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Investors entering into capital relief transactions with European banks – beware the European Bank Recovery and Resolution Directive (2014/59/EU)

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Before entering into a capital relief transaction (CRT) with a European bank investors should specifically consider the European Bank Recovery and Resolution Directive (2014/59/EU) (BRRD). This article proposes some structuring tips for investors entering into CRTs, focusing on transactions with UK banks in particular. As discussed below, structuring tips with banks in other EU Member States will need to be adapted. This is because, as a directive, the BRRD is not uniformly implemented across all EU Member States and domestic insolvency laws can differ widely.

CRTs can provide banks with relief from regulatory capital requirements

A CRT is a transaction between a bank and an investor (typically a hedge fund) whereby, for an agreed price, the bank transfers some or all of its risk in an underlying portfolio of assets to an investor (usually by way of a derivative) with a view to realising some relief from its regulatory capital burden. The bank will pay a regular coupon to the investor in return for the investor agreeing to pay a principal sum on the occurrence of agreed upon events affecting the portfolio (e.g. a payment default by a borrower under a loan from the bank).

The transfer of risk must be effective for the bank to realise relief from its regulatory capital requirements. This generally requires the investor to post a sum of money (or assets) equivalent to the amount of the principal by way of collateral to the bank to secure its contingent obligation to pay the principal. The posting of collateral ensures that the bank will have no credit exposure to the investor vis a vis the investor's obligation to pay the principal to the bank on the occurrence of the agreed upon events.

The investor in turn will be concerned to ensure the return of its collateral on the occurrence of agreed events (such as the insolvency of the bank). This article focuses on this aspect of the transaction.

'Resolution tools' under the BRRD can put the investor's collateral at risk

The BRRD establishes a non-insolvency framework for the resolution of European banks deemed to be failing or 'likely to fail' and in respect of which a private solution is impractical. At the heart of the BRRD are far-reaching 'resolution tools' given to national and pan-European resolution authorities (the pan-European authority being the Single Resolution Board (SRB)). These resolution tools give the authorities power to interfere with a bank's liabilities such as the obligation to return collateral under a CRT.

An investor entering into a CRT with a bank incorporated in an EU Member State should therefore bear in mind the risk of its collateral being interfered with or even lost as a result of action taken by the authorities. An investor will not necessarily have any notice or warning that such action is about to occur.

The 'bail-in' tool is one principal concern to investors. By the stroke of a resolution authority's pen, a bank's 'eligible liabilities' can be written down, converted to equity, or released altogether.

Investors should also be aware that, as a European directive, the BRRD is subject to domestic implementation across each of the EU Member States. If the domestic implementation is inconsistent with the BRRD, the BRRD prevails, but there is still room for some divergence of implementation.

How to minimise the risk of CRTs being impacted by the bail-in tool

The bail-in tool applies to some but not all of a bank's liabilities (see (BRRD, Article 44(2)). An investor should therefore endeavour to structure the bank's liability under the CRT so as to fall within one of those exceptions.

The most relevant exceptions for these purposes are client assets and client money which are *'protected under the applicable insolvency law'* of the Member State where the bank is situated (see BRRD, Article 44(2)(c)). Given the wide divergence of insolvency laws across the Member States, bespoke advice will be necessary to ascertain the scope of the client assets and client money protections.

Client money and client assets exception – obligation to segregate the collateral is critical for UK banks

In terms of English insolvency law, client money or assets within the Custody Rules within the Financial Conduct Authority (*FCA*) Handbook should qualify for the BRRD specified 'client assets' or 'client money' exception (see Client Assets Sourcebook (*CASS*) 7.12.1 and CASS 6.7.2) and so protect the investor from the risk of its collateral being bailed-in under the BRRD.

There seems to us no reason in principle why cloaking the collateral with these protections would impact the availability of regulatory capital relief for the bank. From the bank's perspective, the principal concern is whether, on the investor's insolvency, the bank is exposed to any credit risk of the investor. The position in the UK is that the bank should, in such a situation, be entitled to retain the collateral in accordance with the terms of the CRT and, if any of the agreed upon events occurs, apply the collateral to meet the investor's obligations. The bank's regulator should grant the same de-risking characteristics in respect of the collateral as any 'un-segregated' collateral.

This conclusion bears out because the FCA Handbook provides an exception to the client asset or client money protections upon insolvency of the investor. It does so by permitting the bank to close out and net and retain any excess as security for the investor's on-going obligations under the CRT:

> When a client's obligation or liability, which is secured by that client's asset, crystallises, and the firm realises the asset in accordance with an agreement entered into between the client and the firm, the part of the proceeds of the asset to cover such liability that is due and payable to the firm is not client money. However, any proceeds of sale in excess of the amount owed by the client to the firm should be paid over to the client immediately or be held in accordance with the client money rules.[1]

Although there is no equivalent to CASS 7.11.29 in respect of non-cash collateral, there is no reason in principle why the parties could not structure the transaction so that the custody status ceases upon a trigger event (such as insolvency) of the investor (structuring appropriately so as not to breach the anti-deprivation principle).

What kinds of transactions benefit from segregation?

Whether segregation applies to cash or other assets depends on the terms of the transaction. In structuring CRTs the following should be considered.

Collateral posted under an English law ISDA Credit Support Deed (which provides that the collateral shall be posted by way of security and obliges the bank to 'use reasonable endeavours' to safeguard the collateral), will benefit from the obligation to segregate[2] as the bank has only a bare security interest.

In contrast, segregation will not be required where the bank has a right to use the asset and treat it as if legal title has been transferred (subject only to an obligation to return equivalent assets upon satisfaction of the investor's obligation).[3] Likewise, where full ownership is transferred for the purposes of securing its obligation[4] or a transfer by way of security without the combined obligation to use reasonable endeavours to segregate. Examples include transactions where collateral is posted under an English law ISDA Credit Support Annex, or other form of title transfer financial collateral arrangement under the Financial Collateral Directive[5], or the New York law ISDA Credit Support Annex (if the right to re-hypothecate has not been dis-applied).[6]

Practical Implications of segregation - cost

The extent of the investor protections may decrease the coupon paid on the CRT to the investor, since the bank's restricted ability to use the collateral may affect the desirability of the structure.

Posting the collateral with a third party bank

If the investor is concerned that the bank might have a short-fall in its client money/customer assets (even after any permitted 'taking from the general estate'), a solution may be to post the collateral with a third party institution and enter into a tri-partite arrangement for the benefit of the bank and the investor.

The bank's regulator will need to be consulted closely if such an arrangement is envisaged. CASS 6 and CASS 7 contain some provisions which will need to be kept in mind if this approach is taken.

Cross-border matters

The investor should also bear in mind complications that may arise if the bank sub-contracts with one of its branches or subsidiaries outside the EU to hold the collateral. Complex cross-border insolvency analysis may need to be considered. The investor should guard itself against any risk of this eventuality, or else discuss with the bank any such proposed arrangements in advance of entering into the CRT and, to the extent possible, structure around issues that may arise.

Conclusion

Given the divergence that can exist across the EU, each jurisdiction will present specific structuring issues. Investors should keep the BRRD (and the bail-in tool in particular) in mind when structuring CRTs to ensure their collateral gets transferred back to them in accordance with the terms agreed.

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1 CASS 7.11.29.
2 CASS 3.1.5.
3 The lower standards of conduct set out in CASS 3 will apply instead. In the case of such a 'right to use' arrangement, the only requirement is for the bank to act honestly, fairly and professionally, in accordance with the best interests of its client, when exercising its rights under and fulfilling its obligations under such an arrangement [CASS 3.1.7A] and to keep proper books and records [CASS 3.2.2].
4 CASS 7.11.1 and CASS 6.1.6R.
5 CASS 7.11.5.
6 CASS 6.1.7.