“Onshoring” Statutory Instruments Comment Series: Bank Recovery and Resolution

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Financial Markets Law Committee[1]

This paper has been prepared by the FMLC Secretariat.[2]

[1] In view of the role of the Bank of England, the Financial Conduct Authority and HM Treasury in the U.K.'s preparations for withdrawal from the E.U., Sinead Meany, Sean Martin and Peter King took no part in the preparation of this paper and the views expressed should not be taken to be those of the Bank of England, the FCA and HM Treasury.

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1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (known colloquially and in this paper as "**Brexit**"). On 29 March 2017, HM Government took the first step in the withdrawal process and officially served notice to the E.U. of the U.K.'s withdrawal under Section 50 of the Treaty on European Union ("**TEU**"), beginning a two-year "notice" and negotiation period, and setting the date on which the U.K. will withdraw from the E.U. ("**Exit Day**") as 29 March 2019.[3] A post-Brexit longer-term relationship is, as yet, undecided and, therefore, preparations on the domestic front have focused on a "no deal" eventuality.[4]

1.3. A key element in HM Government's plan to ensure continuity in law during and after Brexit in the U.K. is the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**") which aims, *inter alia*, to incorporate into U.K. law all applicable E.U. legislation and to give powers to Ministers to make such amendments to retained law as are necessary to deal with any deficiencies arising from withdrawal.[5] In furtherance of these aims, HM Treasury has begun to publish drafts of statutory instruments ("**SIs**") which will "onshore" E.U. legislation related to the financial markets.[6]

1.4. This paper considers legal uncertainties arising from the changes proposed by the draft Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018 (the "**draft BRR SI**") which amends the Banking Act 2009 as well as

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3 Legislative provisions defining Exit Day as 29 March 2019 can be found in the European Union (Withdrawal) Act. Section 20(4) of that Act gives a Minister of the Crown the power to amend the definition of Exit Day so that it correctly refers the day on which the E.U. Treaties cease to apply to the U.K.

4 Discussions between the U.K. and the E.U. to agree on a post-Brexit deal are underway—and a 21-month transitional or "implementation" period during which the U.K. will continue to participate in the single market and customs union has been tentatively agreed. See, Blitz, J., "UK and EU agree 'decisive step' with 21-month Brexit transition", Financial Times, (19 March 2018), available at: https://www.ft.com/content/f418a8b2-2b69-11e8-9b4b-bc4b9f08f381.

5 Text of the European Union (Withdrawal) Act 2018 is available at: http://www.legislation.gov.uk/ukpga/2018/16/pdfs/ukpga_20180016_en.pdf.

6 A list of the statutory instruments published in relation to the financial services, included those which have been put before Parliament for approval, can be found on the following webpage: HM Government, *Financial services legislation under the EU (Withdrawal) Act 2018,* (first published 9 August 2018), available at: https://www.gov.uk/government/collections/financial-services-legislation-under-the-eu-withdrawal-act?utm_source=ed3e24c1-615b-4397-a940-f10eb4c57fcd&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate.

other pieces of U.K. legislation to create an amended legislative framework for bank recovery and resolution after Brexit.

1.5. The draft BRR SI, on the whole, does a remarkable job of fitting together pieces of the U.K.'s legislative jigsaw which deal with bank recovery and resolution. The FMLC understands that the draft BRR SI is drafted with the intention of implementing a policy position arising from a "no deal" Brexit. The Committee does not comment on matters of policy or the form that future regulatory approaches, if any, should take and this letter should not be understood to constitute comments thereon. Nevertheless, the Committee has drawn attention to some legal and operational uncertainties which will arise in a "no deal" context in which it is anticipated this BRR SI will be applied.

2. LEGAL UNCERTAINTIES AND IMPACT

Cooperation Arrangements

2.1. Given that the draft BRR SI is aimed at implementing HM Government's policy in the event the U.K. and the E.U. are unable to agree upon a Withdrawal Agreement, it is perhaps unsurprising that it proposes amendments which will have the impact of unilaterally removing the U.K. from certain benefits which are the subject of mutual obligations (e.g. of recognition, notification and consultation) between E.U. Member States and, in particular, withdrawing from regional and international collaboration arrangements agreed in the aftermath of the financial crisis. While the FMLC appreciates that the prospects for coordination in resolution action will depend on future political choices and developments, it wanted to draw attention to the operational impact which is likely to result from the wholesale loss of the rules on coordination (e.g. between authorities participating in resolution colleges), cooperation (e.g. under European Banking Authority ("**EBA**") Framework Arrangements), notification (e.g. to other E.U. national authorities via the EBA) and of the provisions on reciprocity. That impact is likely to be significant given that market participants now rely on the harmonised E.U. resolution framework and the duties of coordination and mutual recognition to which it gives rise as part of their credit planning in relation to counterparties. The impact of any coordination and recognition failures will be exacerbated given that resolution action in the U.K. and E.U. may involve property transfers, asset separation and bail-in, rather than, for example, the old choices between sale or liquidation. There is also a consequential loss of clarity around cooperation arrangements with other Third Countries.

2.2. This latter concern arises from Section 114 of the draft BRR SI which omits Article 224 (*non-binding cooperation arrangements*) inserted by the Bank Recovery and Resolution (No. 2) Order 2014 (the "**second BRR Order 2014**"). Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the "**BRRD**") provides for cooperation arrangements at two principal levels—set out for interest in the footnotes below—but the draft BRR SI does not envisage the U.K. being able to participate in either of these in future.[7]

2.3. In this regard, in the event of a "hard" Brexit, the Committee considers that it would very helpful if HM Government were to consult on a framework of standards to facilitate and regulate the means by which the Bank of England enters into bilateral and multilateral cooperation arrangements with other authorities.

2.4. As a side note, HM Treasury, in an earlier stage in the drafting of the SI, had circulated a confidential draft of the BRR SI (the "**confidential draft BRR SI**") to certain experts—the FMLC Secretariat is grateful to have been included in that group and for the opportunity to review and provide feedback on the confidential draft BRR SI. At that point, the FMLC Secretariat had drawn attention to a related observation: the possibility, perhaps unintentionally, that the Bank of England will be subject to less oversight and fewer restrictions, requirements or duties in resolution as a result of the changes the confidential draft BRR SI introduced. That confidential response had emphasised concerns that the Bank of England would be grappling with post-Brexit turbulence in the British financial sector (possibly with an impact on the share price of U.K. banks) while it simultaneously would be abandoning rules which require the Bank

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[7] Article 97 of the BRRD empowers the EBA to enter into "framework cooperation arrangements with non-E.U. supervisory and resolution authorities of jurisdictions where internationally active financial institutions or groups carry out part of their activities." Last year, the EBA entered into an important agreement setting up framework cooperation arrangements with U.S. national authorities. Without bespoke arrangements, a hard Brexit will mean that the U.K. loses the benefits of this agreement.

Once the EBA has entered into a *framework* arrangement, it is up to Member States' national resolution and competent authorities enter into (specific or plain) cooperation arrangements. Specifically, the BRRD provides:

> Competent authorities or resolution authorities, where appropriate, shall conclude non-binding cooperation arrangements in line with EBA framework arrangement with the relevant third-country authorities indicated in paragraph 2.
>
> This Article shall not prevent Member States or their competent authorities from concluding bilateral or multilateral arrangements with third countries, in accordance with Article 33 of Regulation (EU) No 1093/2010.

Article 224 of the second BRR Order 2014 places an obligation on the Bank of England to enter into such arrangements only if it thinks they would be more effective than any other bilateral or multilateral arrangements. This may not be a strong guarantee of cooperation but it is both a facility and a constraint: the removal of the article in its entirety deprives the U.K. both of the ability to take advantage of any commitment to cooperation by Third Countries which have entered into agreements with the EBA and of the protection afforded by the rule that the Bank must enter into such arrangements where they are efficacious.

to consult, coordinate and cooperate with other national authorities in the resolution of financial conglomerates. The FMLC appreciates, therefore, the additions in the current draft BRR SI which bestow upon the Bank of England, the Financial Conduct Authority (the "**FCA**") and HM Treasury itself powers to make technical standards which will guide the actions of the tripartite authorities in any recovery or resolution circumstances.

Recognition of English Law instruments

2.5. Another consequence of planning for a "no deal" scenario is the treatment in all the "onshoring" SIs, including the draft BRR SI, of actions, institutions and authorities from the European Economic Area ("**E.E.A.**") as if they were actions, institutions and authorities from a Third Country. Specifically, the draft BRR SI makes clear that E.E.A. resolution actions will be subject to the rules which apply to Third Country resolution actions and recognised under Section 89H of the Banking Act 2009. This raises a general market concern about whether English law instruments will continue to meet the conditions for recognition as a bank's minimum requirement for own funds and eligible liabilities ("**MREL**") following Brexit. The EBA has indicated that, post-Brexit, E.U. resolution authorities will need to engage with Member State banks to determine how they can provide legal certainty that any Member State decision to write-down or convert English law governed instruments (existing and new issuances) would be effective under English law, which, at that point, from the E.U.'s perspective, will be a Third Country law.[8]

2.6. Should Member State resolution authorities take the view that Section 89H does not afford E.U. banks or their subsidiaries, which are party to English law contracts, sufficient legal certainty that E.U. resolution measures would be effective under English law, this would pose a risk for contracts and securities issued by E.U. banks and their recognition as MREL in light of the requirements under Article 45(5) of the BRRD. The use of contractual recognition of bail-in clauses, as per Article 55 of the BRRD, might provide comfort for contracts issued under English law since 2016. Several other contracts, however, might only be capable of being amended upon receipt of counterparty consent, which might in some contexts be impossible to obtain. Another concern is that Member State resolution authorities might require banking groups

[8] See: EBA, *Opinion of the European Banking Authority on preparations for the withdrawal of the United Kingdom from the European Union*, (25 June 2018), available at: https://www.eba.europa.eu/documents/10180/2137845/EBA+Opinion+on+Brexit+preparations+%28EBA-Op-2018-05%29.pdf.

which, as part of their Brexit planning, are novating existing English law contracts to E.U. banking subsidiaries, where applicable, to include terms recognising bail-in within these contracts, imposing a significant burden on market participants.

References to other legislation

2.7. As the draft BRR SI and the legislation it amends form but a component of the vast landscape of financial markets legislation, it contains cross-references to definitions, standards and rules from other relevant pieces of directly applicable, domestically implemented (pre-Brexit) or retained (post-Brexit) E.U. law. The FMLC understands that the draft BRR SI makes reference to other E.U. legislation as it will stand at two points in the future so as to allow market participants to plan for a post-Brexit, "no deal" future.

2.8. The first point at which the draft BRR SI freezes cross-referenced legislation is as the legislation will have "effect on the day on which" these Regulations (i.e., the draft BRR SI) are made. This is utilised, for example, in the definition in the draft BRR SI of the capital requirements regulation for the purposes of the Banking Act 2009. The second "cut-off" point is an incorporated reference to E.U. legislation as it will stand as of Exit Day, wherein no explicit cut-off date is provided—no doubt because the provisions of the Withdrawal Act (and, in particular, Schedule 8 of that Act) govern interpretation here and provide that references to E.U. legislation are to that legislation as it shall have effect immediately before and on Exit Day.[9] The kind of incongruence which will result is seen perhaps most keenly in Section 21 of the draft BRR SI, where the definitions of two closely connected concepts—"credit institution" and "investment firm"—are drawn

[9] Schedule 8(1) of the Withdrawal Act states:

Existing ambulatory references to retained direct EU legislation

1 (1) Any reference which, immediately before exit day—

(a) exists in—

(i) any enactment,

(ii) any EU regulation, EU decision, EU tertiary legislation or provision of the EEA agreement which is to form part of domestic law by virtue of section 3, or

(iii) any document relating to anything falling within subparagraph (i) or (ii), and

(b) is a reference to (as it has effect from time to time) any EU regulation, EU decision, EU tertiary legislation or provision of the EEA agreement which is to form part of domestic law by virtue of section 3,

is to be read, on or after exit day, as a reference to the EU regulation, EU decision, EU tertiary legislation or provision of the EEA agreement as it forms part of domestic law by virtue of section 3 and, unless the contrary intention appears, as modified by domestic law from time to time.

from different pieces of legislation. The definition of "investment firms" is drawn from Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (the "**CRR**") *as of the day the BRR SI is made* while the definition of "credit institutions" continues simply to refer to the CRR and will be frozen, implicitly, by the Withdrawal Act on Exit Day.

2.9. While there is an undisputed practical need to have a snapshot of E.U. law as of the date on which the SI is made—that is, because certain provisions of the SI come into force not on Exit Day but on the day after the SI is made—this does give rise to two potential areas of complexity. First, the Committee is unsure about how the SI as currently drafted, with references to E.U. legislation "as of the date on which these Regulations are made", will take into account any changes in E.U. law—including, for example, *via* opinions of the European Court of Justice—in the *interregnum* before Exit Day.

2.10. Second, and similarly, the Committee observes that the SI would have to adapt were the proposed 21-month implementation period to be agreed, during which the U.K. will continue to receive E.U. law which comes into effect. In that case, the cross-references in the SI to other E.U. legislation which were cut-off by Exit Day will presumably be amended to refer to a cut-off date which is the date at which the implementation period ends. A similar exercise would be needed for references to the day on which the draft SI is enacted, which gives rise to concerns that the existence of two snapshots will complicate the continued reception of E.U. law.

2.11. The draft BRR SI also introduces, at two instances, a different kind of cross-reference. Schedule 3 Section 47(3)(b)(h) of the draft BRR SI and Schedule 3 Section 83(2)(a) both insert references to "legislation upon which the United Kingdom relied immediately before exit day to meet its obligations". While this cut-off is similar to the implicit cut-off planned for Exit Day and to be implemented by way of the Withdrawal Act, it does introduce a degree of vagueness which could make any future interpretation of retained law, at best, slow and, at worst, open to error.

<u>Reciprocity and central counterparties</u>

2.12. Section 27 of the draft BRR SI changes the definition of "excluded person" provided in Section 70D of the Banking Act 2009 for the purposes of Sections 70A to 70C of that Act so as to omit "E.E.A. central counterparty" from that definition. Section 70A empowers the Bank of England to suspend obligations to make a payment, or delivery, under a contract where one of the parties to the contract is a bank in respect of which

the Bank is exercising a stabilisation power. The Bank may not, however, suspend the rights of an excluded person to enforce any security interests (Section 70B) or to terminate a qualifying contract (Section 70C). These provisions have ensured, in recognition of the crucial role of CCPs in maintaining operational and systemic stability in the financial markets, that a failing institution was obliged to fulfil its liabilities to E.E.A. central counterparties. Should U.K. banks be permitted to continue to conduct securities settlement and clearing with European systems and CCPs, the removal of the protections against stays in respect of E.E.A. CCPs could possibly have unintended market-wide consequences.

2.13. This unilateral withdrawal from such shared protections also brings into sharp focus the possibility that the E.U. might correspondingly remove protections owed by E.E.A. firms in respect of U.K. CCPs. The result would be that E.E.A. firms are not, similarly, obliged to fulfil obligations owed to U.K. CCPs leading to a remote but not negligible risk of widespread market uncertainty and resulting contagion in the event of a banking failure.

2.14. A similar point arises in relation to protections put into place in the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the "**Partial Property Transfers Order 2009**") for default rules or market contracts of "recognised investment exchanges", "recognised clearing houses" and "recognised central securities depositories". Likewise, the Banking Act 2009 (Restriction of Partial Property Transfers) (Recognised Central Counterparties) Order 2014 (the "**Partial Property Transfers Order 2014**") protects liabilities between persons and a "recognised central counterparty". Schedule 4 of the draft BRR SI omits from both Orders protections which prevent the transfer of property to the extent that such a transfer would contravene E.U. law. The result of this deletion will likely be to remove any protections afforded to E.E.A. trading, clearing and settlement systems as set out in Article 80 of the BRRD. U.K. firms will find themselves contracting with E.U. CCPs in a manner similar to U.S. firms.

3. RECOMMENDATIONS AND CONCLUSION

3.1. In this paper, the FMLC has highlighted legal uncertainties arising from the draft statutory instrument which will onshore regulations relating to bank recovery and resolution. These have included uncertainties related to: (1) cooperation arrangements; (2) the recognition of English law instruments; (3) references to other legislation; and (4)

the loss of protections owed in relation to the functioning of CCPs. In view of the substantial work which has evidently gone into drafting the SI, the FMLC is certain that HM Treasury has already taken into account both the drafting and policy issues highlighted above. The FMLC would, nevertheless, encourage HM Treasury and HM Government to publish, wherever possible, guidance which might enable impacted firms and institutions to begin planning for the future.

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