] from the date of entry into force of the withdrawal agreement”,<sup>99</sup> according to Article 127 of the Withdrawal Agreement,<sup>100</sup> the same Treaties and, generally, EU law still apply as the day before.<sup>101</sup> This includes all the provisions related to Article 55 BRRD, including the BIRC requirement.

Having said that, on the assumption that the Parties will be still eager to follow the path of equivalence in financial regulation, a twofold scenario can be summarised as follows. Firstly, in the case that the UK government might decide to repeal EU regulations and directives, the powers mandated from the BRRD to the Bank of England will cease, but similar regulations might probably be recognised by other EU resolution authorities. On the other hand, taking into consideration that the BRRD has a European Economic Area (EEA) relevance,<sup>102</sup> depending on the future relationship between the EU and the UK, such directive could still apply in the UK. The supporting argument<sup>103</sup> relies on the fact that many of the proposals which derive from the Financial Stability Board (FSB)<sup>104</sup> – in which the

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<sup>88</sup> Following the UK’s General Elections of the 12 December 2019, introduced with the **Early Parliamentary General Election Act 2019**, Chapter 29.

<sup>89</sup> See the speech by **Johnson (2019a)**.

<sup>90</sup> EUCO XT 20024/1/19 REV 1, pp. 1-9. Also, for the communication acknowledging the receipt of the draft Council Decision and PM Boris Johnson’s comments, see **Johnson (2019b)**.

<sup>91</sup> OJ L 278I, 30.10.2019, pp. 1-3.

<sup>92</sup> See **European Union (Withdrawal) Act 2018 (Exit Day) (Amendment) (No. 3) 2019**, Regulation 2 No 1423.

<sup>93</sup> See **European Union (Withdrawal Agreement) Bill 2019**.

<sup>94</sup> **Royal Assent**, Volume 670.

<sup>95</sup> **European Union (Withdrawal Agreement) Act 2020**, Chapter 1.

<sup>96</sup> See P9\_TA(2019)0016, pp. 1-7.

<sup>97</sup> OJ L 29, 31.1.2020, p. 1–6.

<sup>98</sup> OJ L 29, 31.1.2020, p. 7–187.

<sup>99</sup> OJ C 202, 7.6.2016, p. 43. On the topic, see also PE 577.971, pp. 1-8.

<sup>100</sup> OJ L 29, 31.1.2020, p. 66.

<sup>101</sup> See **Bank of England (2020)**.

<sup>102</sup> OJ L 173, 12.6.2014, p. 190. Meaning that the rules of the BRRD are valid not only for all the EU Member States, but also to Iceland, Liechtenstein, and Norway, which are part of the EEA.

<sup>103</sup> Apart from cost/benefit considerations related to a future disapplication of EU law in the UK.

<sup>104</sup> Referring particularly to the FBS’s Key Attributes.

Bank of England and the HM Treasury are member institutions<sup>105</sup> – were subsequently incorporated in the text of the BRRD. It is thus legitimate to assume that, following Brexit, the UK will continue to align with international and European standards, including those regarding the protection of contracts establishing “bail-inable” financial instruments.<sup>106</sup>

Continuing with the post-Brexit scenario, whether the Parties would fail to reach an agreement during the transitional period, EU credit institutions would be in a position of constraint to include a BIRC on all contracts governed by English law. Otherwise, if EU credit institutions would decide to maintain current contracts lacking a “resolution-proof clause”, the following adverse scenario might apply. In the event of a resolution procedure with a bail-in preferred resolution strategy, liabilities and instruments set with contracts that have relied upon the direct effect of the BRRD (hence, not including the “resolution-proof” clause) could be not immediately subject to the write down or conversion. In fact, the relevant resolution authority could decide to leave out those liabilities, therefore causing imbalances in the recovery of the losses and/or recapitalisation of the EU credit institution under resolution. However, the designated authority could decide to proceed by applying the bail-in tool also to those third-country law liabilities. In such case, a duality of situations would arise in relation to the behaviour of the court, in blocking the resolution decision or in disapplying the bail-in for certain liabilities.

The previous scenarios show the importance of the Article 55 requirement, even if it was conceived with the adoption of the BRRD back in 2014. Not predicting Brexit, the BRRD already created a sort of safeguard mechanism requiring credit institutions under its scope to include the recognition of the bail-in clause in all contracts involving the creation of liabilities which could be considered “bail-inable”. Therefore, no problems would have arisen if all existing liabilities of EU credit institutions were “bail-inable”. Out of all the current “bail-inable” liabilities, the most problematic are those established with contracts prior the implementation of the BRRD by the EU Member States, which was expected by 31 December 2014.<sup>107</sup> In addition, the introduction of the BRRD2, as explained, will provide with further implications because of the modifications on Articles 45 and 55 BRRD. Accordingly, the UK may decide not to adopt BRRD2, due to the fact that its transposition is set for the 28 December 2020,<sup>108</sup> thus almost matching the expected end of the transitional period. Whether it is unlikely that the EU and the UK would reach an agreement by that time, as it was previously mentioned, also for the transposition of the original BRRD text the highest majority of the EU MS did not adopt it in their national jurisdictions on time.

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<sup>105</sup> See **Financial Stability Board (2020)**.

<sup>106</sup> On the topic, see **HM Treasury (2019)**.

<sup>107</sup> See COM(2019) 213 final, p. 2.

<sup>108</sup> OJ L 150, 7.6.2019, p. 304.

## Conclusion

The current transitional period, which will last until the end of the year 2020, represents the most important phase because the EU and the UK should – in principle – conclude by this date<sup>109</sup> any agreement, which will set their future relationship. Undeniably, the Parties have more politically sensitive negotiations to undertake (i.e. the internal market) than to focus on the recognition of third-country law contractual liabilities. However, the European Commission issued a recommendation<sup>110</sup> asking the Council the authorisation to formally open the negotiations with the UK and, simultaneously, to be nominated as negotiator on behalf of the EU. Such document is important for the current analysis because – in its section IV – it gives an idea of the strategy that the EU and the UK will pursue. Apart the preservation of financial stability,<sup>111</sup> they made clear that “noting that both Parties will have equivalence frameworks in place that allow them to declare a third country’s regulatory and supervisory regimes equivalent for relevant purposes, the Parties should start assessing equivalence with respect to each other under these frameworks as soon as possible after the United Kingdom’s withdrawal from the Union.”<sup>112</sup>

As a result, if the UK will decide to maintain alignment of its BIRC requirement to the BRRD,<sup>113</sup> it is reasonable to expect for the resolution authorities of the “remaining” 27 EU Member States to determine that “bail-inable” liabilities under English law will still be subject to write down and conversion. At the same time, it is important to underline that the updates of the terms of new contracts provided by several credit institutions of the EU-27 are definitely helping to overcome this issue.<sup>114</sup> However, with reference to pre-BRRD existing contracts, the journey towards the protection of those liabilities can be considered still challenging.

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<sup>109</sup> If the Parties will decide to extend such transition period, this can be done only once to a maximum of two years’ time, with a decision by the EU-UK Joint Committee on the extension to be taken before 1 July 2020.

<sup>110</sup> See COM(2020) 35 final, p. 16. This recommendation is based on the revised political declaration on the future EU-UK relationship, cf. OJ C 384I, 12.11.2019, pp. 178-193.

<sup>111</sup> Financial stability falls within the scope of this study as making UK liabilities “bail-inable” also post-Brexit, would ensure a smooth application of the bail-in tool and an easier resolution procedure.

<sup>112</sup> OJ C 384I, 12.11.2019, p. 182.

<sup>113</sup> It would be difficult at the current stage to assess whether the UK would align itself also to the BRRD2 provisions.

<sup>114</sup> Please note that currently all new contracts, including those concluded post-Brexit, must be still compliant with the Article 55 requirement.

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