

The European Recovery and Resolution Directive –

Potential effects on covered bonds and their issuers

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I. Introduction

1. Purposes of the Recovery and Resolution Directive

- Providing common European framework for early intervention and resolution powers to address systemic risk – but no maximum harmonisation
- Establishing a system of mutual financial assistance for bank resolutions
- Mutual recognition of resolution actions

2. Scope

- All credit institutions and investment firms (institutions) established in the EU
- Branches of third-country institutions
- Certain powers also apply to financial holding companies, mixed financial holding companies and mixed-activity holding companies

I. Introduction

3. New precautionary rules

- Institutions shall prepare recovery and resolution plans (RRPs)
 - Includes description of funding sources and implications of recovery or resolution actions on them: specific attention to impact on covered bonds as funding source
 - Covered bonds platform as a “critical function”?
 - Dependencies/interconnections of covered bonds platform on/with other bank functions?
- A new regime facilitating intra-group financial assistance
 - Potentially beneficial to covered bond issuers as recipients of support, but not as providers of support
- Increased early intervention powers for supervisors
 - Right to require the drawing-up of a plan for a negotiation on the restructuring of the institution’s debt with all or some of its creditors – hardly practical for covered bonds
 - Right to appoint a “special manager” exercising all management functions – unclear whether this overlaps with special regimes for covered bond issuers

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4. Conditions for resolution

- Institution is failing or likely to fail (near insolvency)
- No reasonable prospects of alternative action preventing failure
- Resolution necessary in the public interest, i.e.
 - Ensures continuity of critical functions
 - Avoids significant adverse effect on financial stability
 - Protects public funds and/or protected deposits/investors, or
 - Avoids unnecessary destruction of value

5. General principles for resolution

- Shareholders shall bear first losses
- Creditors bear losses after shareholders in a prescribed waterfall; in principle, equal treatment of all creditors of the same class
- No creditor incurs greater losses than in normal insolvency
 - Important especially for secured creditors and holders of covered bonds

I. Introduction

6. Resolution tools

- Sale of business: shares, assets, rights or liabilities
 - Also applicable to covered bond issuers
 - Special protection for the integrity of covered bonds business?
- Transfer of all or specified assets, rights or liabilities to a bridge institution
 - Integrity of covered bonds business?
- Transfer of assets, rights or liabilities to an asset management vehicle (asset separation), as ancillary power
 - Unlikely to apply to covered bonds business
- Bail-in

I. Introduction

7. Ancillary resolution powers of the resolution authority

- Take control of the institution under resolution
 - Overruling special powers for trustees of covered bonds businesses?
- Amending or altering the maturity or interest rate of debt instruments
 - Would seriously undermine investor confidence in covered bonds
- Making transfers free of any liability or encumbrance affecting the corresponding asset, right or liability (subject to certain safeguard provisions)
 - Could affect certain type of covered bonds, unless expressly exempted
- Discontinue the admission to trading of the institution's financial instruments
 - Applying this to covered bonds would make little sense
- Cancel or modify the terms of any contract or substitute a transferee as a party (subject to safeguards)
 - Could destabilise the legal arrangements of covered bonds business

I. Introduction

- Require the institution under resolution to provide operational services to the recipient of transferred assets, rights or obligations
 - Could affect the cost base of covered bond issuers and, thus, their financial strength rating
- Enforce resolution actions by other EU Member States or third countries
- Suspend any payment or delivery obligations pursuant to any contract until 5pm on the following business day
 - Could affect timely payment on covered bonds
- Restrict secured creditors from enforcing security interests for a limited period
 - Could affect certain covered bond structures
- Temporarily suspend termination rights until 5pm on the following business day
 - Could be relevant for derivative contracts related to the cover pool
 - Resolution actions per se cannot constitute termination rights for “financial contracts”, including derivatives

I. Introduction

8. Safeguards

- No “cherry-picking” upon asset transfers in respect of title transfer financial collateral, set-off and netting arrangements
 - Not all covered bond regimes provide for financial collateral arrangements
 - Will apply to standard derivatives / repo netting arrangements
- Protection of “security arrangements” and “structured finance arrangements”, preventing separation of secured obligation from security or modification or termination of security arrangements
 - Could help some covered bond structures but not all
- Protection of finality of transfer orders and netting under the Finality Directive
 - Will support timely payment by covered bond issuers

II. Bail-in

1. Purpose

- Recapitalisation of institution under resolution, if there is a realistic prospect to restore financial soundness and long-term viability
- Capitalisation of bridge institution

2. Scope

- All liabilities, subject to certain mandatory and optional exclusions
- Mandatory exclusions
 - Deposits guaranteed in accordance with the Deposit Guarantee Directive – but only up to the guaranteed amount
 - “Secured liabilities”, i.e. payment obligations secured by a charge, pledge, lien or collateral arrangements, including from repurchase transaction – but only up to the secured amount
 - Fiduciary obligations, e.g. from the holding of client money
 - Short-term liabilities (original maturity of < 1 month)

II. Bail-in

- Liabilities from salaries or pensions to employees, except variable remuneration
- Liabilities to commercial or trade creditors from the provision of “essential” goods or services
- Liabilities to tax and social security authorities with preferred status under insolvency law
- Optional exclusions
 - Covered bonds as defined in Article 22(4) of the UCITS Directive
 - Liabilities from derivatives if necessary or appropriate to restore the financial soundness or viability of the institution – applicable to derivatives related to the cover pool?

II. Bail-in

3. Specific issues relating to the protection of covered bonds business

- Optional exclusion could further fragment the European covered bonds market
- Scope of exclusion unclear
 - Clearly applies to covered bond obligations
 - Also applicable to assets covering the covered bonds to the extent not part of a formal “security arrangement”? Statutory asset segregation sufficient? What about excess cash invested with banks exceeding deposit protection ceilings? Unsecured bank debentures?
 - Also applicable to over-collateralisation?
 - Uncertainty about the authority’s exclusion of derivatives related to the cover pool
- “Dual recourse” of certain covered bond investors will be affected
- Ability of covered bond issuers to refinance over-collateralisation on an unsecured basis will be affected

II. Bail-in

4. Minimum requirements for bail-inable debt

- Institutions shall maintain a sufficient aggregate amount of own funds and “eligible liabilities” (i.e. bail-inable debt) to non-affiliated third parties as a percentage of total liabilities that do not qualify as own funds, potentially set at 10%
- Impact on covered bond issuers organised as credit institutions?
 - Forces pure-play covered bond banks into ancillary business
 - Disadvantages bank issuers compared to specialised (non-bank) issuers
 - May impact rating of covered bonds issued by banks
- Current approach is ill-suited to special covered bond regimes
- Application of minimum requirement for bail-inable debt to groups with large covered bond issuers disadvantages such banking groups
 - Need to spin-off covered bond issuers?

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