BANKING & PROJECT FINANCE

BAIL-IN

Rare but there

It's advisable to include Swiss stay and bail-in recognition clauses in LMA-style syndicated credit agreements even if not required under Swiss legislation

1 MINUTE READ

As of April 1 2018, Swiss banks will be required to include resolution stay recognition clauses in certain financial contracts. It is to be expected that this requirement will only in very rare cases apply to LMA-style syndicated credit agreements, namely if one of the borrowers is a Swiss bank. Nevertheless, Swiss syndicate members should consider inserting a Swiss stay – or even better – a broad Swiss bail-in recognition clause in order to prevent being disadvantaged over non-Swiss syndicate members, who may otherwise be able to claim that resolution measures taken by Finma do not apply with respect to them.

Swiss market participants have become accustomed to the inclusion of the Loan Market Association (LMA) recommended form of bail-in recognition clause in Swiss law governed syndicated credit agreements, which caters to the recognition clause requirement under article 55 of the European Bank Recovery and Resolution Directive (BRRD). Just in time for the entry into force of Switzerland's own recognition clause requirement on April 1, this article explains why it is rarely required, but sometimes advisable to include Swiss stay or bail-in recognition clauses in syndicated credit agreements.

Finma's resolution powers and the necessity for recognition clauses

When important financial institutions fail, bankruptcy often leads to disorderly liquidation with significant external effects on the financial system and the real economy. This undesired outcome has led governments to intervene by ordering a taxpayer-funded bailout of the failing institution. The financial crisis of 2007–2009 blatantly demonstrated that the need to provide bailout funding can be a significant and unwanted burden on the fiscal budget. After the crisis, regulators sought ways to avoid bailouts by improving the resolvability of large financial institutions, ie wind them up or continue their core functions without incurring negative externalities.

Against this background, the Financial Stability Board (FSB) spearheaded the development of new resolution tools. In 2011, it published the key attributes of effective resolution regimes for financial institutions, a standard setting out the core elements of modern bank resolution regimes. The aim of the key attributes is to find a third way between the Scylla of a disorderly liquidation and the Charybdis of an open-ended public financing of bank bailouts. In essence, rather than the taxpayers, it is the shareholders and creditors who shall foot the bill of bank failures. This amounts to a paradigm shift: while traditional banking regulation typically aims at protecting creditors, the key attributes set out the protection of taxpayers and the primacy of financial stability.

In modern resolution regimes, the designated resolution authorities hold significant power to intervene in individual rights. Typically, a resolution authority disposes of transactional resolution tools on the one hand and the bail-in on the other. In a transactional resolution, assets, liabilities and contracts are transferred to another legal entity, eg a bridge bank or an asset management vehicle. Conversely, a bail-in is a balance sheet restructuring where liabilities of a failed bank are written down (haircut) or converted to equity (debt/equity swap) through an order of the resolution authority. The aim is to use these tools to attain a swift resolution, preferably over a weekend. This should enable the whole bank to continue as a going concern, or at least secure the continuity of certain economically important functions. In this article, the entirety of tools available to resolution authorities will be referred to as resolution powers.

While modern resolution tools were applied in various cases over the past few years, the resolution regime remains untested in a large-scale financial crisis. It is evident that many conditions must be met for a resolution attempt to be successful. But two of those conditions require further elaboration. First, resolution authorities must be able to avoid the termination, close-out netting, liquidation and transfer of a bank's contractual relationships upon the occurrence of a resolution event. Second, resolution powers must be capable of being enforced internationally. Both aspects are crucial.

As to the first requirement, it is important to ensure that a bank's essential contractual relationships are not terminated in connection with the resolution proceedings. This particularly applies to derivatives positions, which provide risk-shifting functions that are essential for financial institutions. For instance, a bank's mortgage portfolio will typically be hedged with interest rate swaps. If such derivatives positions are closed-out and netted due to a resolution event, as is typically stipulated in the relevant framework agreements, the bank's risk exposure will drastically increase and the restructured institution will not be viable after resolution.

Therefore, article 30a of the Swiss Banking Act provides that the Swiss Financial Market Supervisory Authority (Finma) as the Swiss resolution authority may order a stay on contractual termination, netting, liquidation and transfer rights for up to two days. This so-called resolution stay can be imposed on all contractual relationships of a Swiss bank.

As to the second requirement, the effect of measures based on Swiss public law is limited to Switzerland (territoriality). Lacking international agreements for the recognition of foreign resolution powers, lawmakers and regulators introduced requirements for banks to stipulate contractually that their counterparties acknowledge the resolution powers of the bank's home resolution authority. These so-called recognition clauses aim at ensuring enforceability of resolution measures in foreign courts. An example is article 55 of the BRRD, which provides that a recognition of bail-in powers must be included in certain bank contracts that are governed by the law of a country which is not an EU member state.

LMA-style syndicated credit agreements for non-bank debtors do not typically have the same effect as inter-bank credit arrangements

While no recognition of bail-in powers is required under Swiss law (except for bail-in bonds), article 12 paragraph 2bis of the Swiss Banking Ordinance requires Swiss banks to ensure the contractual recognition of Finma's resolution stay powers pursuant to article 30a Swiss Banking Act. This applies to certain types of financial contracts entered into or amended on or after April 1 2018, insofar as they are governed by foreign law or subjected to the jurisdiction of foreign courts. The following sections contain an analysis of whether the Swiss resolution stay recognition clause requirement applies to LMA-style syndicated credit agreements.

A rare requirement in syndicated credit agreements

In order for a syndicated credit agreement to fall within the ambit of the Swiss resolution stay recognition clause requirement, that agreement would have to:

- have at least one in-scope institution party to it;
- be entered into, or amended, on or after April 1 2018;
- be governed by foreign law or subject to the jurisdiction of foreign courts;
- qualify as in-scope contract under article 56 Swiss Bank Insolvency Ordinance-Finma; and
- contain termination, netting, liquidation or transfer rights that could be subject to a resolution stay and that would be triggered by Finma exercising its resolution powers.

The first criterion is an obvious one. The Swiss recognition clause requirement can only be triggered if at least one of the parties to the credit agreement is subject to Finma's resolution powers. Thus, one of the parties must be a Swiss bank, a foreign branch of a Swiss bank, or a foreign subsidiary of a Swiss bank with that Swiss bank guaranteeing the performance of its foreign subsidiary's obligations under the credit agreement. The second criterion does not need much explanation, except that the concept of amendment is interpreted rather broadly. As a result, only changes to the terms of a transaction that occur by operation of contract (eg changes to the margin under a margin ratchet) do not constitute amendments for the purposes of the recognition clause requirement. Regarding foreign choice of law and foreign jurisdiction, it is worth noting that Swiss law governed credit agreements often contain so called asymmetric (or hybrid) jurisdiction clauses. These clauses typically require borrowers, guarantors and security providers to sue in Swiss courts whilst allowing the finance parties to sue in any court with jurisdiction. Therefore, asymmetric jurisdiction clauses could lead to the credit agreement being subject to the jurisdiction of foreign courts.

The fourth criterion is trickier. When looking at the list of in-scope contracts in article 56 of the Swiss Bank Insolvency Ordinance-Finma, the only in-scope contracts relevant to the syndicated lending space (setting aside hedging arrangements) are inter-bank credit arrangements and contracts having the same effect as inter-bank credit arrangements. It goes without saying that a syndicated credit agreement constitutes an inter-bank credit arrangement and, therefore, an in-scope contract if one of the borrowers is a (Swiss or foreign) bank. In all other cases, the assessment becomes more difficult. In our opinion, LMA-style syndicated credit agreements for non-bank debtors do not typically have the same effect as inter-bank credit arrangements. In particular, the mere fact that an amount of money is owed by one finance party to another (eg by a lender to the agent) should not, in and of itself, turn a syndicated credit agreement into an inter-bank credit arrangement. Nevertheless, it cannot be excluded that Finma would conclude that the application of specific concepts (eg the fronting bank concept in connection with L/C facilities) does have the same effect as an inter-bank credit arrangement.

Swiss syndicate members have an interest to not only insert a Swiss stay recognition clause but also a broader Swiss bail-in recognition clause

The last criterion is regularly met if one of the borrowers is a Swiss bank. LMA-style syndicated credit agreements typically contain acceleration rights (allowing, for example, the cancellation of commitments), which the agent may exercise upon the occurrence of an event of default. It is to be expected that a regulator instituting resolution action against a borrower constitutes an event of default under the credit agreement. Hence, such acceleration rights could be subject to a resolution stay and would be triggered by Finma taking resolution measures. The assessment is different if all borrowers are non-banks, because LMA-style syndicated credit agreements do not typically contain termination, netting, liquidation or transfer rights that could be exercised against a finance party. If anything, one could argue that replacement rights under the defaulting lender and impaired agent concepts constitute transfer rights which are capable of being stayed by Finma. At the very least, a regulator instituting resolution action against a finance party typically is a trigger event for the replacement rights under the defaulting lender and impaired agent concepts to kick in.

To summarise, it is to be expected that the Swiss recognition clause requirement will only in very rare cases apply to syndicated credit agreements, namely if one of the borrowers is a Swiss bank.

Preventing disadvantages for Swiss syndicate members

Even if Swiss stay recognition clauses may rarely be required in syndicated credit agreements, Swiss syndicate members should nevertheless consider inserting a Swiss stay – or even better – a broad Swiss bail-in recognition clause. Absent such a clause, resolution measures taken by Finma against a Swiss syndicate member may not be enforceable against non-Swiss syndicate members as the latter may be able to claim that no such reservation was contractually agreed and hence the relevant Finma measures do not apply with respect to them. At the same time, Swiss syndicate members will have to respect resolution measures taken by Finma against another Swiss syndicate member even if no recognition clause has been inserted in the agreement, as they are subject to regulatory supervision by Finma. Therefore, absent a Swiss stay – or even better – a broad Swiss bail-in recognition clause, Swiss syndicate banks may be disadvantaged over non-Swiss syndicate members.

On that basis, Swiss syndicate members have an interest to not only insert a Swiss stay recognition clause – as may in certain instances be required from April 1 2018 – but also a broader Swiss bail-in recognition clause, which covers all of Finma's resolution powers (and not just the stay of termination and similar rights).

Suggested implementation

If one concludes that a Swiss recognition clause should be inserted in an LMA-style syndicated credit agreement, the necessary changes to the LMA documentation depend on whether the underlying transaction mandatorily requires the inclusion of a Swiss stay recognition clause (eg if the borrower is a Swiss bank) or not.

If the underlying transaction does require the inclusion of a Swiss stay recognition clause, the minimum requirement would be to insert the LMA recommended form of bail-in recognition clause. As that clause only incorporates by reference national legislation that requires contractual recognition, it would only recognise Finma's resolution stay powers as per the requirement of article 12 paragraph 2bis of the Swiss Banking Ordinance (but not any of Finma's other resolution powers). The draftsperson should consider adding the element of stay to the LMA recommended form of bail-in recognition clause (for instance by adding '*and any termination, netting, liquidation or transfer right*' before '*under or in connection with the Finance Documents*' in the introductory paragraph and '*a suspension of termination, netting, liquidation or transfer rights;*' as new sub-paragraph (a)(ii) of the bail-in recognition clause) to make it clearer that such measures also fall under that clause.

As outlined above, to avoid being at a disadvantage over non-Swiss syndicate members, it would be advisable for Swiss syndicate members to insist on the expansion of the scope of the bail-in recognition clause to all of Finma's resolution powers, even if those powers are not mandatorily required to be contractually recognised. In addition to the above-mentioned amendments to the bail-in recognition clause, this will require the addition of '*the powers described in section 11 (Elfter Abschnitt) of the Swiss Federal Act on Banks and Savings Banks of 8 November 1934 (SR 952.0); and*' as new paragraph (b) to the definition of write-down and conversion powers. These amendments would also be the recommended way to document the broadest possible Swiss recognition clause in case the underlying transaction does not mandatorily require the inclusion of a Swiss resolution stay recognition clause.


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