European Financial
Markets Lawyers Group

- THE VICE-CHAIRMAN -

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Dear Mr Nava,

Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms

We refer to the Commission's proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms of 6 June 2012 (COM(2012) 280 final).

The harmonization of the laws governing the resolution and recovery of institutions is an important element of the manifold European and international initiatives to overcome the structural weaknesses observed during the severe financial crisis. We welcome such initiatives and its positive impacts on financial markets.

The European Financial Markets Lawyers Group (EFMLG)[1] would like to contribute to the discussion on the new framework by highlighting particular aspects as outlined in the Attachment.

Some of the comments are driven by the need for a holistic view that combines the multiple initiatives, namely the creation of the new European market infrastructure for derivatives (EMIR), the strengthening of the prudential capital regime for institutions (CRD4/CRR) and the overhaul of the regimes governing the provision of services in financial instruments (MiFID2/MiFIR) and protecting the integrity of the financial markets (MAD2/MAR).

Such view should consider the interdependencies and knock-on effects created by the mentioned initiatives and how they impact on the proposed framework for the recovery and resolution of institutions.

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[1] The EFMLG is an international group of senior lawyers acting on behalf of the major commercial banking institutions of the European Union. The EFMLG is committed to provide legal support to the historical task of achieving an integrated financial market in the European Union (EU). It aims to examine legislative and regulatory issues and differing market practices that hinder the full development of a EU-wide single financial market and to identify the major barriers. In that regard, it provides advice and recommendations and identifies best practices with the aim of facilitating harmonisation and convergence in EU financial markets.

Other comments are of more technical nature referring to potential inconsistencies and conflicts in principles or just asking for more clarity.

None of them should be construed as fundamental criticism. Contrary, we encourage the European Union in proceeding on the chosen path.

If you have questions or would like to discuss our comments in person, please do not hesitate to contact us. We would be pleased to meet with you and your colleagues.

Best regards

Holger Hartenfels

Vice-Chairman

Encl.

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Attachment

European Financial Markets Lawyers Group's (EFMLG) Comments on the Proposal for a Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms (the "Directive")

A. Protection of Business and Trade Secrets

The Directive requires institutions to draw up, maintain and update recovery plans which include information on the institution's critical functions and core business lines. Items covered by the recovery plan are arrangements and measures to restructure business lines and to maintain access to critical market infrastructure, IT services and funding as well as strategies to restore financial soundness. Resolution authorities must prepare resolution plans, which set out the options for applying resolution tools to the institution. The resolution plan shall include details on how critical functions and core business lines of the institution could be legally and economically separated, how the value and marketability of such functions and business lines could be determined and a description of the critical interdependencies.

The information provided in the recovery and resolution plans is extremely sensitive and any disseminating of it in the public could cause severe damage to the institution. The European directives provide certain safeguards. They require that professional secrecy shall be binding in respect of all competent authorities, resolution authorities as well as persons employed or instructed by them. Those authorities and persons are prohibited from divulging confidential information received during the course of their professional activities including information submitted in the recovery and resolution plans. However, given the sensitivity of information exchanged during the process of preparing recovery and resolution plans some of the approaches taken in the Directive should be reconsidered.

<u>PROPOSAL:</u> Group recovery and resolution plans should not be shared with the whole supervisory college. The threshold test applicable to significant branches should be applied to subsidiaries as well and group recovery and resolution should only be shared amongst those authorities that are responsible for "significant subsidiaries". Cooperation agreements with third countries on protection of business and trade secrets should not be negotiated by Member States. The principles outlined in Article 25 (6) or (7) of Regulation (EU) No 648/2012 (EMIR)[2]- the European Banking Authority (EBA) or the Commission establish cooperation agreements with the relevant competent authorities of third countries or they determine whether the guarantees of professional secrecy applied in the third country are equivalent to those applicable in Europe-should be applied instead.

Some countries provide its citizens with the right to access information maintained by the government. In Germany, for example, such right is granted under the Freedom of Information Act[3], which applies to all federal bodies and institutions including the Federal Financial Supervisory Authority.[4] Usually, such acts provide for certain safeguards which protect personal data, business secrets or intellectual property by requiring the responsible authority to detach sensitive information or to blacken it. However, as those measures are subject to discretion

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[2] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201/1 of 27 July 2012).

[3] Federal Act Governing Access to Information held by the Federal Government of 5 September 2005 (Federal Law Gazette I, p. 2722)

[4] Pursuant to § 3 of the Freedom of Information Act no access is given "*where such access compromises the protection of intellectual property. Access to business or trade secrets may only be granted subject to the data subject's consent.*" German courts (e.g., the Higher Administrative Court of Hessen, decision of 9 March 2010, 6 A 1684/08) have decided that the safeguards do not protect the BaFin own assessments and decisions. They also decided that the need for reviewing and blackening confidential information would not justify a withholding of information.

(what is sensitive information?) and because manual processes are prone to errors and omissions, we fear that they are not always efficient enough to ensure sufficient non-disclosure.

PROPOSAL: Member States should ensure that recovery and resolution plans are completely exempted from their national freedom of information acts.

B. Financial Intra-group Support

The Directive governs the provision of financial support within groups on a voluntary basis. Group financial support agreements are subject to approval of the consolidating supervisor. Creditors of the group must not have any right to draw under the financial support, if provided in the form of a guarantee. Further, the Directive reserves the competent authorities' right to oppose to any performance under the financial support agreement.

The above requirements conflict with the minimum requirements for the recognition of guarantees as credit risk mitigation under Directive 2006/48/EC and the future Capital Requirements Regulation (CRR)[5]. Hence, an institution facing the subsidiary of a parent institution would not benefit from any financial support for capital adequacy purposes. A group would be left with two options: It could endow its subsidiaries with sufficient own capital which ensures at least an investment grade rating. Alternatively, if legal barriers are not given, it could transfer the activities from the subsidiaries to the mother company.

PROPOSAL: A parent institution should be able to issue guarantees that suffice for capital adequacy purposes on a voluntary basis. Alternatively: Existing guarantees should be grandfathered and only discontinued where they create an impediment to resolution.

C. Special Manager

The Directive requires the Member States to ensure that competent authorities may appoint a special manager who replaces the management of the institution and who has all powers of the management of the institution under the statutes of the institution and under national law as well as the powers required for the restoration of the sound and prudent management of the institution.

PROPOSAL: As provided for in some Member States, competent authorities selecting a special manager and the special manager itself should be liable for all decisions taken by the special manager (other than those approved by the shareholders meeting). The liability should be capped at a certain amount which allows coverage by insurance companies. For G-SIFIs at least, the special manager should be appointed alongside the current management of the bank that should be able to take essential decisions for running the bank.

D. Interplay of Prudential Capital Requirements and Early Intervention and Resolution Measures

The prudential capital requirements specified in Directive 2006/48/EC and the future CRR are serving as important trigger for early intervention, bail-in and resolution measures. Where an institution does not meet or is likely to breach those capital requirements, competent authorities may apply one of the early intervention measures specified in the Directive, which include the implementation of the recovery plan. Resolution measures may be triggered by a breach of capital requirements if such breach would justify the withdrawal of the institution's license. The same trigger applies to the bail-in tool. The recent experience with the EBA stress tests demonstrate how volatile capital requirements are and how much discretion competent authorities have when defining and adjusting capital requirements.

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[5] See Article 208 of the CRR, Commission's proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms of 20 July 2011 (COM(2011) 452 final).

PROPOSAL: It should be clarified that a change to the capital requirements or to its interpretation or application should not trigger early intervention and resolution measures. Institution should have time to adjust to new regulatory standards. As far as Article 23(1) of the Directive is concerned, it should be clarified that only the own funds requirements and the requirements specified in Article 22 and Annex V (“ICAAP”) are relevant for triggering the early intervention measures.

E. Bail-in, Derivatives and the Principle “No Creditor Worse Off”

The Directive establishes the principle that no creditor incurs greater losses than that would be incurred if the institution would have been wound down. The bail-in regime proposed for derivatives conflicts with that principle.

The Directive requires the Member States to ensure that the write-down and conversion powers apply to liabilities arising from derivatives. Resolution authorities are required to determine the value of such liabilities in accordance with the principles outlined in the Directive and the regulatory technical standards adopted by the Commission. Where derivatives are covered by a netting agreement, values are to be determined on a net basis in accordance with the terms of the netting agreement. The consequence of a write-down is that the net value written down is to be treated as discharged for all purposes and shall not be provable in any proceeding.

The issue with derivatives is that the net value determined by resolution authorities is not a liability. It represents the fair value as of the time of determination. The net value is the equivalent of the payment amount that would be owed by one part to the other if the derivatives were terminated and closes-out at the time of determination. Such value is uncertain and it changes over time in accordance with the price movements observed in the financial markets. In order to create a dischargeable liability that could be subject to bail-in, the resolution authority would have to terminate and close-out the derivatives. Terminating and close-out derivatives would comply with the “no-creditor-worse-off” principle. However, it would conflict with the Directive pursuant to which derivatives should be continued even if subject to bail in.

Derivatives create payment obligations and related liabilities (e.g., under an interest rate swap one party pays quarterly amounts of a given currency based on a specified fixed rate and the other party pays quarterly amounts of the same currency based on a specified floating rate, like 3-month-EURIBOR). However, reducing payment obligations under individual transactions would open otherwise hedged positions and considerably impact on the risk management and the regulatory capital requirements of the ailing bank’s counterparty. This approach would be in breach of the “no-creditor-worse-off” principle. It would also threaten the stability of any central counterparty (CCP) that engages in clearing of derivatives.

The Directive does not consider EMIR and the requirement to clear all standardized OTC derivatives through CCPs where they are subject to comprehensive margin requirements. EMIR also requires margining for OTC derivatives that are not cleared through CCPs. Full implementation of EMIR would therefore ensure that all derivatives entered into by European institutions would be fully or substantially collateralized. They would therefore benefit from the exemption provided for in Article 38(1)(b) of the Directive. A daily margining would also trigger the “less-than-one-month”-exemption of Article 38(1)(d) of the Directive.

PROPOSAL: Derivatives should not be included in the scope of the bail-in tool.

F. Scope of Bail-in Tool – Eligible Liabilities

Article 38 provides for a list of liabilities that are protected from bail-in. It is noted that liabilities that benefit from the right of set-off are not expressly included in such list. This is a major concern particularly with respect to debit and credit balances on accounts that may be subject to cash pooling or other cash management arrangements. Uncertainty in this area means that rights of set-off that are currently relied upon as credit risk mitigation are impacted.

PROPOSAL: It should be clarified that liabilities are not subject to bail-in if and to the extent the creditor has a right of set-off. That might be achieved by a rider to paragraph 2(b) confirming that, for the purposes of Article 38, secured liabilities include liabilities supported by set-off. It should also be clarified that liabilities without a fixed maturity date but which are repayable on demand or at a time determined by the creditor also fall within the definition of liabilities with an "original maturity of less than one month". A current account would be the typical example.

G. Restrictions on Termination and Close-out and Related Safeguards

The proposed framework applicable to close-out netting arrangements is well balanced and not subject to any fundamental concern. It is especially appreciated that the resolution authorities shall make all reasonable efforts to ensure performance under the derivatives during the period of suspension (Article 63(2) of the Directive). What should be clarified is the interplay with Article 61 of the Directive which authorizes resolution authorities to suspend payment or delivery obligations during the stay. Article 61 of the Directive constitutes "an action by the resolution authority" as such term is used in Article 63(1) of the Directive. The consequence would be that a failure to pay or to perform under a derivative caused by a "moratorium" based of Article 61 of the Directive would not trigger any termination right.

PROPOSAL: It should be clarified that all failure to pay or deliver under any derivative or related collateral arrangement would justify a termination of such derivative. In Article 61(1) of the Directive a clarification with respect to the "relevant time" should be added as it provided already in Article 63(1) of the Directive.

The Directive protects termination and close-out netting agreements only, if the party has an enforceable right to close-out and net. The EFMLG reaffirms its view that the Commission should supplement the Directive by a new instrument that ensures the validity and enforceability of close-out netting across Member States. It is paramount for the legal safety and robustness of the European financial markets that the same efforts are taken in other areas including the enforceability of close-out netting and the portability of derivatives cleared by CCPs.

PROPOSAL: A new paragraph should be added to Article 63 of the Directive to the effect that Member States shall ensure that the rules under national insolvency law relating to the voidability or unenforceability of legal acts detrimental to creditors do not apply to termination and close-out netting arrangement. The paragraph should be supplemented by regulatory technical standards developed by EBA (e.g., in accordance with the future principle published by UNIDROIT) and adopted by the Commission.

H. Safeguards for Structured Finance

The Directive provides safeguards for structured finance transactions that ensure that all and not just some of the property, rights and liabilities that constitute part of a structured finance transaction are transferred to another bank[6]. Article 71(2) of the Directive provides for a specific rule applicable to deposits. The purpose of the rule is uncertain. It is indicated that there is no protection under paragraph 1 where only rights and liabilities in relation to deposits are

[6] A typical structured finance transaction is a synthetic securitization under which an originator institution buys protection against credit risks arising under its loan agreements (loan book) in a tranched fashion by issuing senior and junior notes. The proceeds of the notes may be credited to an account maintained with the originator institution where the balance on the account is pledged to a trustee on behalf of the secured parties which include the institution and the holders of the note. The account agreement between the originator institution and the trustee may provide for a minimum rating requirement ensuring a transfer of the deposit to an eligible bank in case of a downgrading of the institution below the minim rating. Noteholders are concerned about the bankruptcy of the originator institution especially as the amount of proceeds credited to the account usually exceed the amount (of EUR 100,000) protected under Directive 94/19/EC. Sometimes it is uncertain whether the noteholders (which are usually not the owner of the account) are eligible for protection under the relevant deposit guarantee scheme.

transferred or not transferred. It is also not clear whether this rule applies only to deposits that are “guaranteed in accordance with Directive 94/19/EC”.

In case of a resolution of the originator institution, resolution authorities may identify the loan book as part of the institution’s critical functions and transfer it to a bridge bank. In this situation the Directive should ensure that the credit linked notes hedging the loan book as well as the encumbered deposit-the latter one is a liability of the institution that forms part of the securitization-are transferred to the bridge bank too. If the resolution authority decides that only the deposits held by the originating bank are critical, it may transfer such account to a bridge bank. In this situation the secured parties under the structured finance transaction would benefit from the safeguards provided under Article 70 of the Directive, i.e. the deposits can only be transferred unless the liability under the credit linked note (to redeem the note) which is secured by the deposit is also transferred.

The only case that seems to be covered is a transfer of the loan book and the related credit linked notes, but without the deposits: Article 71(2) of the Directive could be read as withdrawing protection in situations where only the deposits are <u>not</u> transferred. However, as indicated above, this approach would only be justified if and to the extent the deposit would be guaranteed in accordance with Directive 94/19/EC. Further, this approach would conflict with Article 70 of the Directive, because it is not just the noteholders that benefit from the deposits. It is first the bridge bank that would need the coverage of the deposit to fund the loss allocations observed in its loan portfolio.

<u>PROPOSAL:</u> The second paragraph of Article 71 should be deleted. It should also be clarified that minimum rating requirement in account agreements used for structured finance arrangement can operate as agreed between the parties and are not subject to the suspension proposed in Article 63 of the Directive.

I. Safeguards for Central Counterparties and Systems

The Directive ensures that resolution measures do not conflict with the rules and regulations of a clearing and settlement system or a central counterparty that, e.g., is involved in the clearing of derivatives.

<u>PROPOSAL:</u> As indicated above (with respect to derivatives and close-out netting arrangements), it should be clarified that obligations cleared through a CCP are not subject to bail-in, because they constitute secured liabilities. The same may be achieved by adding in the chapeau of Article 72(1) of Directive after the word “transfer” the word “, bail-in”. Further, a new paragraph should be added to Article 72 of the Directive to the effect that Member States shall ensure that the rules under national insolvency law relating to the voidability or unenforceability of legal acts detrimental to creditors do not apply to a transfer of transactions and related margin within a clearing and settlement system.

J. Definitions

The definitions of “debt instruments” and “instruments of ownership” include “instruments giving rights to acquire” such debt instruments, shares or ownership instruments. It should be clarified whether and to what extend this definition applies to derivatives (like bond options or equity forwards) or securities lending or repurchase transactions and whether the safeguards provided for in the Directive apply to the measures taken under Article 56(1) of the Directive.

The definition of “derivatives” (in Article 2(56) of the Directive) refers to Annex I to Directive 2004/39/EC. The definition does not cover physically settled commodity derivatives, certain commercial foreign exchange forwards and spot transactions, although these transactions are usually covered by the same termination and close-out netting agreement. The given shortfalls in coverage will cause uncertainty and unintended nock-on effects wherever the term "derivative" is used. An example is the bail-in tool where the net-amount calculated by the resolution authority would have to be adjusted by those transactions that are not "derivatives".

The definition of "financial contract" (in Article 63(6) of the Directive) shows redundancies. Repurchase transactions are mentioned twice (in (a)(iii) and (d)). It should be clarified that the futures and forwards contracts mentioned in (c) include contracts relating to securities. The definition could be used for enhancing the definition of "derivatives", but only with some re-grouping of the transactions (e.g., securities lending transactions should be deleted from (a)(i) and included in (d) or a separate letter; (a)(iii) should be merged into (d)) which would enable a specific reference to derivatives only.

<u>PROPOSAL:</u> We propose to broaden the authorization given to the Commission under Article 2, of the Directive to clarify the above mentioned terms. As far as the term "derivative" is concerned, an alternative could be a reference to the definition of "financial contracts" provided in Article 63(6) of the Directive.

K. Relations with Third Countries

The Directive provides in Article 87 that Member States must ensure that they have powers to take resolution action in relation to a branch in a Member State of a third country institution. In paragraph 2(c), it is expressly stated that such powers must be available where there have been home country resolution powers invoked and the EBA has refused to recognise such home jurisdiction resolution action.

We would query to what extent this mandatory requirement to create of conflicts of laws situations has been fully thought through. Firstly, this would seem to cut across the universalist approach to insolvency law which characterises the overall approach of insolvency laws at the EU level (i.e. the Insolvency Regulation and similar winding up directives for insurers and credit institutions). Additionally, the insolvency laws of a growing number of Member States (like the English law as exemplified by recent court decisions on the legislation implementing the UNCITRAL Model Law) have an increasingly overtly universalist approach. Uncertainty will thus be created over how this positive requirement to implement resolution powers in conflict with home country insolvency laws and the universalist doctrine will be reconciled in the domestic insolvency laws of such Member States.

There is also concern from the point of view of participants in resolution actions over the robustness and certainty of any action taken under the Article 87 powers when the participants may, through their own assets or activities in the home jurisdiction, be exposed to the application of the home jurisdiction insolvency laws. For example, we would expect that an entity that received assets from a branch of a US entity as part of local EU resolution which conflicted with a FDIC mandatory stay would find itself subject to action in the United States for return of those assets to the FDIC receiver.

<u>PROPOSAL:</u> We would suggest that it should not be mandatory for Member States to provide in their law for the creation of conflict of laws situations with other home jurisdictions. We would also suggest that attention should be given to seeking agreement with home jurisdictions that actions taken with respect to branches in Member States will be recognised by the home state. Alternatively, if general recognition on the part of the home state is not possible, there would still be considerable value in obtaining recognition by the home state of the primacy of the law of the host state in systemically important areas such as recognition of EU settlement finality laws and laws relating to financial collateral in collateral given in respect of payment and settlement systems. That is currently not the case, for example, with respect to the United States. The level of mutual recognition of host state resolution action by home states would seem logically go to the issue of the scope of the systemically important activities such entities are to be permitted to carry out through branches in host member states. It is suggested that simply contemplating the creation conflict of laws situations is a meaningful or helpful answer to the issue.

L. Miscellaneous

Article 7(6) of the Directive: The phrase “substantial practical or legal impediments to the prompt transfer of own funds” is used in other European directives. It is used in the provisions of the “waivers” in Articles 69(a), 80(7)(e) of Directive 2006/48/EC, the list of items to be disclosed provided in Annex XII, Part 2, no. 2(c) of Directive 2006/48/EC as well as in the “waiver” in Article 11(9)(b) of EMIR for intra-group margining of derivatives. EMIR provides for competency to define such phrase by regulatory technical standards (Article 11(15) of EMIR) and we expect that the regulatory technical standard will also impact on the interpretation of the same phrase used in other parts of the European acquis.

PROPOSAL: We propose to carefully analyzing the potential knock-on effects that the EMIR guidance might have on other directives applicable to institutions.