

Introduction

Just as the storm clouds gather over Greece and institutional investors run for cover again, another less-reported development in the banking sector has appeared on the horizon.

Unlike the European Market Infrastructure Regulation (EMIR), where the pension fund central clearing exemption has just been extended to August 2017, little attention seems to have been given to the potential impact of the European Bank Recovery and Resolution Directive (BRRD) on pension funds.

What Does the BRRD Do?

Back in 2010, in the immediate aftermath of the financial crisis, G20 leaders called for a “review of resolution regimes and bankruptcy laws in light of recent experience to ensure that [those regimes and laws] permit an orderly wind-down of large complex cross-border institutions.” The BRRD is the regulatory response to this systemic risk and was adopted by the EU in May 2014. It has applied in the United Kingdom since January 2015 and may have significant implications for derivative programmes where an EU bank fails.

Bail-In Powers

Where a bank is failing, it may go into “bail-in”. In summary, the bail-in tool provides resolution authorities (in the UK, the Bank of England) with a write down and conversion power in relation to the liabilities of the financial institution that is failing. Bail-in powers must be in place no later than 1 January 2016.

If an EU bank goes into bail-in, a resolution authority can:

- **close out and terminate that bank’s derivative contracts without counterparty (i.e. pension fund trustees) consent**
- **value the termination amounts owing from that bank to its counterparties under its derivative contracts**
- **suspend counterparties’ termination rights under derivative contracts with that bank**
- **reduce the amount owing to counterparties through a write down of those liabilities.**

Although most derivative contracts will be collateralised on a regular, if not daily, basis and so should have a relatively low credit risk, the possibility that pension fund trustees will have one or more derivative trades with a failing bank that it cannot terminate or transfer to another bank will be of concern.

The ability to override contractual rights is similarly troubling. Typical market solutions to an Event of Default or a Termination Event caused by a bank may no longer be possible (such solutions include novating outstanding derivative trades to a different bank, demanding additional collateral or closing out existing trades).

Recent Developments

Whilst the BRRD is in force, many provisions are being phased in over a significant period of time (as is the case with EMIR). As a part of this process in May 2015, the European Banking Authority published a consultation paper that sets out draft Regulatory Technical Standards (RTS) on the valuation of liabilities arising from derivatives under the BRRD.

What Are Pension Fund Trustees Recommended to Do?

The European Banking Authority¹ has stated that an intention of the BRRD is that market participants, such as pension fund trustees, “... properly scrutinise the risk profile and management practices of an institution [a counterparty bank] in normal times”².

Unfortunately, the EBA has not provided any guidance as to what constitutes “proper scrutiny”. Scrutiny implies that banks must consent to disclose information, which is easier said than done. ISDA agreements do contain provisions for counterparties to exchange information, but it is certainly not common for pension fund trustees to ask to see risk management policies, disaster recovery plans or even disclosure of material litigation (which might address the “risk profile” issue).

Even if banks were to acquiesce to such amendments to contracts now, how many trustees would know how to assess the disclosed information?

1 The European Banking Authority is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its overall objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector.

Directive 2014/59/EU (the Bank Recovery and Resolution Directive — BRRD) on crisis prevention, management and resolution assigns to the EBA the task to develop a wide range of Binding Technical Standards, Guidelines and reports on key areas of recovery and resolution, with the aim of ensuring effective and consistent procedures across the Union, in particular with respect to cross-border financial institutions.

2 Consultation Paper: Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the BRRD.

Immediate Actions

These may be avenues to pursue for new ISDA agreements but for existing ISDA agreements, where no regulatory requirements currently oblige banks to be proactive in disclosing their risk profiles or management practices, what can be done?

- **Ongoing checks as to the creditworthiness of counterparty banks.** In the past month, both The Royal Bank of Scotland and Deutsche Bank, two banks that have a significant derivatives market presence as counterparties to pension fund trustees, have been subject to credit rating downgrades. Pension fund trustees should consider whether credit rating downgrade Termination Events in their derivative contracts with respect to counterparty banks are set at an appropriate level.
- **Reduction of concentration risk.** One simple way of mitigating the risk of a counterparty bank going into bail-in is to increase the number of counterparties dealt with. Other than the obvious benefit of spreading credit risk, adding counterparty banks should allow for more competitive pricing and favourable legal terms, potential access to a greater range of products and a greater ability to novate trades across to a replacement bank if an EU counterparty bank defaults.
- **Review your IMAs with LDI managers.** If pension fund trustees who have LDI programmes in place do nothing else, they should review the obligations their investment managers are under to ensure best execution of derivative transactions (managers are required to disclose their policies on execution of transactions under MiFID) and ask what additional steps they will take to prevent the full impact of a bank bail-in under the BRRD.

Contacts



Clifford Sims

Partner, Pensions
T +44 207 655 1193
E clifford.sims@squirepb.com



Jeremy Ladyman

Senior Associate, Financial Services
T +44 113 284 7250
E jeremy.ladyman@squirepb.com

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations nor should they be considered a substitute for taking legal advice.

© Squire Patton Boggs.