

# QUADRILATERAL CONFERENCE

## BANK REFORM: RING-FENCING

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# Ring-fencing models: prudential tactics and market drivers

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# **Ring-fencing models: Prudential tactics and market drivers**

**Dimitris Tsibanoulis**  
**Quadrilateral Meeting**  
**London, 2 July 2013**

- **Regressing between restrictive-interventional measures after crises, on one hand, and prudential rules, as part of deregulatory/ re-regulatory approaches during booming eras, on the other**
  - to tackle the lack of comprehension of new products and practices on the part of market stakeholders and
  - to timely respond to the new challenges facing international markets
- **How to cope with the risk factors in banking under the light shed by the crisis ?**
  - The problems as identified in the Liikanen Report:
    - Excessive risk taking, due to disengagement of trading risks from conventional banking considerations (by using depositors' money),
    - Too high leverage (e.g. through short term non ring fenced securitisation, opening a window to shadow banking),
    - Too big complexity to be comprehended and controlled,
    - Inadequate capital basis,
    - Extensive interconnectedness through a wide variety of vehicles,
    - Lack of institutional framework to resolve failed banks and policy deficits in the deposit guarantee schemes.

# The Liikanen Report – Structural Proposals

- **Initial regulatory reforms proposals point to:**
  - a) capital adequacy and liquidity requirements (Basel III)
  - b) recovery and resolution (EU Directive proposal).
- **Proposals for drastic changes in the EU banking sector as a response to the challenges posed by the crisis (*the High-level Expert Group / the Liikanen Report*)**
  - Structural reforms aiming at establishing a sound and efficient banking system in the service of society and the EU economy, augmenting and complementing the set of regulatory reforms already enacted or proposed by the EU, the Basel Committee and national governments
  - Recommendation of five measures to tackle the problems in the banking sector revealed by the crisis

# Separation of retail banking from trading activities

- **First proposal: Establishing a ring fencing mechanism**
  - Separation of retail banking from trading/investment activities (without traumatising however the concept of *universal banking*)
  - Proprietary trading and other high risk trading activities should be assigned to a separate legal entity and carried out on a stand-alone basis, ring fenced from the deposit bank
  - The separated activities can remain in the same banking group: the universal banking model in Europe would be preserved in essence
  - Banking and market synergies should not be lost (to avoid unnecessary burden to markets and the public)
- **The two basic alternatives (the “two avenues”) of the Liikanen Report for policy choices**
  - (Immediate) mandatory separation of banking activities or
  - Combination of measures: imposing a non-risk-weighted capital buffer for trading activities and leaving the separation of activities conditional upon supervisory approval of a recovery and resolution plan (minority proposal)

# Reform rationale and principles (I)

- **Deposits – carrying both explicit and implicit guarantees through the Deposit Guarantee Schemes – would no longer directly support risky trading activities**
  - Excessive risk-taking incentives induced by deposit guarantee schemes
  - Difficulties in trading activities risk quantification and pricing within the context of rapid risk profiles changes
  - Capital requirements prove to be insufficient to cover excessive and incomputable risks
- **Back to the traditional banking culture!**
  - Reduction of risk arising from the mixing of two different banking management cultures supported by controversial short term remuneration schemes
  - Funding can flow to the real economy, to enhance growth and keep the economy going

# Reform rationale and principles (II)

- **Risk limitation through easing banks' complexity and tackling interconnectedness**
  - Banks will become simpler in structure and easier to monitor
  - Recovery and resolution will be easier – No bail out, in the form of public support to banks anymore necessary [*in order to protect, among others, (guaranteed) deposits*]!
  - Fewer channels of contagion
  - Limits on trading activities are expected to reduce the counterparty risks of deposit banks [Intergroup loan financing among other considerations]
- **Corporate Governance of banking institutions made simpler**
  - Reducing the number of tasks entrusted to governing and supervisory bodies, in order to make a more feasible and coherent working environment
  - Redefining above tasks so as to bring about a more feasible corporate governance paradigm, free of the inherent antinomies posed by the dichotomy of controversial banking objectives



# Bank ring fencing

“Too big to fail”, Structural Firebreaks and Resolution – a legal overview

Chris Allen – Managing Director, Barclays

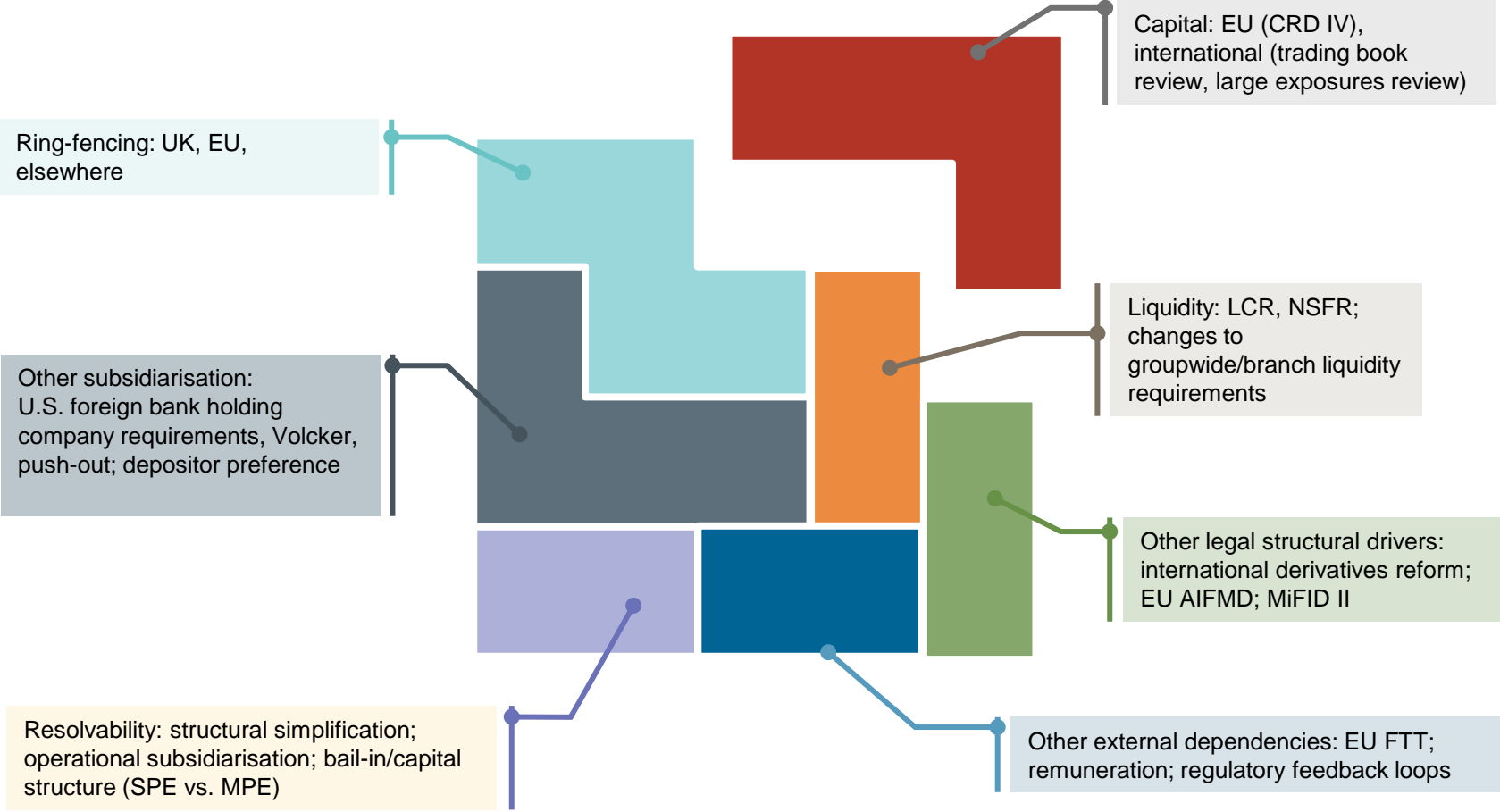
July 2013



# Key Structural Drivers

- The UK Banking Reform Bill is only one of many structural drivers
- European Commission is also looking at bank structural reform (Liikanen)
- The US requirements under the Dodd Frank Act require certain structural changes (notably under s.165) – Volcker also relevant, as is “Push Out”
- The wider “Resolution” agenda – note the UK continues to push for the implementation of the FSB’s *Key Attributes for Effective Resolution Regimes* through the EU Recovery and Resolution Directive (RRD)
- The evolving global prudential framework is a key factor in relation to structure – consolidated capital oversight and increased impact of e.g., regionalised or subsidiary specific leverage tests make the funding of fragmented asset pools more complex
- Law makers are trending towards expansive cross border scope of their rules (e.g., EMIR Art 25, global reach of CRR, CFTC Cross border Guidance under Title VII...)
- European Banking Union

# Legal and regulatory drivers of bank structural reform



# The Interconnectedness theme

- The drivers of structural reform are multi-dimensional
  - Geography – the position in the UK relative to Europe and the US
  - Business line/sector driven issues – the split between retail activity and wholesale and the fragmentation within wholesale driven by legislative tensions (Liikanen relative to Vickers) and geographical drivers (Dodd Frank s.165)
  - The mix of where geography and business line factors overlap – the UK retail ring fencing proposals will almost certainly only apply in respect of the EEA markets – it is highly likely that non-EEA retail will have to reside within the “wholesale” part of the organisation
  - Strategy drivers – the cross border scope the Dodd Frank Title VII, EMIR Article 25 and Article 11 and various aspects of MiFID2/MiFIR are unprecedented. Consolidated capital regulation removes a degree of subsidiarisation optionality as a response to expansive cross border rules relating to swaps (see Article 25 EMIR as an example) but the market has already responded tactically to these pressure points e.g., the steps taken to ensure no or de minimis United States nexus within subsidiaries within complex banking groups in the context of Swap Dealer registration
  - Commercial optionality – the requirements of the Banking Reform Bill impact how we might otherwise navigate Ops Sub both in terms of governance and control and also location strategy for certain critical payment systems access
  - Capital - as assets fragment so there can be an amplification of the economic impact of certain capital regulations. The tier 1 leverage ratio applied to non-branch US operations under Dodd Frank s.165 illustrates the point but the issue is of wider relevance . Lev ratio challenges under Basel III are driving the consolidation of assets from broker dealers to parent banks (along with non-material holdings) but that option to consolidate is at risk. The way in which assets are funded is changing

# Bank reforms: the differences between Volcker, Vickers, Liikanen and the new French approach






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# Contents

- 1. Background of the structural banking reforms**
- 2. Ongoing political and regulatory initiatives**
  - 2.1  U.S.A
  - 2.2  EUROPEAN UNION
  - 2.3  FRANCE
  - 2.4  UNITED KINGDOM
  - 2.5  GERMANY
- 3. Synthesis & Comparative table**

# Structural Banking Reforms

## A changing landscape

by Andrew Alter  
BNP Paribas

&

**The boundary between Market-Making and  
Proprietary trading in the light of the upcoming  
legislation**

by Hubert de Vauplane  
Kramer Levin



BNP PARIBAS

**KRAMER LEVIN**  
KRAMER LEVIN NAFTALIS & FRANKEL LLP

# 1- Background to the banking structure reforms

## WHY?

- A response to the financial crisis: « Too big to fail FAIL », avoid systemic crisis.
- Protect deposits against highly speculative and risky trading activities (prevent banking groups from taking excessive risks with insured deposits), avoid deposit loss risk and costs for tax payers.



## TWO SOLUTIONS HAVE BEEN CONSIDERED TO MAKE BANKING GROUPS SAFER AND LESS CONNECTED TO HIGH-RISK TRADING ACTIVITIES

- **Prohibition of risky speculative activities** (e.g. proprietary trading, investments in hedge funds and private equity funds)
- **Ring-fencing of risky speculative activities:** mandatory separation between investment and retail activities.



## A SENSE OF “DÉJA VU” OR A STEP BACKWARD?

- **USA:** Banking Act of 1933 or Glass Steagall Act, enacted as an emergency response to failure of 5.000 banks. It separated commercial banking from investment banking. It was repealed in 1999.
- **UK:** before the « Big Bang » of 1986, restrictive practices were imposed so that commercial banks did not conduct investment banking. Strong deregulation since 1986.
- **FRANCE:** before the « Banking Act » of 1984 that created the concept of « universal banking », banks were not able to expand to all businesses i.e. retail banking and investment banking.





## 2 – On-going political & regulatory initiatives

### ▣ The Volcker rule

*“I did not realize that the speculative trading by commercial banks had gotten as far out of hand as it had”.*

### ▣ The Liikanen report

*“The huge cost of the financial crisis, both in terms of direct public support to Banks and lost economic output has sadly fallen to tax payers, causing an understandable and justified public outcry.”*

### ▣ The Vickers report

*“Banking is risky”. Those risks “should sit with investors, not the taxpayers. Nor should they sit with retail depositors”.*

### ▣ The Hollande’ project

*“My real enemy is the world of finance which has taken control over our lives. I will separate banking activities useful for investment and employment from speculative activities.” (campaign slogan).*

### ▣ The Schaeuble’ draft bill

*“We are taking a head-on approach to the financial system’s lack of resilience to crisis as well as the lack of accountability on the part of banks and bankers”.*





## 2.1 USA – Volcker Rule

The Volcker Rule is a key title (Title VI, sec 619) of the Dodd-Frank Act enacted on 21 July 2010.

### WHY?

The Volcker Rule, was created to address a perception that banks engaged in high-risk speculation leading to an unacceptable level of systemic risk.

### How?

Prohibiting certain activities considered as risky.

These prohibitions are subject to numerous exemptions, some of which carry significant metrics calculations and reporting obligations.

### TIMING

- Publication of proposed implementing rules in October 2011
- Effective Date – 21 July 2012
- Expected final implementing rule by the end of 2013
- Conformance period: 21 July 2012 – 21 July 2014 - Good-faith efforts to comply with the Volcker Rule





# 2.1 USA – Volcker Rule

*Who is concerned ?*



- Banking entities**, such as FDIC-insured commercial banks, industrial loan companies ...
- Non-US bank** (and any parent company) that has a US branch, agency, .
- Subsidiaries and affiliates** of which the bank holds 25% or more of any class of voting securities.

## Volcker Rule prohibitions

## Permitted activities

▶ **Proprietary trading** means engaging as principal for the trading account in any transaction to purchase or sell, acquire or dispose of securities, derivatives, etc.

**Prohibitions on Proprietary Trading**

- ❑ Market-making related activities, Underwriting
- ❑ Risk-mitigating hedging
- ❑ Trading solely outside of the U.S.
- ❑ Trading in government securities (U.S.)
- ❑ Trading on behalf of customers
- ❑ Trading by insurance co. for general account
- ❑ Bona fide liquidity management

▶ **Ownership interest in or sponsorship of**

- US hedge funds and private equity funds
- Any similar non-US funds

**Prohibitions on Fund Sponsorship or Ownership Interests**

- ❑ **Asset management activities:** Aggregate investments may not exceed 3% of Tier1 capital.
- ❑ Activities solely outside of the U.S.
- ❑ Foreign funds regulated and publicly offered (e.g. UCITS)
- ❑ Risk-mitigating hedging
- ❑ Investments in small business investment companies, Loan securitizations

Transactions causing the bank to have a credit exposure with a sponsored or an advised hedge fund or private equity fund

**Covered Transactions between Covered Funds and Banking Entity**

Prime brokerage and other activities

# 2.1 USA – Volcker Rule



## EXTRATERRITORIAL REACH

- The Volcker Rule applies to **any banking entity, wherever situated**, that has a **US branch, agency or bank subsidiary**, as well as to the institution's **other subsidiaries and affiliates around the globe**.
- **Exemption for the activities conducted solely outside of the US (SOTUS).**

## 2.2 European Union - Liikanen report



### WHY?

To assess whether additional reforms directly targeted at the structure of individual banks would further reduce the probability and impact of failure, and would ensure the continuation of vital economic activities

- High-level Expert Group on structural bank reforms established by Commissioner Barnier and chaired by Erkki Liikanen, Governor of the Bank of Finland.
- [Analysis and recommendations of the Expert Group released in its Report of 2 October 2012](#)

### How?

Mandatory legal separation of particularly risky financial activities from deposit activities, if the risky activities amount to a significant share of the bank's business (exceeding 15-25% of the bank's total assets or EUR100bn) or should their volume be significant with respect to the financial stability.

- ⇒ To ensure protection against intra-group contagion, risky activities will be conducted by a **trading entity, economically independent** and easily separable from the rest of the Group with separate capital and funding, and which will **meet prudential regulatory requirements on a stand-alone basis** (e.g. CRD IV).
- ⇒ The trading entity could neither own nor be owned by an entity itself carrying out other banking activities. An integrated banking group could be structured by way of a holding company owning both trading entities and other banking entities.



## 2.2 European Union - Liikanen report



Retail banks would be able to carry on the following “*permitted activities*” in addition to accepting retail / insured deposits

- Retail payment services
- SME lending
- Trade finance
- Consumer lending
- Mortgage lending
- Interbank lending (but see right)
- “Plain vanilla” securitisation for own funding purposes
- Participation in loan syndications
- Private wealth management
- Asset management (query whether this includes management of captive funds and other group investment vehicles)
- Exposures to UCITS funds
- Use of derivatives for “*own asset and liability management purposes*”
- Sale and purchase of assets in liquidity portfolio
- Hedging services to non-bank clients, subject to risk limits (to be defined)
- Securities underwriting

The report recommends pushing the following activities out of the retail bank in a separate “trading entity”

- Proprietary derivatives and all asset and securities positions (presumably following MiFID / EMIR definitions) incurred as a result of market-making
- Proprietary securities business
- Loans, loan commitments or unsecured credit exposures to hedge funds (e.g. prime brokerage), private equity funds, SIVs and “*other entities of a comparable nature*”

In addition, the trading entity would not be permitted to supply retail payment services. This raises the question of how wholesale and retail payment services (and related payment system memberships) would need to be split.

## 2.2 European Union - Liikanen report



### └ TERRITORIAL SCOPE OF APPLICATION

“The separation requirements apply on the consolidated level and the level of subsidiaries”.

### └ TIMING

- ✓ The Liikanen report was subject to a 6-week public consultation closed on 13/11/2012, [89 responses](#) including ECB, French Banking Federation, Febelfin, Association of German Banks etc.
- ✓ European Parliament’s [own initiative report](#) of 08.03.2013 supporting the Liikanen recommendations and urging the European Commission to come forward with a proposal for mandatory separation of banks’ retail and investment activities.
- ✓ **European Commission’s proposal expected Q3 2013.**

## 2.3 France – Draft bill on banking separation



### WHY?

“This law fulfils President’s commitment to separate those activities that are useful to finance the economy from speculative activities. This includes measures of separation, the strengthening of supervision of market activities and the prohibition of some activities.”

**Text has been adopted by “Assemblée Nationale“, and Senate. Final vote should intervene in June.**

### How?

- Mandatory separation of prop trading activities into a subsidiary with specific prudential requirements and constrained financial relations with a group;
- Activities related to client service, clearing, hedging, market-making, ALM management, investment operations are exempted from separation;
- Mandatory separation of operations with hedge funds that are not secured according to criteria controlled by ACP;
- Separated subsidiaries should not engage in high frequency trading and agricultural commodity futures.



## 2.3 France – Draft bill on banking separation



### └ Territorial scope of application

The text applies at a group level on a consolidated basis. This approach suggests potential extra-territorial legal application.

### └ Timing

Banks should identify by 1st July 2014 activities that should be transferred. Effective transfer should happen by 1st July 2015.



## 2.4 UK – Banking Reform Bill

### WHY?

*“The aims of these reforms are clear. First, since future financial crises rarely repeat the pattern of the past, we must focus on making banks more resilient to shocks. Second, we must make our banks more resolvable so that, should they fail, it is in a manner that does not threaten the provision of vital services essential to the real economy.”* (HM Treasury White Paper on Banking reform, June 2012).

### How?

The proposals revolve around **two key concepts** – “**core activities**”, such as accepting retail deposits and other key retail services, which are to be protected within the ring-fenced retail bank; and “**excluded activities**”, which would be pushed out of the retail bank (i.e. into a separate legal entity).



Another key concept is the “**electrification**” of the **ring-fence** – under which the authorities would have a reserve power to enforce full separation of retail banks and investment banks in the event that banks do not implement the changes in the spirit that it intended.

Andrew Tyrie (who chairs the Independent Commission on Banking) has argued that “[...]electrification would reduce the uncertainty that would inevitably accompany endless gaming of the rules”



## 2.4 UK – Banking Reform Bill

### └ TERRITORIAL SCOPE OF APPLICATION

- **The focus is on UK incorporated banks and other entities carrying on “core activities.”**

The potential competitive advantages for incoming EEA firms were picked up in the Vickers report, which noted that “[...]any bank in the European Economic Area (EEA) could simply ‘branch’ into the UK and would have a competitive advantage over a UK bank.”

- It is still possible that Vickers could be used by the new Prudential Regulation Authority (the “PRA”) to pressure some incoming firms into subsidiarising in the UK (see quote from the Government’s initial response to the Vickers reforms): ***“The UK branches of banking groups from outside the UK will generally be unaffected by ring-fencing provisions, although the Government would expect the prudential supervisor of branches of banking groups based outside the European Economic Area (EEA) to give careful consideration to whether it is appropriate to permit significant amounts of mandated services to be undertaken in a branch rather than through a UK subsidiary. UK branches of EEA banks would remain unaffected.”***

### └ TIMING

The Vickers proposals have now been introduced into Parliament in the form of the Financial Services (Banking Reform) Bill. Banks expected to be given until 2019 to implement the ring-fence in full.

## 2.5 GERMANY – Draft Bank Separation law



### TIMING

- **Governmental draft of 4 March 2013 provides, inter alia, for an amendment of § 25f of the German Banking Act (“Kreditwesengesetz”).** The heading will be changed into: “Special Requirements to an orderly business organization of CRR credit institutions and groups of institutions, financial holding groups, mixed financial holding groups and financial conglomerates a member of which is a CRR credit institution.”
- **The draft will be soon introduced in Parliament.**
- **Deadlines**
  - **for establishment of financial trading institutions: 1 July 2014**
  - **for general application of regulations (including prohibition rules): 1 July 2015**

### How?

- CRR credit institutions and enterprises which belong to a group of institutions, a financial holding group, a mixed financial holding group or a financial conglomerate a member of which is a CRR credit institution may not engage in transactions for own account if:

1) In case of institutions which prepare a balance sheet in conformity with international accounting standards:

- The positions classified as financial assets available for trading and sale exceed a value of EUR 100 billion on the balance sheet date of the preceding financial year, or
- The balance sheet total of the CRR credit institution or group of institutions, financial holding group, mixed financial holding group or financial conglomerate a member of which is a CRR credit institution is not below EUR 90 billion on the balance sheet date of each of the three most recent financial years and the positions exceed 20 per cent of the balance sheet total of the preceding financial year of the CRR credit institution or group of institutions, financial holding group, mixed financial holding group or financial conglomerate a member of which is a CRR credit institution,

## 2.5 GERMANY – Draft Bank Separation law



2) In case of institutions subject to the accounting rules of the German Commercial Code:




- ❑ the positions attributable to the trading portfolio and to the liquidity reserve exceed a value of EUR 100 billion on the balance sheet date of the preceding financial year, or
- ❑ the balance sheet total of the CRR credit institution or group of institutions, financial holding group, mixed financial holding group or financial conglomerate a member of which is a CRR credit institution is not below EUR 90 billion on the balance sheet date of each of the three most recent financial years and the positions exceed 20 per cent of the balance sheet total of the preceding financial year of the CRR credit institution or group of institutions, financial holding group, mixed financial holding group or financial conglomerate,

Unless the business is operated in a financial trading institution in the meaning of § 25f para.1.






### PROHIBITED TRANSACTIONS

- Transactions for own account;
- Credit and guarantee business with German hedge funds or funds of hedge funds,;
- Dealing on own account (except for market making activities in the meaning of Art. 2 para. 1 lit. k) of the Regulation (EU) No. 236/2012 of 14 March 2012 on short sales and certain aspects of Credit Default Swaps.
- As far as a CRR credit institution or an enterprise is concerned which belongs to a group of institutions, financial holding group, mixed financial holding group or financial conglomerate a member of which is a CRR credit institution, the German supervisory authority (the BaFin) can issue a prohibition of the transactions listed below and order the cessation or transfer of these transactions to a financial trading institution in the meaning of § 25f para.1, even if the value of these transactions does not exceed the thresholds referred to in 2 a), if there is reason to assume that these transactions might jeopardize the solvency of the respective institution:
- Market making activities;
- Other transaction in financial instruments which are comparable to the aforementioned transaction by the risk involved.

# 3 - Synthesis & Comparative table

					
<b>Prohibition Ring-fencing</b>	Prohibition of certain risky financial activities	Ring-fencing	Ring-fencing	Ring-fencing	Ring-fencing
<b>Prohibited/ Ring-fenced financial activities</b>	<ul style="list-style-type: none"> <li>✓ Proprietary trading</li> <li>✓ Investment or sponsorship of hedge funds / private equity funds</li> <li>✓ Specific transactions with hedge funds or private equity funds managed by the bank</li> </ul>	<ul style="list-style-type: none"> <li>✓ Proprietary trading</li> <li>✓ <b>Market making</b>, all assets or derivative positions incurred in market-making</li> <li>✓ Private equity</li> <li>✓ Hedge funds related activities , including prime brokerage</li> </ul>	<ul style="list-style-type: none"> <li>✓ Proprietary trading</li> <li>✓ Unsecured transactions with hedge funds</li> </ul>	In the UK, the ring-fence would surround the protected (rather than the excluded) activities, e.g. retail deposits, payments and core investment services. Some retail derivatives may also be ring-fenced.	<ul style="list-style-type: none"> <li>✓ Transactions for own account</li> <li>✓ Credit and guarantee business with private equity and hedge funds (including funds of hedge funds)</li> <li>✓ Dealing on own account (defined in the relevant EU Directive 236/2012)</li> </ul>
<b>Permitted activities conducted by the deposit bank</b>	<ul style="list-style-type: none"> <li>• <b>Market-making</b></li> <li>• Underwriting</li> </ul>	<ul style="list-style-type: none"> <li>• Lending to companies</li> <li>• Trade finance</li> <li>• Consumer lending</li> <li>• Mortgage lending</li> <li>• Retail payment services</li> <li>• Interbank lending</li> <li>• Participation in loan syndications</li> <li>• Plain vanilla securitization for funding purposes</li> <li>• Securities underwriting</li> <li>• Private wealth hand asset management</li> <li>• Exposures to regulated money market funds (UCITS)</li> </ul>	<ul style="list-style-type: none"> <li>• Client service,</li> <li>• Clearing,</li> <li>• Hedging,</li> <li>• <b>Market-making</b>,</li> <li>• ALM management,</li> <li>• Investment operations</li> </ul>	In the UK, it is the excluded activities which would be pushed out of the retail bank, e.g. wholesale and investment banking activities such as dealing in investments as principal, transacting with financial institutions and <u>carrying on business outside the EEA</u> , with exceptions to allow ring-fenced banks to manage their own risks prudently.	All other activities, including market making activities (defined in EU Directive 236/2012) However, the BaFin can issue a prohibition order and order the cessation of market making activities or other transactions comparable to market making by their risk involved or transfer of positions to a financial trading institution, if the position value does not exceed the defined thresholds (see below material scope), if the solvency seems jeopardized.

# 3- Synthesis & Comparative table

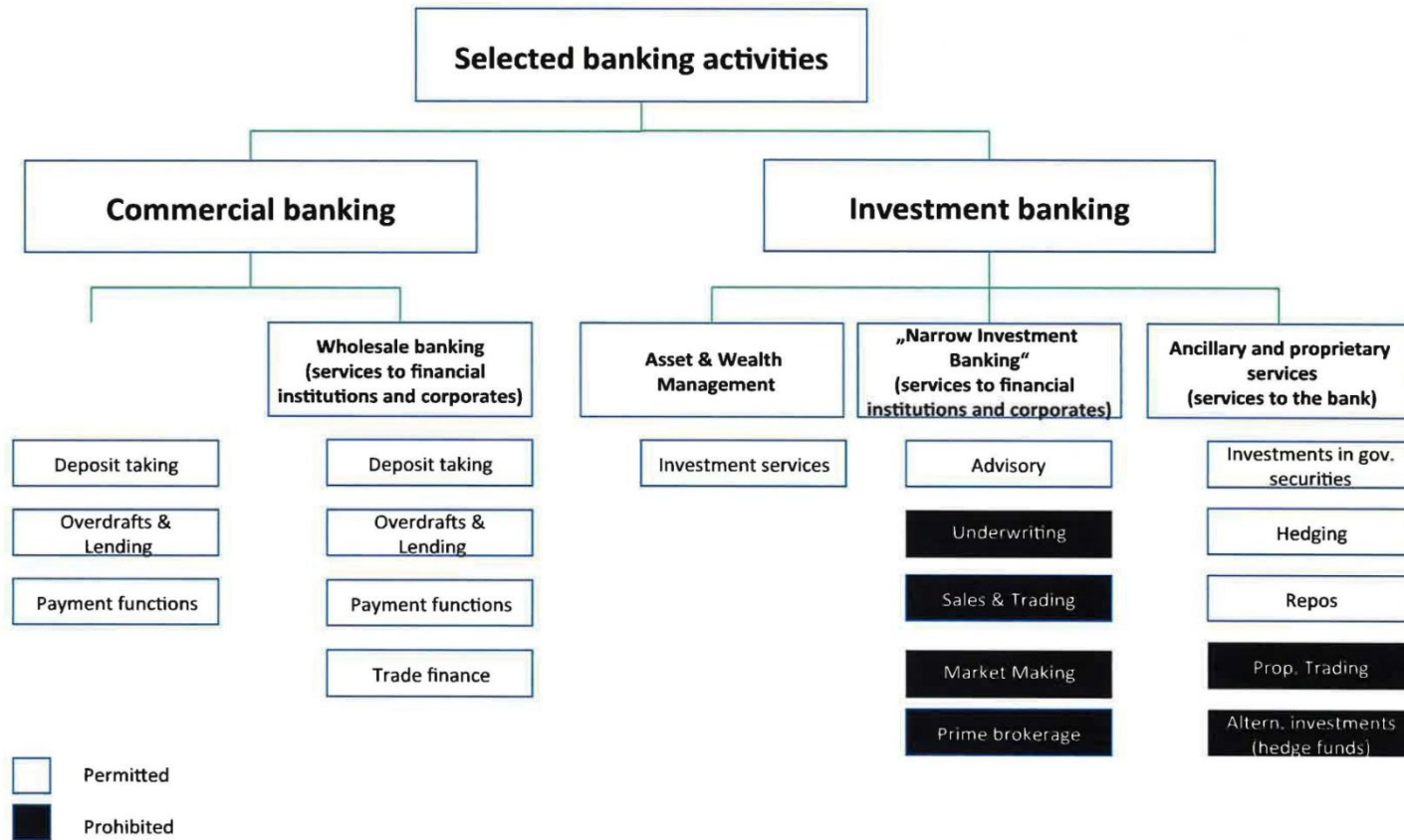
					
<b>Territorial scope</b>	<p>All banks having a US agency or entity + all its affiliates, subsidiaries in the world</p> <p>Exception: activities executed solely outside the US (restrictive interpretation)</p>	<p>Consolidated level and level of subsidiaries.</p>	<p>Consolidated level and level of subsidiaries.</p>	<p>UK incorporated banks and other entities carrying on "core activities" from an entity incorporated in the UK. For incoming firms, a general pressure to subsidiaries only – no direct application.</p>	<p>Banks incorporated in Germany. According to present state of discussion only 19 « big » German banks will be affected.</p>
<b>Material scope</b>	<p>No thresholds for the application of the VR .</p> <p>Some thresholds apply for quantitative metrics</p>	<p>The ring-fencing would apply to:</p> <ul style="list-style-type: none"> <li>• Risky activities exceeding 15-25% of the bank's total assets or EUR100bn</li> <li>• Significant volume with respect to financial stability</li> </ul>	<p>Thresholds to be determined ("décret en Conseil d'Etat")</p>	<p>Deposits from HNWIs (i.e. who have, on average over the previous year, held free and investible assets worth GBP 250,000 or more) and financial institution SMEs need not be ring-fenced.</p>	<p>Prohibition to apply if positions</p> <ul style="list-style-type: none"> <li>- exceed €100 bn. on the balance sheet date of the preceding year, or</li> <li>- balance sheet total is not below € 90 bn. in the last three financial years and positions exceed 20 per cent of the institution's balance sheet total of the preceding financial year.</li> </ul>
<b>Timing</b>	<ul style="list-style-type: none"> <li>➤ Entered into force on 21st July 2012</li> <li>➤ Expected final implementing rule Q3 2013</li> </ul>	<p>European Commission proposal expected Q3 2013</p>	<ul style="list-style-type: none"> <li>➤ To be voted by Summer 2012</li> <li>➤ Identification of transferred activities by July 2014 – effective transfer by July 2015</li> </ul>	<p>Bill currently being negotiated in Parliament; ring-fencing to be implemented in full by 2019.</p>	<p>Governmental draft of 4 March 2013 will soon be introduced in parliament. Deadlines:</p> <ul style="list-style-type: none"> <li>- for establishment of financial trading institutions: 1 July 2014;</li> <li>- for general application of regulations (including prohibition rules) 1 July 2015</li> </ul>

Until law do us part? Yes, but which one and to what extent ?

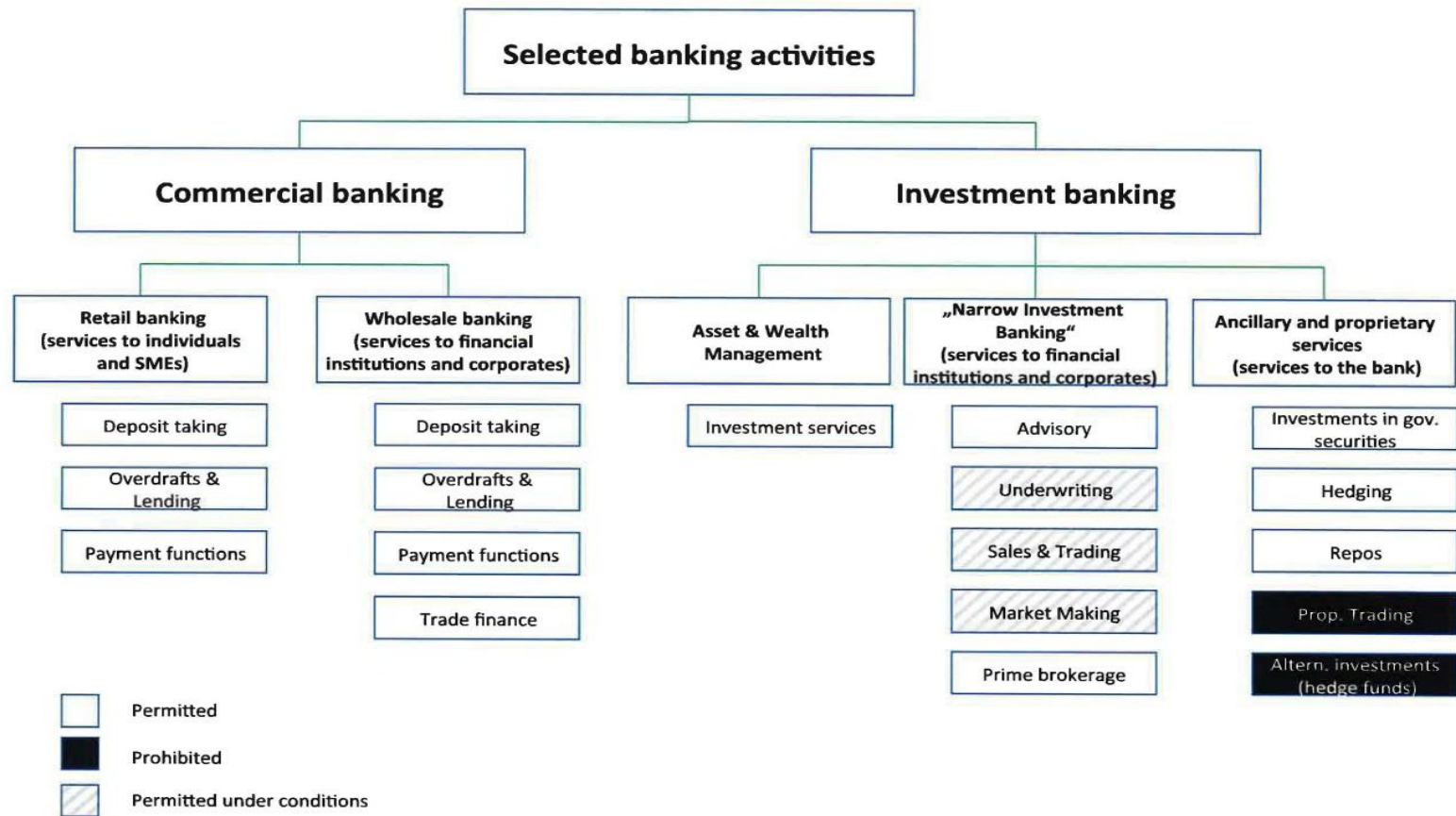
- Inspiration for the new legislation makeover: the Glass-Steagall Act
- To what extent are regulators ready to modify legislations? And what is the approach regarding the separation of banking activities?



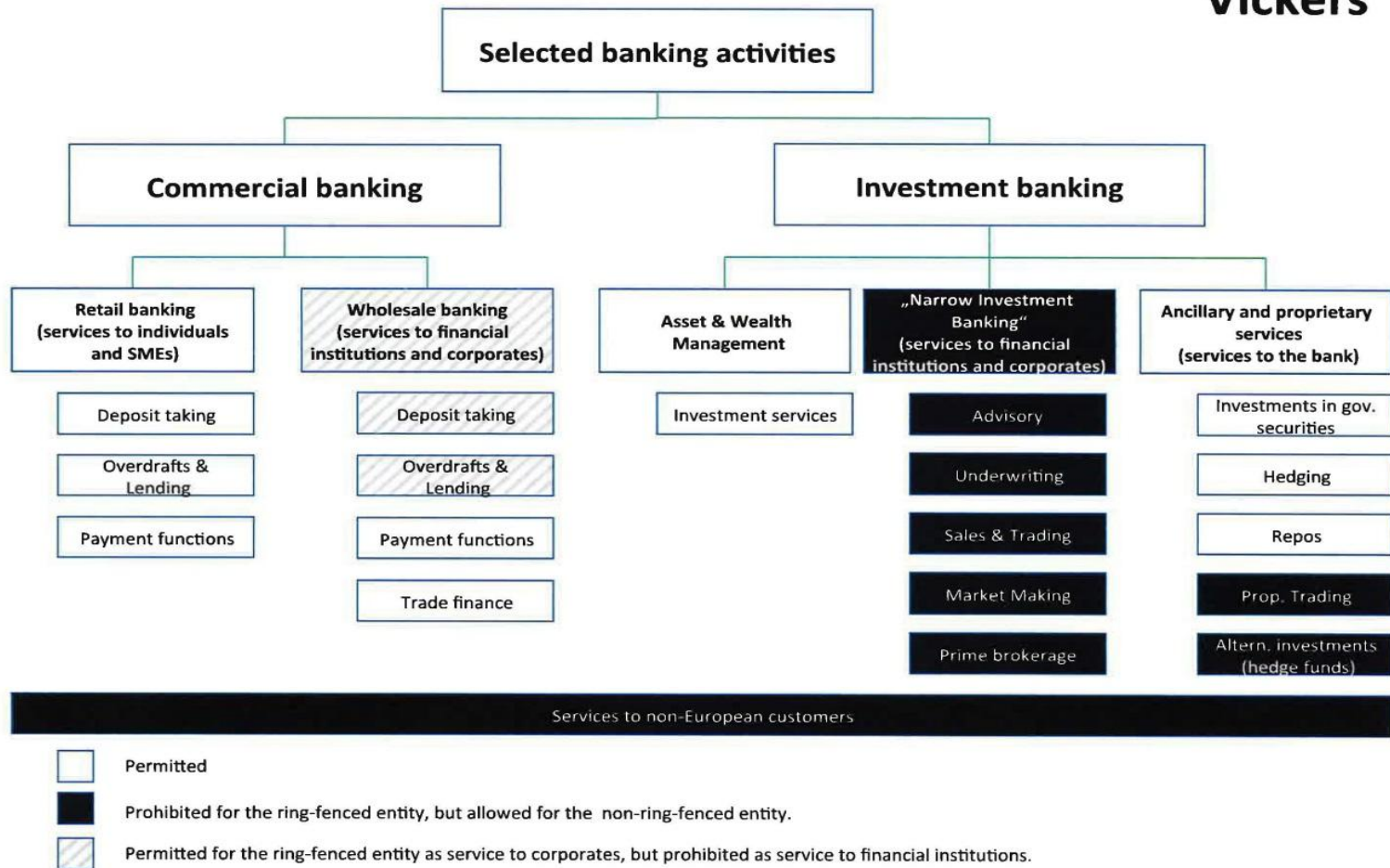
# Glass Steagall \*



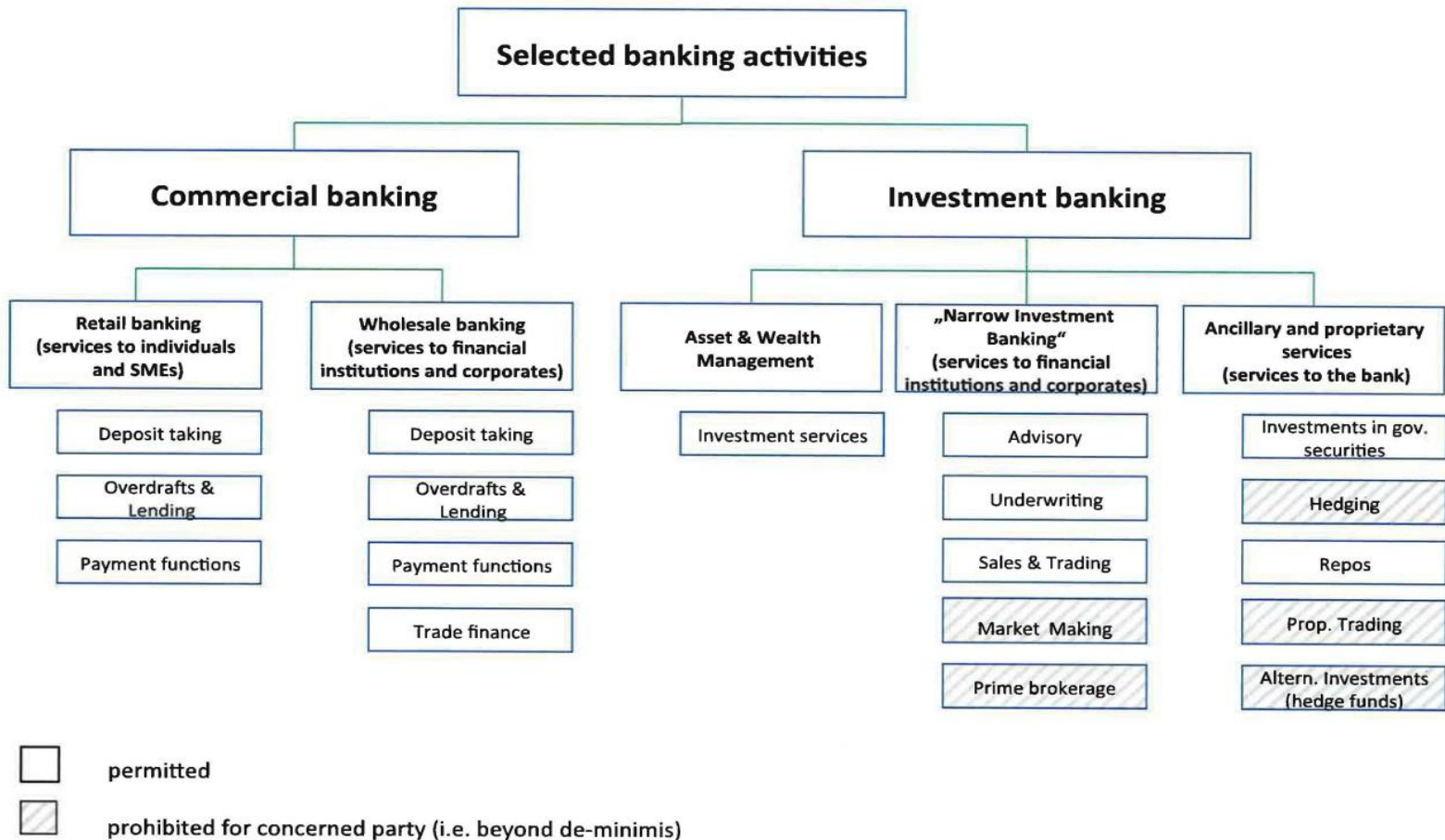
\* Thanks for graphics to **Jan Pieter Krahen** from Center for Financial Studies at Goethe University, SAFE, CEPR, and for his presentation « Towards a separation of deposit and investment banking activities, on April 18, 2013.



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## The unfound notion of “own account dealing activities”

- Finally, one of our biggest concerns is: **where is the boundary between market-making and proprietary trading?**
- To what extent is own account dealing activity defined?

## Market-making according to the EU regulation

European Directives' « heritage »: The notion represents a set of activities here and there to which, in addition, a large number of actors tend to consider themselves as market-making related practitioners, merely in order to benefit from exemptions...

# Market-making according to the EU regulation

The European regulation on short selling (*ventes à découvert*) defines *market making* as: transactions by the company as part of its usual business, by fulfilling orders initiated by clients or in response to requests for purchase ...

## Market-making according to the EU regulation

In the Markets in Financial Instruments Directive, the regulator refers to a person and no longer to an activity, and that does not give a perspective on an activity itself, but tends to subject a part of proprietary traders to the rules, the criteria of which remains unclear...



# Market-making according to the EU regulation

## Financial Transactions Tax:

The provision exempts transactions carried out in the course of market-making activity, under criteria which are very similar to those provided by the Volcker rule.

## Volcker's philosophy regarding the prohibitions

- Paul Volcker: « *Do market making, but do not engage proprietary trading in market making* »
- No concrete definitions, list of examples and exceptions;
- Reasonable interpretation of the law;
- « Broad and specific » authorities of regulators to define those concepts

## Strict distinction under the Volcker rule

Market-making according to Paul Volcker's testimony :*“The banking entity's trading desk must hold “itself out as being willing to buy and sell . . . the covered financial positions for its own account on a regular or continuous basis”.*

## Some antagonisms

“Market-making is inherently a form of proprietary trading. A market maker acquires a position from a client at one price and then lays off the position over time at an uncertain average price...some forms of trading that clearly serve no market-making intent can be proscribed, an attempt to separate “legitimate and acceptable” market-making from “speculative and risky” market-making is not productive”.

Darrell Duffie, Stanford University

## Vickers v. Volcker

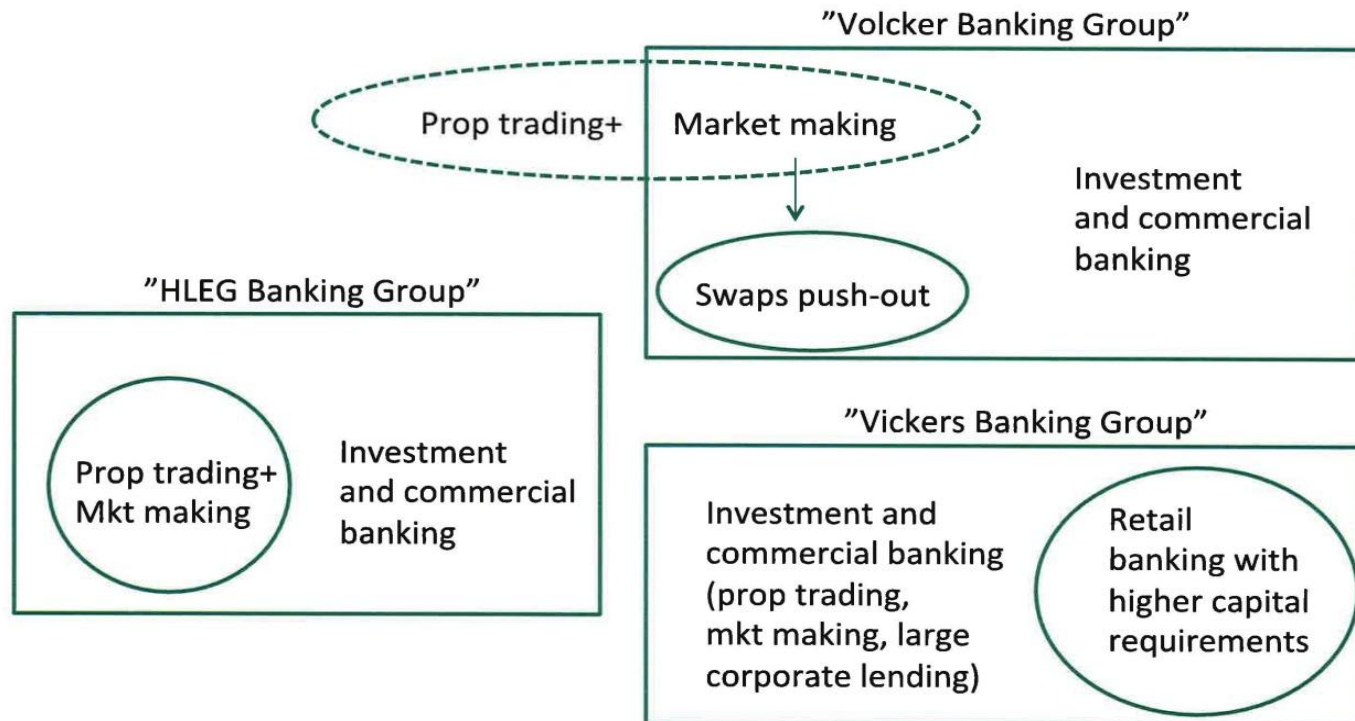
“...the distinction between market-making and a bank trading with its own money is ill-understood and would sap too much time from regulators”

Sir John Vickers  
to the UK's Parliamentary Commission on  
Banking Standards

## The Independent Commission of Banking (ICB) and the High-Level Expert Group (HLEG) comments

- Hard to distinguish from the regulatory point of view;
- On different levels market-making can be distinguished from proprietary trading differently:
  - quite easy to distinguish on “the trading floor”,
  - not so easy market-making’s “pure form”: when it starts to look like proprietary trading only when things do not go as planned...

## Proposal by HLEG Banking Group in comparison \*



\* Thanks for graphics to **Jan Pieter Krahen** from Center for Financial Studies at Goethe University, SAFE, CEPR, and for his presentation « Towards a separation of deposit and investment banking activities, on April 18, 2013

**Thank you for your attention!**  
**Any questions?**

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# FRENCH BANKING LAW

## Separation aspects

BERTRAND BRÉHIER  
Quadrilateral Meeting  
London, 2 July 2013



# General Overview

- The French government published, on 19 December 2012, a bill of law relating to the separation and regulation of banking activities which includes notably :
  - the separation of proprietary trading activities from the main activities of certain institutions;
  - the creation of a new regime for the recovery and resolution of certain banking and financial institutions;
  - the enhancement of the regulatory framework for financial institutions;
  - the strengthening of customers protection (in particular retail customers).



# General Overview

- The bill was voted by the French Assemblée Nationale and the Senate during its first reading in February and in March. The bill is currently discussed by the Senate in second reading. The final enactment is scheduled for the middle of this year



# Structure of Banks

- On the separation of proprietary trading activities, the bill prohibits credit institutions:
  - from carrying dealing on own account activities in financial instruments
    - When these trading activities in financial instruments exceed certain thresholds to be set out by Decree
  - from entering into any unsecured transactions for their own account with leveraged collective investment schemes (in particular hedge funds) or other similar investment vehicles.



# Structure of Banks

- However, the bill authorises credit institutions to carry out dealing on own account activities for:
  - market making activities ;
  - the provision of investment services to clients ;
  - the clearing of financial instruments ;
  - the hedging of risks ;
  - the sound and prudent management of the treasury of the group ;
  - (long term) investment for their group.



# Structure of Banks

- Any other dealing on own account activities must be carried out through a “ringfenced” subsidiary subsidiaries that respect, on an individual basis, all prudential rules and that can not benefit from their parent company’s support.
  - This “trading” subsidiary:
    - must be licensed as investment firms or credit institutions and should be based in France
    - is not authorised to receive deposits from the public that benefit from the deposit guarantee scheme
    - should comply with prudential ratios



# Structure of Banks

- cannot carry out HFT transactions as defined in the French General Tax Code and agricultural commodity derivative transactions.
- In the French General Tax Code, HFT is defined as the act of habitually transmitting orders using an automated processing system for these orders which is characterised by the transmission, modification or cancellation of successive orders on a specific security separated by a time period of less than half a second



# Structure of Banks

- In other words, there is a separation between activities seen as “useful to the economy financing” from those deemed to be “speculative”. Market activities that are client-oriented (such as market making) as well as hedging activities will continue to be exercised at the bank’s level. In practical terms, French banks will be required to identify the activities to be transferred by 1 July 2014, and then transfer these activities to a subsidiary by 1 July 2015.
- In order to ensure a proper distinction of client and market liquidity activities from pure proprietary trading activities to be segregated, the French law requires a very comprehensive framework to be put in place based on activities mandates, indicators... with enhanced controls and investigation powers given to supervisors.





# Structure of Banks

- In addition, the Minister of Economy, based on proposals from supervisors, can require that even authorized trading activities as market making (if reaching levels considered as endangering the stability of the economy) be transferred in the segregated entity, for any specific or all French banks.



# Q & A Session

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# WELCOME



---

**Lord Walker, FMLC**

# QUADRILATERAL CONFERENCE

## SHADOW BANKING



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**Antonio Sáinz de Vicuña, FMLG**

**Masaru Ono, FLB**

**Bertrand Bréhier, EFMLG**

**Kate Gibbons, FMLC**

**Sanjev Warna-kula-suriya, FMLC**

**Holger Hartenfels, EFMLG**

**Michael Nelson, EFMLG**

**Kunihiko Morishita, FLB**

# Chairs' Introduction

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**Antonio Sáinz de Vicuña, EFMLG**

**Masaru Ono, FLB**

# **Shedding light on the shadow banking system: overview of FSB, OICV, BCBS and European Union initiatives**

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**Bertrand Bréhier, EFMLG**

# **Shadow banking system : aspects relating to money market funds**

**BERTRAND BRÉHIER**  
**Quadrilateral Meeting**  
**London, 2 July 2013**

# At international level

- **Publication of IOSCO's final report developing 15 recommendations for money market funds (MMF)-09/10/12**
  - Limitation of asset types in which MMF can invest (i.e. prohibition of exposure to equity markets and commodity markets)
  - Strict supervision of the use of costs amortization for the valuation of assets
  - Knowledge of investors' needs, behaviour and amount of holdings
  - Obligation to keep a certain percentage of highly liquid assets
  - Conversion, to the extent possible, of constant NAV MMF to floating NAV MMF

*The FSB endorses these recommendations in its consultation concerning shadow banking that was initiated on 18/11/12*



# Regarding the United States

- **On June 5, 2013, the Securities and Exchange Commission issued a draft text on MMF (as a reminder, first proposals under the Schapiro presidency did not succeed as the industry's resistance turned them down)**
- **Regarding certain aspects (ABCP...), the US proposal is less stringent.**

# At European Union level

- **Unofficial European Regulation proposal relating to MMF**
  - **Overview of the current situation**
    - MMF hold 38% of short term debt issued by credit institutions (this percentage is significantly higher in France)
    - MMF market is concentrated in France, in Luxembourg and in Ireland (more than 95% of the market)
    - The industry of MMF management was identified as systemic

# At European Union level

- **Scope of the text**
  - UCITS or AIF established funds
  - Managed and/or marketed in the Union
  - Investing in money market instruments or deposits or « reverse repo »
  - Offering returns in line with money market rates and/or of preserving the value of the investment.
- **Articulation with UCITS and AIFM directives**
  - Dispositions of the Regulation will add to the UCITS and AIFM directives

# At European Union level

- **Eligible assets**
  - **Money market instruments (TCN, commercial paper)**
    - with a legal or residual maturity equal or inferior to 397 days
    - extended maturity MMF shall also be allowed to invest in a money market instrument that undergoes regular yield adjustments in line with money market conditions every 397 days or on a more frequent basis while not having a residual maturity exceeding 2 years

# At European Union level

- issuer of the money market instrument has been awarded one of the two highest internal rating grades (the procedure and internal rating criteria are strictly circumscribed by article 14)
- these conditions will apply to money market instruments received by the MMF as part of reverse repurchase agreement

# At European Union level

## ▪ **Deposits**

- the deposit should be repayable on demand or may be withdrawn at any time,
- the deposit matures in no more than 12 months; and

## ▪ **Derivatives**

- the underlying of the derivative instrument consists of interest rates, foreign exchange rates, currencies or indices representing one of these categories
- the derivative instrument serves only the purpose of hedging the duration and exchange risks inherent to other investments of the MMF
- the OTC derivatives are subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the MMF's initiative

# At European Union level

- **Prohibited activities**
  - **MMF may not:**
    - engage in securitization and invest in asset backed commercial paper
    - enter into repurchase agreements
    - enter into securities lending or securities borrowing agreements
    - gain exposure to equities or commodities
    - borrow or lend cash
    - engage in short selling of money market instruments

# At European Union level

- **Obligations relating to investment policies**
  - **Diversification rules**
    - MMF shall invest no more than 5% of its assets in money market instruments issued by the same body (which means instruments issued by the Group)
    - MMF shall invest no more than 5% of its assets in deposits made with the same credit institution
    - The aggregate amount of cash provided to the same counterparty of an MMF as part of reverse repurchase agreements shall not exceed 20% of its assets



# At European Union level

- MMF shall not combine, where this would lead to investment of more than 10% of its assets in a single body, any of investments in money market instruments issued by that body, deposits made with that body, OTC financial derivative instruments giving counterparty risk exposure to that body

# At European Union level

- **Other provisions**
  - Prohibition for the funds managers to use external rating for the purpose of rating the MMF
  - **Rules for NAV valuation**
    - **Possibility of valuating the NAV on the basis of amortized costs (constant NAV MMF) uniquely under certain conditions :**
      - Creation of a buffer consisting of a minimum of 3% of assets' value
      - This buffer should compensate the difference between the constant NAV and the real NAV

# At European Union level

- **External support**
  - For constant NAV MMF the external support is authorised under certain conditions for the establishment of the buffer
  
  - Prohibition principal of external support for other MMF unless under exceptional circumstances (systemic risk or instable economic situation)

# FSB proposals on shadow banking

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**Kate Gibbons, FMLC**

**Sanjev Warna-kula-suriya, FMLC**

The background of the slide is a blue-tinted image of financial data. It features a grid of numbers, some of which are highlighted in white boxes. A line graph with a dashed trend line is visible in the upper right quadrant. The numbers include '\$8,677', '\$8,051', and '903'.

# Shadow Banking

Kate Gibbons

2 July 2013

C L I F F O R D  
C H A N C E

FMLC Quadrilateral  
Meeting

# Shadow Banking – FSB Focus

WS1 - chaired by BCBS

regulation of banks' interactions with shadow banking

WS2 – chaired by IOSCO

regulatory reform of money market funds (MMFs)

WS3 – chaired by FSB

regulation of other shadow banking entities

WS4 – chaired by IOSCO

regulation of securitisation

WS5 – chaired by FSB

regulation of securities lending and repurchase agreements

# The FSB “Two Step Approach”

Data gathering – “cast the net wide”

Policy purpose – narrow focus on non-bank credit intermediation

involving maturity/liquidity transformation

imperfect credit risk transfer

leverage

regulatory arbitrage concerns



# WS1 Banks' Interaction With Shadow Banks

## Basel II.5 and Basel III

- Increased capital requirements
- Enhanced internal capital adequacy assessment process under Pillar 2
  - securitisation risk, reputational risk and implicit support
- Enhanced the Pillar 3 disclosure requirements related to securitisation

## Policy Recommendation expected mid 2013

- Scope of consolidation
- Boundary of consolidation
- Large Exposures
- Banks' investment in funds



# WS2 Money Market Funds

## IOSCO Policy Recommendations

General regulatory framework

Valuation

Liquidity management

MMFs that offer a stable NAV

Use of credit ratings

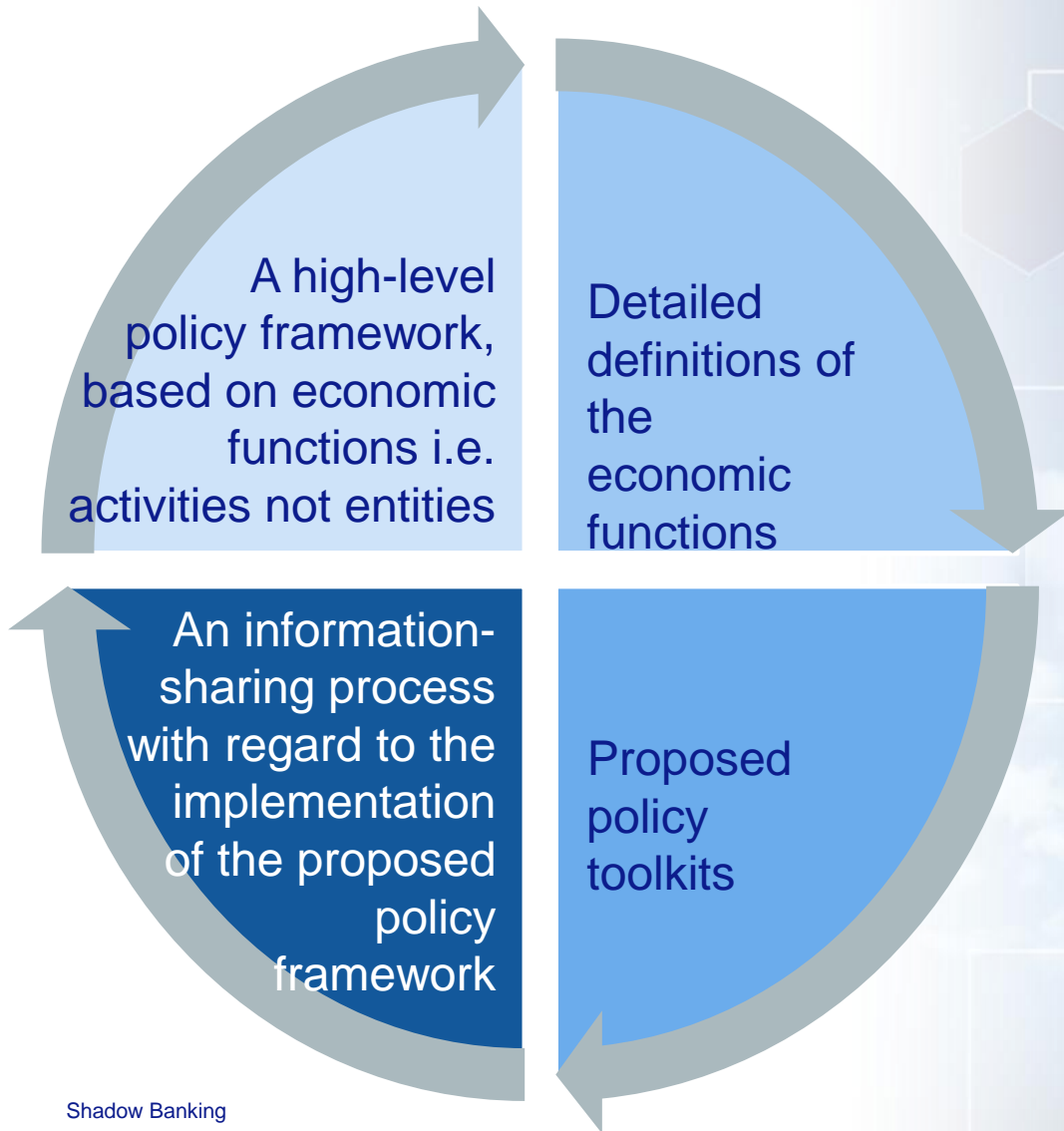
Disclosure to investors

MMFs' practices in relation to repos



# WS3 Other Shadow Banking Entities

## Policy Areas



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# FMLC Quadrilateral Meeting on 2 July 2013

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## Shadow Banking and Securitisation

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Sanjev Warna-kula-suriya

London  
Brussels  
Hong Kong  
Beijing

SLAUGHTER AND MAY

# Shadow Banking and Securitisation

- What caused the problems?
  - no skin in the game —————> bad underwriting practices (U.S. sub-prime)
  - undue complexity and overreliance on rating agencies
  - extreme asset/funding maturity mismatching (SIVs)
  - banking book vs trading book arbitrage
- Regulatory Response
  - risk retention, disclosure and due diligence requirements (Art.122a)
  - higher capital charges on resecuritisations (e.g. CDOs)
  - rating agency regulation
  - removal of banking book vs trading book arbitrage

# Shadow Banking and Securitisation (contd)...

- Market Response
  - simpler capital structures and higher credit enhancement
  - SIVs are gone; normal securitisation asset/liability profile
  - standardisation of structures and documents (PCS Initiative)
- Issues for FSB/IOSCO to bear in mind:
  - securitisation is a funding tool and engine for growth
  - danger of overlapping and disproportionate regulation (systemic risk?)
  - curtailing investor freedom and financial innovation
  - allowing recent regulatory and market developments to settle

# Shadow banking risks in securities lending and repos

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Holger Hartenfels, EFMLG



# **Shadow Banking - Securities Lending and Repurchase Transactions**

**Holger Hartenfels  
Quadrilateral Meeting  
London, 2 July 2013**

# Financial Crisis & G20 Summits



- The *Larosière* Report of 25 February 2009 identified the build up of a shadow banking system as a factor that aggravated the financial crisis.
- The final report of the U.S. Financial Crisis Inquiry Commission of January 2011 (page 345) identified AIG's securities lending and cash collateral reinvestment policy as a key contributor to its failure.
- The G20 Summits in Seoul (11/12 November 2010), Cannes (3/4 November 2011) and Los Cabos (18/19 June 2012) agreed and reaffirmed to “*strengthen regulation and oversight of shadow banking*”.

# FSB Report of 2011

- The Financial Stability Board (FSB) Report “*Shadow Banking: Strengthening Oversight and Regulation - Recommendations of the Financial Stability Board*” of 27 October 2011.
- The FSB Report identifies securities financing transactions as being at the heart of the development of shadow banking activities by
  - facilitating the use of securitization products for funding,
  - providing a source of funding for shadow banking entities,
  - leading to increased interconnectedness in the financial systems,
  - through reinvestment of cash collateral, providing a significant source of lending to term money.
- The FSB Report also introduces a new workstream on securities lending and repurchase transactions.

- On 19 March 2012 the European Commission published its green paper on “Shadow Banking”.
- The green paper identifies securities lending and repurchase agreements as activities that can be “*used rapidly to increase leverage and are a key source of funds used by some shadow banking entities.*”
- It also identifies specific issues that should be dealt with in the future:
  - Improve transparency
  - Analyse the role of market infrastructure
  - Enhance collateral management
  - Regulate the reinvestment of cash collateral ...
  - ... and the use/re-hypothecation of client assets.

# FSB Consultation Paper of 2012



- On 18 November 2012 the FSB published its Consultative Document “*Strengthening Oversight and Regulation of Shadow Banking – A Policy Framework for Addressing Shadow Banking Risk in Securities Lending and Repos*”.
- The following provides an overview on the measures proposed by the Consultative Document.

# Trade Repositories

- Competent authorities should collect granular data on securities lending and repurchase transactions.
- The FSB Report specifies the data (e.g., notional, haircut on securities, maturity) that should be collected on transaction level, on entity level and on an aggregated basis.
- Trade repositories should be established for the collection of data.
- As an interim solution, data should be collected through industry surveys.
- Aggregated data should be published on a regular basis.

# Central Counterparties

- The FSB Report encourages competent authorities to evaluate the costs and benefits of establishing central counterparties for the clearing of securities lending and repurchase transactions.

# Standardized Haircuts

- Competent authorities should introduce minimum requirements for the calculation of haircuts for securities that serve as collateral.
- The minimum requirements should address pro-cyclicality, e.g., by requiring a numerical floor on haircuts.
- The FSB Report discusses different approaches in determining such minimum haircuts and the potential negative impact on the liquidity of the financial market.
- Prudential regulators (Basel 3) should review the existing regulatory requirements for the calculation of collateral haircuts.



# Reinvestment of Cash Collateral

- Competent authorities should specify minimum requirements for the reinvestment of cash collateral received by securities lenders.
- These requirements should/may include
  - The minimum portion of cash collateral to be kept in short-term deposits or held in highly liquid assets,
  - Specific limits for the weighted average maturity of the portfolio into which cash collateral is reinvested,
  - A maximum remaining term of maturity for each single investment,
  - Concentration limits for the reinvested portfolio.
- These minimum requirements should apply to all financial entities that engage in securities lending, including pension funds, insurance companies and mutual funds.

# Reinvestment of Cash Collateral



- Securities lenders should develop reinvestment policies that take into account whether unexpected requests for returning cash collateral could be met.
- Those policies should account for periods of stressed markets.
- Lending agents should develop guidelines for cash collateral reinvestment and communicate those guidelines to their clients, i.e., the beneficial owner of the lent securities
- Lending agents should disclose to their clients the composition of the reinvested portfolio.

# Use of Client Assets

- Financial intermediaries (e.g., custodians, prime brokers) that hold client assets should provide sufficient disclosure to its clients on whether and to what extent they reserve the right to use the clients' assets.
- Clients should be able to identify and monitor their exposure in the event of the financial intermediary's bankruptcy.
- Assets may be used or re-hypothecated in order to cover the clients' position but not for the intermediary's own-account activities.
- Only entities that are subject to adequate regulation of liquidity risk should be allowed to engage in the use of client assets.
- The FSB Report proposes to harmonize client asset protection rules with respect to re-hypothecation.
- On 8 February 2013, IOSCO published a consultation report on *Recommendations Regarding the Protection of Client Assets*.

# Change of Bankruptcy Laws

- The FSB Reports discusses whether the automatic stay exemptions (safeguards) for repurchase transactions provided for in certain jurisdictions should be discontinued.
- Reference is made to a number of academics (e.g., *Duffie/Darrell/Skeel*, “A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements”, Stanford University Working Paper 108, 2012 and *Perotti*, “Systemic liquidity risks and bankruptcy exceptions”, CEPR Policy Insight No. 52, 2010 ), which question legislative initiatives like the 2005 Amendment of the U.S. Bankruptcy Code and the implementation of the European Financial Collateral Directive of 6 June 2002.
- The FSB Report proposes not to priorities changes to bankruptcy laws at this stage because of the significant difficulties in implementation.

# The efforts of the FSOC in the US to address shadow banking

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Michael Nelson, FMLG

# Shadow banking related regulation in Japan

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**Kunihiko Morishita, FLB**

# Quadrilateral Meeting July 2, 2013



## Shadow Banking Regulation in Japan

**Kunihiko Morishita, FLB**



# Financial Regulatory Authorities in Japan

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- Financial Services Agency (FSA)  
<http://www.fsa.go.jp/en/index.html>
  - Securities and Exchange Surveillance Commission (SESC)  
<http://www.fsa.go.jp/sesc/english/index.htm>
-





## Reaction by Japanese Regulatory Authorities

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- Following G-20 recommendations, Japan has implemented, or is in the course of implementing, certain measures to cope with financial instability:
    - Basel III, OTC Derivatives (CCP, ETP), etc.
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# Regulation on Shadow Banking

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- Concept of “Shadow Banking” is now well recognized
  - The need to properly regulate shadow banking activities is also generally recognized  
(e.g. FSA paper Feb. 27, 2013)
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# □ Regulator's Reaction

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- Not proactive or aggressive to date
  - Sufficiently Regulated?
    - investment funds, stock lending, repos, securitization, etc.
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## Reactions from private sector

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- Comments by Japanese Bankers Association (May 25, 2012, January 11, 2013)

<http://www.zenginkyo.or.jp/en/news/entryitems/news120525.pdf>

<http://www.zenginkyo.or.jp/abstract/opinion/entryitems/opinion250161.pdf>

<http://www.zenginkyo.or.jp/en/news/entryitems/news130111.pdf>

- Letter from JFMC(\*) to FSB (January 11, 2013)

[http://www.financialstabilityboard.org/publications/c\\_130129bg.pdf](http://www.financialstabilityboard.org/publications/c_130129bg.pdf)

\*JFMC: Japan Financial Markets Council (established on Sept. 2012)

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# Contact Details

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# Q & A and Chairs' Summary

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**Antonio Sáinz de Vicuña, FMLG**

**Masaru Ono, FLB**

# QUADRILATERAL CONFERENCE

## DERIVATIVES



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**Joyce Hansen, FMLG**

**Barnabas Reynolds, FMLC**

**Geoffrey Yeowart, FMLC**

**Holger Hartenfels, EFMLG**

**Moïse Bâ, EFMLG**

**Garland Sims, FMLG**

**Pamela Hutson, FMLG**

**Lisa Shemie, FMLG**

# Chair's Introduction

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Joyce Hansen, FMLG



# Clearing under EMIR

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Barnabas Reynolds, FMLC

# Remaining Difficulties in Cleared Derivatives Regulation

Barnabas Reynolds

Partner

Shearman and Sterling LLP

London

2 July 2013

## Overview

Despite much success in trans-Atlantic harmonisation of derivatives regulation, difficulties remain

## Proprietary protections - general

- Porting and client money/assets priority treatments dependent in some systems eg UK on actions of potential wrongdoer in segregating assets
  - Unclear position of CCP - and CM, for indirect clearing - for civil liability for moving assets on basis of good faith estimates of property entitlements (eg on back of records of CCP)
  - Laws such as tracing and constructive trusts developed to protect proprietary interests interfere with necessary certainties and are difficult to apply sufficiently swiftly in fast-moving financial world
  - US priority claim method and ability for relatively swift Court sanction of payout has some merit but difficulties remain when client asset shortfall in requisite types of security
  - Lack of trans-Atlantic harmonisation leads to significant expectation mismatches
  - Limitations of regulation as solution

## Proprietary protections – indirect clearing

- Most indirect clients will not have a contractual relationship with the CCP or be subject to CCP rules, so their asset relationship is controlled at clearing member level;
- Difficult to give indirect clients priority on CM client insolvency through porting at CM level:
  - would involve the CM performing a public function over property entitlements and interfering with normal insolvency waterfall of its clients
  - CM unlikely to be willing to port unless property entitlements absolutely clear and some form of immunity for good faith decisions
  - UK Treasury seeking to narrow the application of these provisions, but unclear whether EMIR requires it to go further

## Insolvency law uncertainties

- Development of pre-insolvency steps such as VM write-downs, tear-ups, market suspensions (with potential cessation of margin calls during suspension, leading to build-up of exposures)
- Uncertainties as to efficacy of these steps under default rules given no insolvency – needs clarification of supremacy of default rule mechanics pre-insolvency
  - Regulators can pre-approve default rules

## US v EU Customer Segregation

- The US requires FCMs to segregate initial customer margin using LSOC:
  - customer assets are protected from some, but not all, fellow customer risk; and
  - customers are subject to pro-rata sharing if there is a shortfall from investment or custodial loss
- The EU requires the choice to be offered between full customer segregation or an omnibus account:
  - it is possible to offer US customers LSOC in the form of an omnibus account; and
  - it may not be possible to offer US customers full individual segregation, as FCMs must use LSOC
- This is arguably in breach of EU law and also gives rise to discrepancies in customer protection when EU clearing houses, or EU-recognised clearing houses, are used by US entities

## Trans-Atlantic Differences: Margin Requirements

- Current EU requirement is to calculate margin using a minimum two-day liquidation assumption for cleared derivatives, with a possible top-up for proportionality purposes
- CFTC requires a minimum one-day liquidation assumption
- Under applicable EU law, requirements should take into account:
  - international competitiveness; and
  - international recommendations (e.g. the CPSS-IOSCO Principles),with a view to developing internationally consistent, non-discriminatory regulatory technical standards.
- The stated aims of EMIR are to reduce the risk of regulatory arbitrage, guarantee a level playing field and strengthen international supervisory coordination



## Trans-Atlantic Differences: Extraterritoriality

- The EMIR clearing obligation extends outside the EU to OTC derivatives contracts entered into by non-EU entities where:
  - they enter into a contract with a financial counterparty or non-financial counterparty exceeding the clearing threshold, if they would have been subject to EMIR, were they established in the EU; or
  - the contract is between two non-EU entities which would have been subject to the clearing obligation if established in the EU and the contract has a “direct, substantial and foreseeable effect” in the EU, or as an anti-evasion measure.
- The Commission has asked ESMA to draft regulatory technical standards on the cross-border application of EMIR by 25 September 2013
- US approach to ET based on effects on US, presumably due to uncertainties as to efficacy of foreign regulation; EU approach not overtly based on such suspicions

## Trans-Atlantic Differences: Consistency in Recognition Requirements

- ESMA may recognise third country CCPs under EMIR if certain conditions are met, including the third country complying with requirements equivalent to EU requirements.
- Questions remain over what ESMA will require from third countries to deem their requirements equivalent.
- Certain issues are highly political, e.g.:
  - the two day margining requirement; and
  - open access requirements for clearing houses to accept trades executed on any venue.
- An equivalence decision will impact trade between continents. The EU should first ensure that its rules are reflective of international standards and then proceed to ensure that its decision-making process is consistent.

# Segregation and porting of client accounts in UK central counterparty systems following EMIR

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**Geoffrey Yeowart, FMLC**

# **Segregation and porting of client accounts in UK central counterparty systems following EMIR**

Geoffrey Yeowart  
Hogan Lovells International LLP

2 July 2013

# Segregation of client accounts

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- Framework governing central counterparties (CCPs) has been strengthened by Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)
- EMIR has been implemented in the UK by the Financial Services and Markets Act 2000 (Over the Counter Derivatives, Central Counterparties and Trade Repositories) Regulations 2013
- CCP must offer its clearing members the choice between accounts on the basis of individual client segregation or omnibus client segregation (EMIR, Article 39(2) & (3))
- Clearing member must offer to its clients the same choice and inform them of the costs and level of protection
- In the case of individual account segregation, any excess collateral may not be exposed to loss on another account
- CCP may provide in its operating rules for a right of use over margin and default fund contributions provided by way of a security financial collateral arrangement (subject to article 47)

# Portability of client accounts

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- CCP must at least contractually commit itself to trigger procedures for the transfer of assets and positions held by a defaulting clearing member on client account to another clearing member if so requested by the relevant client or clients
- The other clearing member is obliged to accept the transfer only where it has previously entered into a contractual relationship with the relevant client(s) by which it has committed itself to do so
- If the transfer does not occur within a predefined period specified in its operating rules, the CCP may take steps permitted by its rules to manage the risk, including liquidating the assets and positions on client account
- Excess collateral on client account remaining after completion of the default management process by the CCP is returnable to the relevant client(s) or, if they are not known to the CCP, to the clearing member for the account of its clients
- What is required to enable a CCP to make porting workable?

# Default waterfall requirements

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- Article 45(1) to (3) of EMIR provide that:
  - CCP will use margin posted by a defaulting clearing member prior to other financial resources in covering losses incurred by the CCP
  - if such margin is not sufficient to cover the losses, the CCP will use the default fund contribution of the defaulting clearing member to cover them
  - if such margin and contribution are not sufficient, the CCP will use its dedicated own resources (i.e. an amount at least equal to 25% of its minimum capital, including retained earnings and reserves, held in accordance with Article 16 of EMIR)
  - if such margin, contribution and resources are not sufficient, the CCP will use default fund contributions of non-defaulting clearing members in covering the losses
- CCP may not use the margin posted by non-defaulting clearing members to cover losses resulting from the default of another clearing member (EMIR, Article 45(4))
- Extent to which margin held to cover client individual accounts and client omnibus accounts may be applied

# Potential uncertainties

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- EMIR does not address the question of how to allocate any excess losses remaining after the resources in the waterfall have been exhausted
- CCP is permitted under article 43(3) to require non-defaulting members to provide additional funds in the event of a default of another clearing member but it is stated that "The clearing members of a CCP shall have limited exposures to the CCP"
- How widely or otherwise does this requirement apply? Should the liability of a non-defaulting clearing member be capped or can it be satisfied in other ways (e.g. by the clearing member having a right of termination?)
- Is the requirement on a CCP to exercise its right of use in accordance with article 47 intended to restrict only the manner in which it is to be exercised?



# Collateral and client money segregation

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**Holger Hartenfels, EFMLG**

**Moïse Bâ, EFMLG**

# **Collateral & Client Money Segregation**

**Holger Hartenfels  
Quadrilateral Meeting  
London, 2 July 2013**

# IOSCO Consultation Paper

- On 8 February 2013, the International Organization of Securities Commissions (IOSCO) publishes its consultation paper on “*Recommendations Regarding the Protection of Client Assets*”.
- The consultation paper responds to the lessons learned during the financial crisis, including the insolvency of Lehman Brothers and MF Global.
- It defines 8 principles that intermediaries should comply with when holding assets of clients. Those principles include
  - Accurate and up-to-date records/accounts of client assets,
  - Appropriate arrangements to safeguard the clients’ rights in its assets and to minimise the risk of loss and misuse,
  - Explicit and written consent to any waiver or modification of client protection (if permitted at all).

# Segregation under MiFID

- The first example of client asset segregation is Article 13 of Directive 2004/39/EC of 21 April 2004 on markets in financial instruments (MiFID).
- Article 13(7) MiFID requires investment firms that hold financial instruments of clients (e.g., shares or bonds), to make adequate arrangements to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency; it prohibits the use of the financial instruments, except where clients explicitly consent.
- Article 13(8) MiFID requires investment firms that hold client money, to make adequate arrangements to safeguard such funds; it prohibits the use of client money, unless the firm is a credit institution (i.e., authorized to take deposits).

# Segregation under EMIR

- The second example of client asset segregation is Article 39 of Regulation (EU) No. 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), which specifies the minimum level of protection for client clearing.
- Article 39(2) EMIR requires central counterparties (CCPs) to offer separate accounts enabling clearing members to distinguish in such accounts the assets and positions held for the account of the clearing member (house account) from those assets held for the account of its clients (omnibus client segregation).
- Article 39(3) EMIR requires CCPs to offer also separate accounts enabling clearing members to distinguish the assets and positions of an individual client from the assets and positions of other clients (individual client segregation).

# Segregation under EMIR

- The term “assets” is defined in Article 39(10) EMIR and refers to the collateral (initial margin) posted by a client.
- “Distinguishing assets and positions” means that the collateral covering client’s position is not exposed to losses connected to positions recorded in other accounts.
- Article 39(5) EMIR requires clearing members to offer its clients at least the choice between omnibus client segregation and individual client segregation and inform them of the costs and level of protection associated with each option.

# Segregation under EMIR

- ESMA, Q&A, dated 4 June 2013, CCP Question 10: “EMIR does not allow the use of unsegregated accounts. Article 39(2) and 39(3) of EMIR provide that CCPs must offer both 'individual client segregation' and 'omnibus client segregation' (these terms being defined in Articles 39(2) and 39(3) of EMIR). While CCPs might offer other levels of protection in addition to individual client segregation and omnibus client segregation (e.g. an omnibus gross margin client model), omnibus client segregation is the minimum level of client protection that can be used under EMIR.”

# 1<sup>st</sup> Incentive – Low Risk Weight

- One incentive for complying with segregation requirements is given under Article 305(2) of draft Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms version of 26 June 2013 (CRR):
- Institutions may calculate the own funds requirements for its trade exposures for CCP-related transactions based on a 2% risk weight if the positions and assets of that institution related to those transactions are distinguished and segregated.
- Segregation must apply at the level of both the clearing member and the CCP.
- The assets must be bankruptcy remote in the event of the default or insolvency of the clearing member or one or more of its other clients.



# 2<sup>nd</sup> Incentive – No Bail-in

- Another incentive for complying with segregation requirements will be given under Article 38 (2) of draft Directive [ ]/2013/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (RRD):
- Resolution authorities shall not exercise the write down and conversion powers (the so-called “bail-in tool”) with respect to liabilities that arise by virtue of the holding by the institution of client assets or client money, provided that such client or beneficiary is protected under the applicable insolvency or civil law.
- Question: Is the segregation model chosen by intermediaries recognized in the bankruptcy laws?

# German Law Perspective

- Germany is a civil law jurisdiction. The trust (*Treuhand*) is an institution that has been developed by the English legal system (during the 12th and 13th centuries), which did not find its way into German law.
- In recent years, some German acts introduced bankruptcy remoteness of certain assets which could be explained as a trust relationship:
  - § 22a KWG: refinancing registers used for segregation of receivables on the balance sheet of an originator
  - § 29 PfandBG: cover pool register of mortgage banks that create a bankruptcy privilege for *Pfandbrief* holder
- However, these acts are the exemptions.

# German Law Perspective

- The bankruptcy remoteness of a trust relationship is recognized under German common law.
- There exist Supreme Court (*Reichsgericht*) decisions dating back as far as 1899. However, there is uncertainty with respect to details.
- Initially, the Supreme Court required the trustee to receive the assets directly from the trust maker.
- An exemption was made for bank accounts held by the trustee and used for payments made by third parties on behalf of the trust maker.
- The requirements is, that the monies are distinguishable from other assets of the trustee. Hence, transparency of the trust relationship (indicated in the name of the account) and non-commingling with own assets of the trustee are minimum requirements.

# German Law Perspective

- There exist case law with respect to notary trust accounts and lawyer trust accounts (*Anderkonten*) that support that view.
- In a bankruptcy of a notary or lawyer, the client would be able to claim separation (*Aussonderung*) of cash balances credited to the trust accounts in accordance with § 47 of the German Insolvency Code.
- This approach is recognized under §34a WpHG, which implements the above mentioned Article 13 MiFID and which requires the investment firm to transfer moneys into a trust account maintained with a credit institution.
- Trust accounts are also used by *Eurex Clearing AG* for omnibus client segregation and individual client segregation on the CCP level.

# **« Collateral & Client Money Segregation » French Law Perspective**



**Moïse Bâ  
Quadrilateral Meeting  
London, 2 July 2013**

# Contents

**1. Client money/assets segregation**

**2. Collateral segregation**

**3. Anticipated evolutions**



# Client money/assets segregation

- Derivatives markets are subject to fundamental changes and Clients will look in the near future to centrally clear a large proportion of their derivatives transactions on CCPs. Firms now, to address these new client needs, target to strengthen derivatives client clearing services overall, including insuring protection of client's assets/money.
- The French client asset protection principles, resulting from the implementation of Mifid rules, are twofold. Under Article L. 533-10 of the Code, investment service providers shall, when holding financial instruments belonging to clients,
  - (i) safeguard clients' ownership rights by keeping their own financial instruments separate from clients' securities
  - (ii) prevent the use of clients' instruments for their own account except with the client's express consent.

The requirement to safeguard clients' assets is further developed in the **AMF General Regulations** through different sets of provisions;



# Further on rules applicable to the segregation of client assets and money in France



- **No generic definition of “Client Money” under French law – more a conceptual approach to define various type of funds, needing to be segregated by an investment Firm.**
- **When providing investment services and/or performing investment service activities, credit institutions are deemed to act under French law as investment service providers as such term is defined under Article L. 531-1 of the French Monetary and Financial Code .**
- **As a matter of principle, credit institutions acting in their capacity as investment service providers are required to comply with the same rules of conduct and organisational requirements as those applying to investment firms, unless specifically otherwise provided.**
- **Distinction to be drawn between funds and assets held on behalf of clients: Client asset protection rules set out in the Code and the French "*Autorité des marchés financiers*" General Regulations are equally applicable to both investment firms and credit institutions, whereas client money rules set out in the governmental Order of 2 July 2007 relating to the segregation of funds of investment firms’ clients only apply to investment firms.**



# Collateral segregation

- **No creditor of a clearing member, of an investment firm or of the CCP may assert any right on collateral provided to secure positions taken on a market in financial instruments, even on the basis of French law governing insolvency proceedings (Art. L. 440-7 of the *Code monétaire et financier*),**
- **Protection for collateral transferred: France and the full title transfer basis route !**



# Anticipated evolutions

- **New legislation (the “*Projet de loi de séparation des activités bancaires et financières*” (PLBF), actually on its way to be adopted) modifies the monetary and financial code to implement EMIR (art. L 440-7 seq.).**
- **As to the Collateralisation aspects: The PLBF refers to Art 21 I-38 (re. financial guarantees) of the Code. This reference could be interpreted as allowing a choice between a full transfer and a « nantissement » (a pledge).**
- **How the use of a pledge could increase the client money protection?**
- **It is a step forward but drafting changes to the monetary code (slight adaptation to bring consistency and further clarity) may be necessary.**

# Banking reform and resolution: UNIDROIT principles on the operation of close-out netting

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Garland Sims, FMLG

UNIDROIT

(International Institute for the  
Unification of Private Law)

**Principles on the Operation of Close-  
out Netting Provisions**

# Background

- Principles formally adopted by the Governing Council of UNIDROIT at its 92<sup>nd</sup> Session at Rome in May 2013.
- Project initiated by General Assembly in Rome on 1 December 2010.
- Study Group of experts met for three meetings between April 2011 and February 2012 and developed drafts.

# Background (cont'd)

- Soft law (principles) rather than a hard law (treaty) approach proposed.
- At its 91<sup>st</sup> session (May 2012) the Governing Council approved a request of the Secretariat to convene a Committee of governmental experts to further discuss the hard law vs. soft law approach.
- This Committee convened in October 2012 and March 2013 and finalized the draft.

# The Principles

- There are eight Principles (a ninth, on the subject of governing law) was abandoned.
- The Principles are general statements.
- Commentary provides more detail.

# Principle 1

- Scope: eligible parties and eligible obligations.
- Creation, validity, enforceability, effectiveness against third parties and admissibility in evidence of a close-out provision.



# Principle 2

- Definition of ‘close-out netting provision.’
- See handout.
- ‘Whether by way of novation, termination or otherwise.’

# Principle 3

- Definition of ‘eligible party’
- ‘Person’ other than ‘natural person acting for personal, family or household purposes.
- ‘Qualifying financial market participant’ (banks, etc.)
- QFMP includes corporation as determined by implementing State that is ‘important’
- Public authority

# Principle 4

- Definition of 'eligible obligation'
- Derivative instruments
- Repurchase agreements, etc.
- Title transfer collateral arrangements
- Contract of sale re FX, money market instruments, investment funds, bullion
- Implementing States may broaden scope

# Principle 5

- Formal acts and reporting requirements
- Enforceability of close-out not dependent on such or use of standardized forms other than a requirement that it be evidenced in writing.

# Principle 6

- Operation in general
- Should not impose enforcement requirements beyond those specified in the close-out netting provision itself.
- Should provide for severability (bad obligations/jurisdictions should not invalidate)
- Does not validate fraudulent contracts

# Principle 7

- Operation in insolvency and resolution
- Not affected by stay (subject to P8)
- No cherrypicking
- Not preferential, etc.
- Actual fraud not validated

# Principle 8

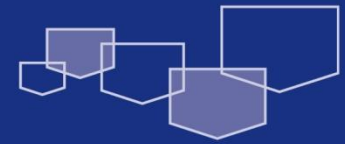
- Resolution
- Without prejudice to stay 'or other measure' in the context of resolution of financial institutions
- Above is 'subject to appropriate safeguards.'

# The new Basel guidance on foreign exchange

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**Pamela Hutson, FMLG**





BASEL COMMITTEE ON BANKING SUPERVISION

SUPERVISORY GUIDANCE FOR MANAGING  
RISKS ASSOCIATED WITH THE SETTLEMENT OF  
FOREIGN EXCHANGE TRANSACTIONS

QUADRILATERAL CONFERENCE LONDON

PAMELA R. HUTSON  
GENERAL COUNSEL – CAPITAL MARKETS  
U.S. BANK NATIONAL ASSOCIATION

July 2, 2013



## Basel Committee on Banking Supervision: Managing FX Risk

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- Published February 2013, replacing similar guidance by Basel Committee on Banking Supervision (BCBS) in 2000. Represents two years of collaboration and drafting.
- Working Group chaired by Jeanmarie Davis, Federal Reserve Bank of New York.
- Should be read in conjunction with the BCBS/IOSCO margin requirements for non-centrally cleared derivatives published in 2012.
- Intended for banking supervisors as well as banks themselves.
- BCBS intends to monitor banks and banking supervisors for their progress in implementing guidance commencing 2015.



# Basel Committee on Banking Supervision: Managing FX Risk

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## ▪ **Guideline 1: Governance**

- A bank should have strong governance arrangements over its FX settlement-related risks, including a comprehensive risk management process and active engagement by the board of directors.

## ▪ **Guideline 2: Principal Risk**

- A bank should use financial market infrastructure organizations (e.g. CLS) that provide payment vs. payment (“PVP”) settlement to eliminate principal risk when settling FX transactions. Where PVP settlement is not practicable, a bank should properly identify, measure, control and reduce the size and duration of its remaining principal risk.

## ▪ **Guideline 3: Replacement Cost Risk**

- A bank should employ prudent risk mitigation regimes to properly identify, measure monitor and control replacement cost risk for FX transactions until settlement has been confirmed and reconciled.

## ▪ **Guideline 4: Liquidity Risk**

- A bank should properly identify, measure, monitor and control its liquidity needs and risks in each currency when settling FX transactions.



# Basel Committee on Banking Supervision: Managing FX Risk

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## ▪ **Guideline 5: Operational Risk**

- A bank should properly identify, assess, monitor and control its operational risks. A bank should ensure that its systems support appropriate risk management controls, and have sufficient capacity, scalability and resiliency to handle FX volumes under normal and stressed conditions.

## ▪ **Guideline 6: Legal Risk**

- A bank should ensure that agreements and contracts are legally enforceable for each aspect of its activities in all relevant jurisdictions.

## ▪ **Guideline 7: Capital for FX Transactions**

- When analyzing capital needs, a bank should consider all FX settlement-related risks, including principal risk and replacement cost risk. A bank should ensure that sufficient capital is held against these potential exposures, as appropriate.

# **Dodd-Frank implementation issues: business conduct and documentation requirements**

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**Lisa Shemie, FMLG**

# FMLC/EFMLG/FLB/FMLG Quadrilateral Meeting London, July 2013

**Regulatory Reform**

**External Business Conduct Rules / Overview**

Lisa Shemie - JPMorgan

# Treatment of Foreign Exchange Instruments under Title VII of Dodd-Frank

Instrument type	Description	Application of CFTC Rules					
		Mandatory clearing / SEF electronic execution	Private regulatory reporting	Public real-time reporting	Business conduct obligations	Documentation requirements	Uncleared margin standards
<b>Foreign Exchange Spot</b>	Instrument involving physical exchange of two different currencies to be settled within T+2 business days, or to facilitate securities settlement within the ordinary securities settlement cycle	No	No	No	No	No	No
<b>Foreign Exchange Forward</b>	Instrument involving physical exchange of two different currencies to be settled on a specified future date that is beyond T+2 business days	No	Yes	No	Yes	Yes	Regulators still developing international framework
<b>Foreign Exchange Swap</b>	Instrument involving physical exchange of two different currencies on a specific date followed by a reverse physical exchange of the two currencies at a later date	No	Yes	No	Yes	Yes	Regulators still developing international framework
<b>Foreign Exchange Option</b>	Instrument provides holder, upon exercise, with right to exchange one currency for another currency or to receive payments as a result of changes in the value(s) of specified currencies (i.e., plain vanilla, non-deliverable options, barriers, binaries, knock-ins, knock-outs and options with other exotic features)	Not currently covered by mandate but could be in the future	Yes	Yes	Yes	Yes	Yes
<b>Foreign Exchange Non-Deliverable Forward</b>	Instrument where single currency payment on settlement date is determined by reference to a rate source that publishes an exchange rate for two currencies (i.e., where one of those currencies is subject to exchange controls or other restrictions)	Not currently covered by mandate but could be in the future	Yes	Yes	Yes	Yes	Yes

# CFTC External Business Conduct Rules

## Heightened KYC / Suitability Requirements

- Verification of ECP status
- Know your customer requirements
- End-user exception
- Institutional suitability requirement
- Verification of Special Entity status

## New Pre-Trade Disclosure Requirements

- Disclosure of material risks
- Disclosure of material characteristics
- Disclosure of conflicts and incentives
  - Relative compensation
- Scenario analysis
  - Notification of right to receive scenario analysis
- Daily mark
  - Pre-trade and post-trade obligation

## Special Entity Provisions

- Recommendations and advisor status
  - Safe harbors for:
    - ERISA
      - (i) plan represents that it has a representing fiduciary
      - (ii) fiduciary represents that it will not rely on recommendations
      - (iii) plan represents that it will comply with policies to ensure that recommendation is evaluated by fiduciary
    - Non-ERISA plans
      - (iv) SD does not express opinion as to whether Special Entity should enter into swap
      - (v) Special Entity represents that it will not rely on recommendations and will rely on advice from qualified independent representative
      - (vi) SD discloses that it is not undertaking to act in the best interests of the Special Entity
  - Best interest standard
- Independent Representative qualifications
- Special disclosure of SD capacity
- Political contributions



# Key Elements of Protocol 1- Action Required by May 1<sup>st</sup>

Issue	Necessary Action
<b>Eligible contract participant</b> status – required for all swap counterparties	Confirm ECP type (Part III, Question 2) <ul style="list-style-type: none"> <li>• Certain commodity pools must also provide additional ECP representation for FX instruments (Addendum 1, §4)</li> </ul>
<b>Financial entity</b> status – included in SDR reports and may affect reporting responsibility for non-dealer trades and eligibility for end-user exception	Confirm status (Part III, Question 5)
<b>Special Entity</b> status (e.g., pension plan or endowment) – additional business conduct obligations apply	Confirm status (Part III, Question 6) <ul style="list-style-type: none"> <li>• ERISA plan must identify representative that is an ERISA fiduciary (Part II, Question 8)</li> <li>• Non-ERISA Special Entity must identify qualified independent representative (Part II, Question 7) – could be third party trading advisor or an internal employee</li> </ul>
<b>Safe harbor election</b>	Incorporate additional schedule as follows: <ul style="list-style-type: none"> <li>• Non-Special Entity (Schedule 3 through Part III, Question 9)</li> <li>• Non-ERISA Special Entity (Schedule 4 through Part III, Question 7)</li> <li>• ERISA Special Entities (adhere to Schedule 5 or 6 through Part III, Question 8 or 9)</li> </ul>
<b>Pre-trade disclosures</b>	<ul style="list-style-type: none"> <li>• Provide e-mail address for delivery (Part III, Question 10)</li> <li>• Consent to initial oral disclosure (Part III, Question 11)</li> <li>• Consent to non-disclosure of pre-trade marks for highly liquid instruments (Addendum II, §2)</li> </ul>

First Addendum to Protocol 1 also includes question on Active Fund status.

Second Addendum to Protocol 1 also includes questions on Category 2 and U.S. person status.

# Swap Trading Relationship Documentation Requirements

The Swap Documentation Relationship Documentation Requirements become effective on July 1, 2013, and cover the following products:

- FX Deliverable Forwards
- FX Swaps
- FX Non Deliverable Forwards (NDFs)
- FX Options

FX Spot is not subject to the Swap Documentation Rules:

“FX Spot Transaction” means a foreign exchange transaction that settles via an actual delivery of the relevant currencies within two business days or by the customary timeline of the relevant market.”

“FX Securities Conversion Transaction” means a foreign exchange transaction entered into for the purchase or sale of an amount of foreign currency equal to the price of a foreign security with respect to which (i) the security and related foreign currency transactions are executed contemporaneously in order to effect delivery by the relevant securities settlement deadline and (ii) actual delivery of the foreign security and foreign currency occurs by such deadline.”

# Swap Trading Relationship Documentation Requirements

Minimum requirements to comply with the Swap Documentation Rules:

Requirement	Description
Trading relationship terms	Including “terms addressing payment obligations, netting of payments, events of default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution.”
Valuation	Written documentation, in which the parties agree on the process for determining the value of each swap at any time, including alternative methods for determining value and a valuation dispute resolution process
Other notices	Counterparty status, clearing election notices, orderly liquidations

Compliance with Swap Documentation Rules may be accomplished by adhering to the ISDA Dodd-Frank Protocol 2.0 (the March 2013 DF Protocol).

# Q & A and Chair's Summary

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Joyce Hansen, EFMLG

# QUADRILATERAL CONFERENCE

## FINANCIAL CRISIS RESPONSE (Asia – U.S.)

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**Joanna Perkins, FMLC**

**Akihiro Wani, FLB**

**Shawei Wang, FMLG**

# Chair's Introduction

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**Joanna Perkins, FMLC**

# **1998 Japanese financial crisis and 2008 global financial crisis in the context of recovery and resolution plans: a Japanese approach**

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**Akihiro Wani, FLB**

# 1998 Japanese Financial Crisis and 2008 Global Financial Crisis in the Context of Recovery and Resolution Plans

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Akihiro Wani

*Partner*

2 July 2013



# 1998 Financial Crisis and Countermeasures in Japan

# 1. Back to 1998 – Prelude and Catastrophe

---

## 1.1 Sanyo Securities Co., Ltd. (3 November 1997)

The freezing order issued by a court upon the filing of an application for the commencement of the corporate reorganization proceedings did not exclude the repayment of loans borrowed by Sanyo Securities in the short-term money market; this caused defaults. Such defaults were unprecedented in the Japanese market and they created a small systemic risk. (This was caused partly by a lack of insight on the part of the court and the regulators.)

# 1. Back to 1998 – Prelude and Catastrophe (Cont.)

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## 1.2 Hokkaido Takushoku Bank, Ltd. (15 November 1997)

Hokkaido Takushoku Bank (then one of the city's major banks), which had incurred severe losses due to non-performing loans (“NPLs”) linked to real estate investments, became unable to raise enough funds in the short-term money market for its operation due to the default by Sanyo Securities. Special insolvency proceedings for banks had yet to be legislated. It was almost impossible to apply ordinary insolvency proceedings to this Bank (such as the Corporate Reorganisation Act or the Bankruptcy Act) due to the large number of creditors (depositors) and its role in the settlement system in the regional economy of Hokkaido. The systemic risk was the biggest concern for the regulators. It eventually had to transfer its business to Hokuyo Bank, Ltd., a regional bank in Hokkaido, and Chuo Trust Bank (now Sumitomo Mitsui Trust Bank), and the Bank of Japan granted special loans to Hokkaido Takushoku Bank to bail them out. (There was a lack of appropriate insolvency legislation for bank insolvency.)

# 1. Back to 1998 – Prelude and Catastrophe (Cont.)

---

## 1.3 Yamaichi Securities Co., Ltd. (24 November 1997)

Yamaichi Securities, which was one of the Big Four securities companies in Japan at the time, incurred heavy losses due to undisclosed off-balance transactions and could not obtain enough funding from its main bank. Accordingly, the firm entered into voluntary dissolution procedures, which finally turned into bankruptcy proceedings. The Bank of Japan granted special loans (in the amount of JPY 1,200,000,000,000) to Yamaichi Securities via Fuji Bank (now Mizuho Bank) to avoid systemic risks in the domestic market and overseas market. (There was a lack of procedures to avoid systemic risks, especially those overseas, and also a lack of appropriate insolvency procedures to protect a large number of shareholders.)

# 1. Back to 1998 – Prelude and Catastrophe (Cont.)

---

## 1.4 The Long-Term Credit Bank of Japan, Ltd. (23 October 1998)

The Long-Term Credit Bank of Japan (“LTCB”) was one of Japan’s major banks, and it had a wide range of domestic and international operations. Due to an increase of NPLs at LTCB and failures of attempts to merge with other financial institutions, it was temporarily nationalised under the Financial Revitalisation Act (the “FRA”, which passed the Diet on 16 October 1998) (“Temporary Nationalisation”). The government injected approximately JPY 11,700,000,000 into LTCB. (The ultimate final loss is estimated to be approximately JPY 5,000,000,000,000.) LTCB was then sold to New LTCB Partners CV in March 2000, and it changed its name to Shinsei Bank. (This marked the introduction of new legislation to bail out a troubled bank by temporary nationalisation.)

# 1. Back to 1998 – Prelude and Catastrophe (Cont.)

---

## 1.5 Nippon Credit Bank, Limited. (13 December 1998)

Nippon Credit Bank, Limited (“NCB”), which had domestic and international operations, also suffered from NPLs and loans to non-bank institutions. After an investigation by the FSA, a JPY 270,000,000,000 deficit was found and the bank became temporarily nationalized. Approximately JPY 5,400,000,000,000 was injected into NCB by the government. (The ultimate final loss is estimated to be approximately JPY 3,800,000,000,000.) NCB was sold to an investment group and changed its name to Aozora Bank. (A Temporary Nationalization approach was now established.)

## 2. Countermeasures against Systemic Risk under the FRA (now a part of the Deposit Insurance Act (the “DIA”))

---

- 2.1 The FRA provides three solutions for the troubled banks.
- (1) Capital Injection by the Deposit Insurance Corporation (the “DIC”) in the form of a subscription of shares of a troubled but still solvent bank (item 1, paragraph 1, Article 102 of the DIA, “Item 1 Countermeasure”);
  - (2) Granting a loan to a bankrupt or insolvent bank exceeding the amount necessary for the pay-off followed by the liquidation of the bank (item 2, “Item 2 Countermeasure”); and
  - (3) Temporary Nationalisation (acquisition of the shares by DIC) of an insolvent bank (item 3, “Item 3 Countermeasure”).

Item 3 Countermeasure is applicable only when Item 2 Countermeasure does not work sufficiently. This is to avoid creating difficulties in the regional or national credit system (i.e. “systemic risk”).

## 2. Countermeasures against Systemic Risk under the FSA (Cont.)

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2.2 The Countermeasure of the DIA applies to banks and smaller deposit-taking financial institutions but not to securities companies or insurance companies, as banks make up the core organisation of the settlement system in Japan.

Japan has not experienced any serious financial crises since the 1998 financial crisis thanks to rigorous and intense inspections of financial institutions by the FSA.

2.3 Japanese are rather receptive to the idea of “too big to fail” based on their experience of the bail out of the failing housing loan corporations, which preceded 1998 crisis.



## 2. Countermeasures against Systemic Risk under the FSA (Cont.)

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- 2.4 Under the current regime, the relationship between insolvency proceedings pursuant to the DIA and insolvency proceedings pursuant to ordinary insolvency legislations such as the Bankruptcy Act, the Corporate Reorganisation Act and the Civil Rehabilitation Act is uncertain, and there is no court precedent.
- Also, no attention is paid to the conglomeration of financial institutions, especially regarding the possible systemic risk caused by shadow banking institutions.

# 2008 Financial Crisis and Japanese Response

### 3. Lehman Crisis and New Countermeasures

---

- 3.1 No substantial effect on the Japanese markets.
- 3.2 However, it showed a new type of financial crisis: the loss of liquidity and loss of fair value in the Japanese and global markets, and this raised serious concerns about global systemic risks.

The countermeasures provided in the DIA only focus on the protection of the creditors of a bank (namely, the depositors); they do not help to improve the deteriorated situation here.

A new mechanism is required to (i) avoid the sequential suspension of transactions by market participants and (ii) stabilise the markets by ensuring that market participants perform their systemically important contractual obligations. This may work to improve the mindset of market participants.

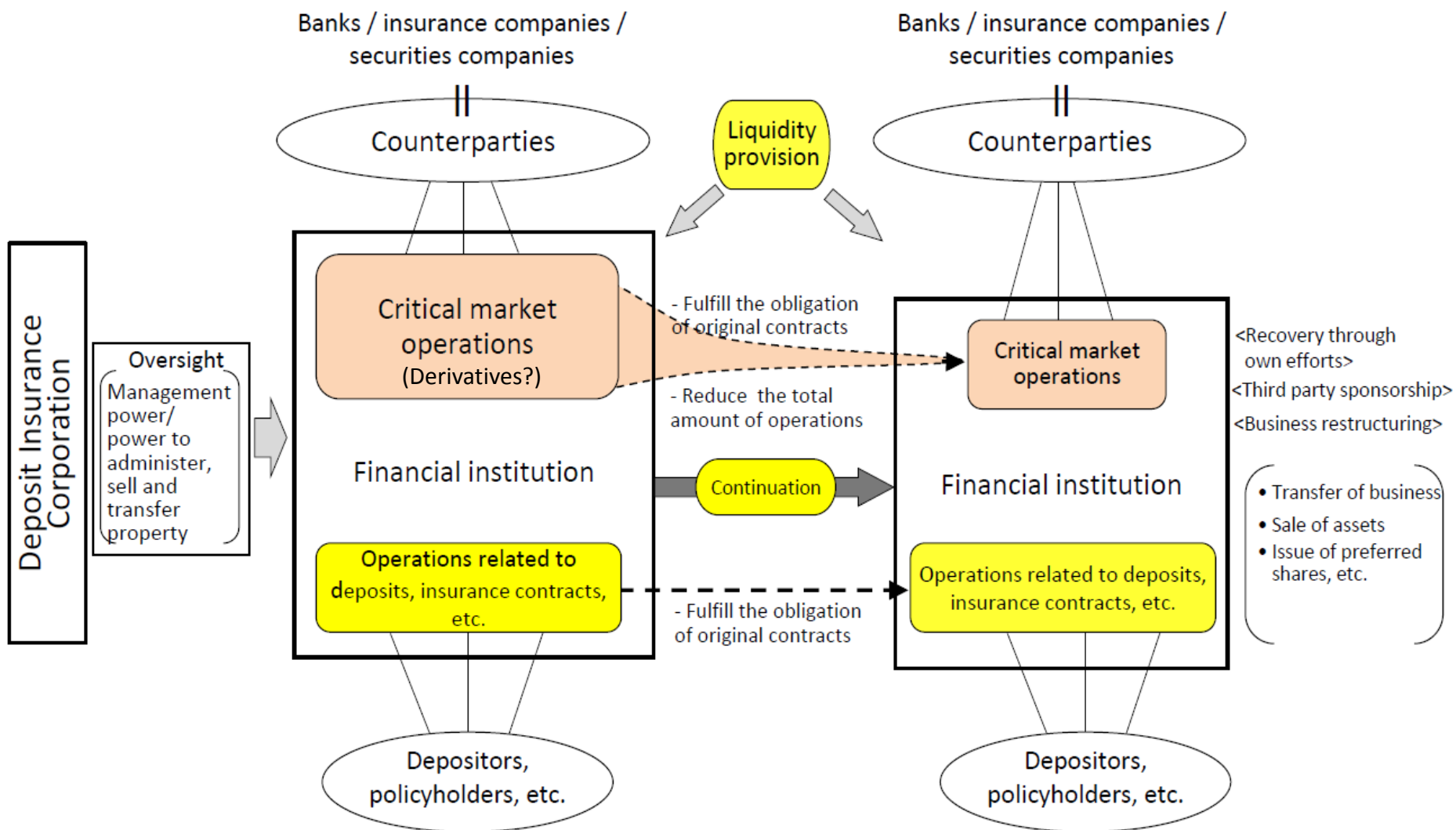
### 3. Lehman Crisis and New Countermeasures (Cont.)

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- 3.3 New Legislation: The Amendment to the DIA passed the Diet on 12 June 2013.
- (1) Wider scope of coverage: All financial institutions including banks, financial instrument business operators (securities companies), insurance companies and financial holding companies.
  - (2) Provision of liquidity and financial assistance: Ensuring the performance and the continuation of the contractual obligations by the market participants, which are systemically important, on one hand, while reducing and terminating other transactions of the troubled financial institutions on the other hand. Thus, the orderly resolution of financial institutions will be achieved. The contractual bail-in will also take place when the above measures become operative. Please refer to the next diagrams.

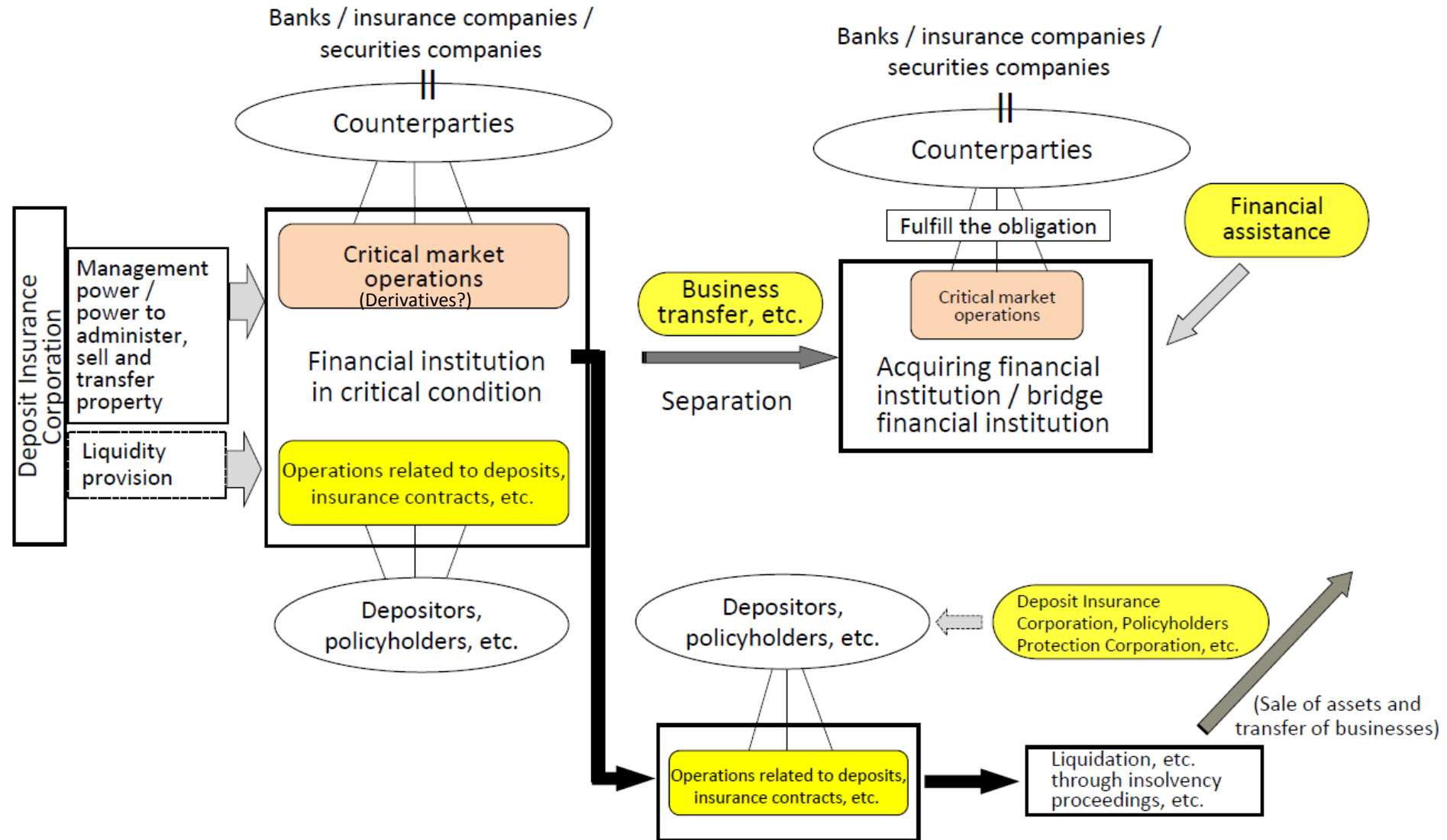
# Orderly Resolution of Financial Institutions (1)

(In the case of a financial institution that is not in the state of insolvency)



# Orderly Resolution of Financial Institutions (2)

(In the case of a financial institution such as an insolvent one)



# Way Forward

### 4. Way Forward

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- 4.1 The new legislation succeeds in the basic design of the FRA (or the DIA).
- 4.2 However, the restrictions on the scope of business of securities companies and insurance companies may be rigorously restricted, similar to those for banks. Historically, the scope of business of the securities companies has been relaxed since 1998 to encourage the expansion of the capital markets business in Japan. Will this trend change?
- 4.3 Huge discretionary power to intervene in the recovery and resolution procedures of troubled financial institutions is granted to the Financial Services Agency. Sometimes its power prevails the power of the court.



### 4. Way Forward (Cont.)

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- 4.4 Preventing the export of the systemic risks to outside countries is also an issue to tackle. Currently, some of the regulators seem to think that this can be prevented by allowing a wider extraterritorial application of their own regulations. Does this work?
- 4.5 “Inspect’ the financial institutions: “Eject” their bad assets and “Inject” capital, if necessary, seems to be the proper path.
- 4.6 International cooperation among the regulators and bankruptcy courts will be key for preventing a recurrence of the crisis.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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# **The Federal Reserve Board's recent proposed rules regarding enhanced prudential standards for Foreign Banking Organisations**

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**Shawei Wang, FMLG**



FEDERAL RESERVE BANK *of* NEW YORK

# Federal Reserve Proposed Rule re: Enhanced Prudential Standards for FBOs

**Shawei Wang**

July 2, 2013

Any errors are the sole responsibility of the author, and any views expressed are those of the author only, and do not reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System. Many thanks to Phoebe Clarke for her contributions to this presentation.

# Background: FBO Activity in the United States

- 1970s - 1990s:
  - Expanded operations in U.S.
  - Largely net recipients of funding from parent
  - Engaged in traditional lending
  - Limited risk to overall US financial stability

# Background: FBO Activity in the United States

- Run-up to 2008-2009 financial crisis:
  - Became more complex and interconnected
  - Expanded broker-dealer operations
  - Relied on less stable, short-term wholesale funding
  - Shifted to being net providers of funding: sent U.S. dollars upstream to parent

# Financial Crisis

- As a result of shifts:
  - FBOs contributed to U.S. financial instability
  - FBOs required considerable support from:
    - The Federal Reserve
    - Home-country central banks and governments

# Post-Crisis: Dodd-Frank Act

- Dodd-Frank Act required the Federal Reserve Board to:
  - (1) Establish enhanced prudential standards
  - (2) Establish early remediation requirements

- For:

## Domestic SIFIs

(Rules proposed 12/2011)

Domestic Bank Holding Companies with >\$50B in consolidated assets

Domestic nonbank financial companies designated for Federal Reserve oversight

## Large FBOs

(Rules proposed 12/2012)

Foreign Banking Organizations with >\$50B in total, global assets & U.S. banking presence

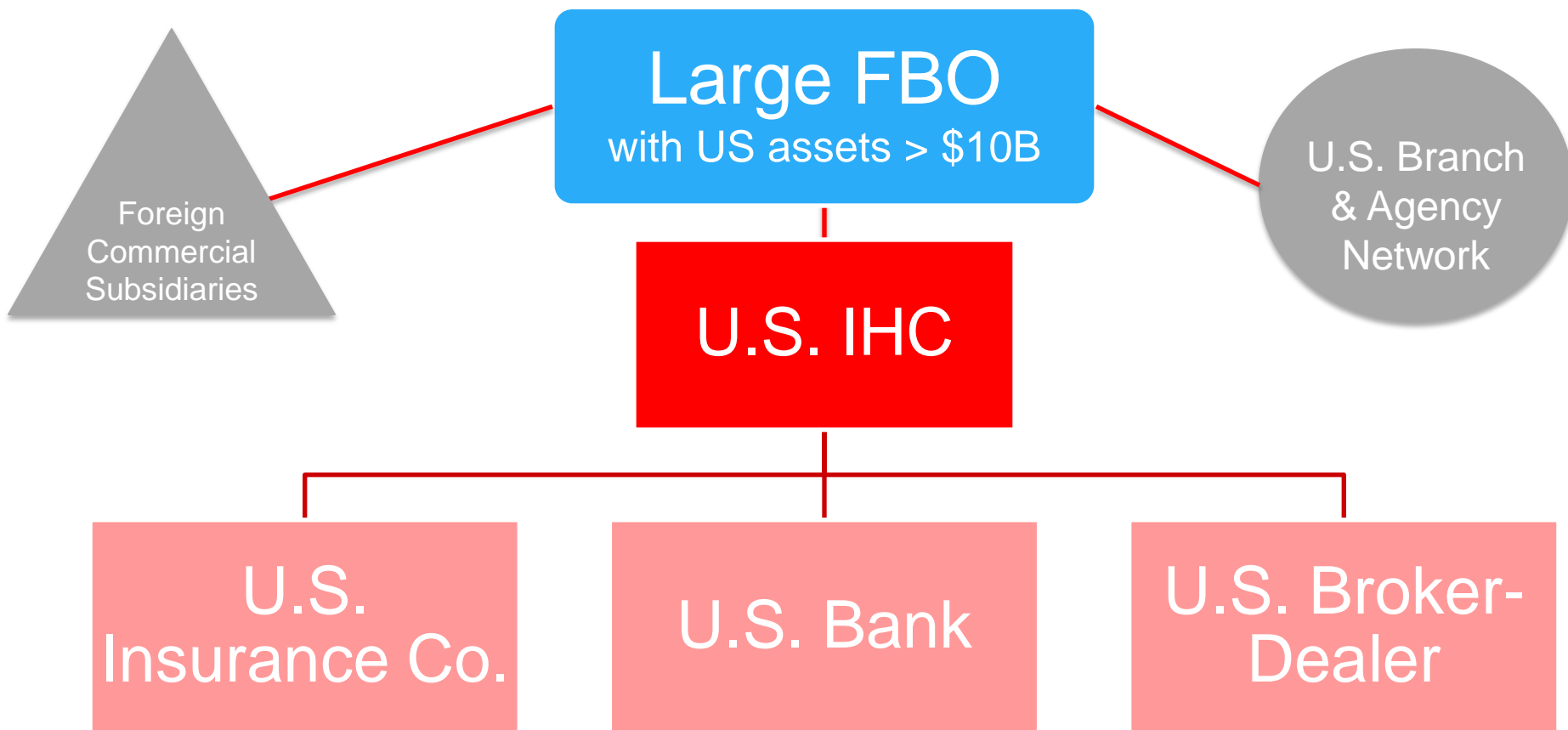
Foreign nonbank financial companies designated for Federal Reserve oversight



# Purpose of Proposed Rules

- Reduce risks of FBOs to U.S. financial stability
- Harmonize the supervision of foreign institutions and U.S. bank holding companies
  - Rules that apply to U.S. bank holding companies and FBOs are broadly comparable

# Proposed Rule: Intermediate Holding Company



# Proposed Rule: Intermediate Holding Company

- IHC structure increases uniformity in regulation:
  - Across FBOs
  - Between U.S. bank holding companies and FBOs
- Enhanced Prudential Standards apply to IHC as a whole and include:
  - Capital standards
  - Liquidity standards
  - Stress test requirements
  - Single counterparty credit limits
  - Risk management requirements

# Proposed Rule: Capital Requirements

- Risk-based standards
- Same as those that apply to U.S. bank holding companies
- Large FBOs (total global consolidated assets > \$50B) must also:
  - Meet home-country capital standards
  - Home-country standards must be consistent with Basel III

# Proposed Rule: Liquidity Requirements

- 30-day liquidity buffer:
  - U.S. IHC: must maintain all **30** days in U.S.
  - U.S. Branch and Agency Network: must maintain **14** days in U.S.

## Proposed Rule: Stress Tests

- IHC must run annual stress tests
- Stress tests similar to those imposed on U.S. bank holding companies
- Larger IHCs:
  - Required to run more frequent stress tests
  - Subject to annual stress tests conducted by supervisors

# Proposed Rule: Single Counterparty Credit Limits

- IHC prohibited from having aggregate net credit exposure to an unaffiliated counterparty in excess of **25%** of consolidated capital stock and surplus
- Large IHC (assets > \$500B):
  - Subject to more stringent credit exposure limits

## Proposed Rule: Risk Management

- FBOs with total assets > \$10B must maintain a US Risk committee
- Larger FBOs subject to additional requirements



# Proposed Rule: Early Remediation

- Defines capital and leverage ratios that trigger additional requirements:
  - Larger Liquidity buffers
  - Limits on FBO's ability to expand U.S. operations
  - Limits on FBO's ability to make capital distributions
- Large FBOs: automatically subject to requirements
- Small FBOs: subject to requirements on discretionary basis

# Conclusion

- Proposed effective date: July 1, 2015
- Proposal balances many considerations:
  - U.S. financial stability
  - National treatment
  - Equality of competitive opportunity
  - Dodd-Frank requirements
  - Home-country standards
  - Others

# Q&A and Chair's Summary

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Joanna Perkins, FMLC

# QUADRILATERAL CONFERENCE

## RECOVERY AND RESOLUTION (EUROPE)

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**Joanna Perkins, FMLC**

**Antonio Sáinz de Vicuña, EFMLG**

**Guy Morton, FMLC**

**Francis Dickinson, EFMLG**

**Habib Motani, FMLC**

**Olivier Coupard, EFMLG**

# Chair's Introduction

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**Joanna Perkins, FMLC**

# Update on banking union

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**Antonio Sáinz de Vicuña, EFMLG**

# Update on European Banking Union

**Antonio Sáinz de Vicuña**  
**Chairman of the EFMLG**

Quadrilateral Meeting  
London, 2 July 2013

*\* The views expressed are solely those of the author  
and do not necessarily reflect the position of the EFMLG or the ECB*

# SSM Background: “A genuine EMU” (4 Presidents’ Report, 5.12.2012)



## Stage 1 (2013)

- **Banking Union**
  - Establishment of the **SSM** via ECB
  - Adoption of BRRD, DGSD and CRDIV/CRR
  - Agreement on Framework for Direct Bank Recapitalisation via ESM
- **Fiscal Union**
  - Application of SGP (Six-pack (into force Dec. 2011), Two Pack (into force May 2013))
  - Implementation of Fiscal Stability Treaty (TSCG or Fiscal Compact)
- **Economic Union**
  - Application of Macroeconomic Surveillance Framework (2 Regulations within 6 pack)
  - Agreement on Framework for ex ante coordination of economic policy reforms.

## Stage 2 (2013-2014)

- **European Resolution Authority and Fund**
- **Framework for “Competitiveness Contracts”**

## Stage 3 (post 2014)

- **Central shock-absorption function**





## **FIVE REASONS JUSTIFYING THE SSM...**



**1. Fungibility of money in a monetary area**

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**2. The “stability *Trilemma*”**

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**3. Horizontal central control of liquidity flows: detecting imbalances, Basel III ratios**

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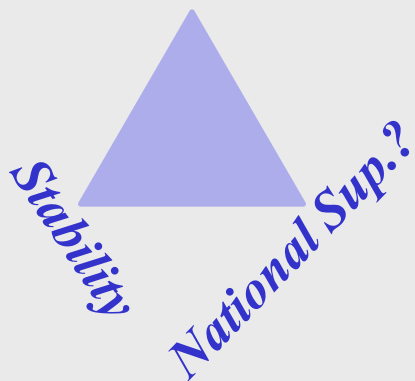
**4. No “*Home bias*” in bank supervision**

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**5. Enabling ESM direct recapitalisation**

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*Integration*



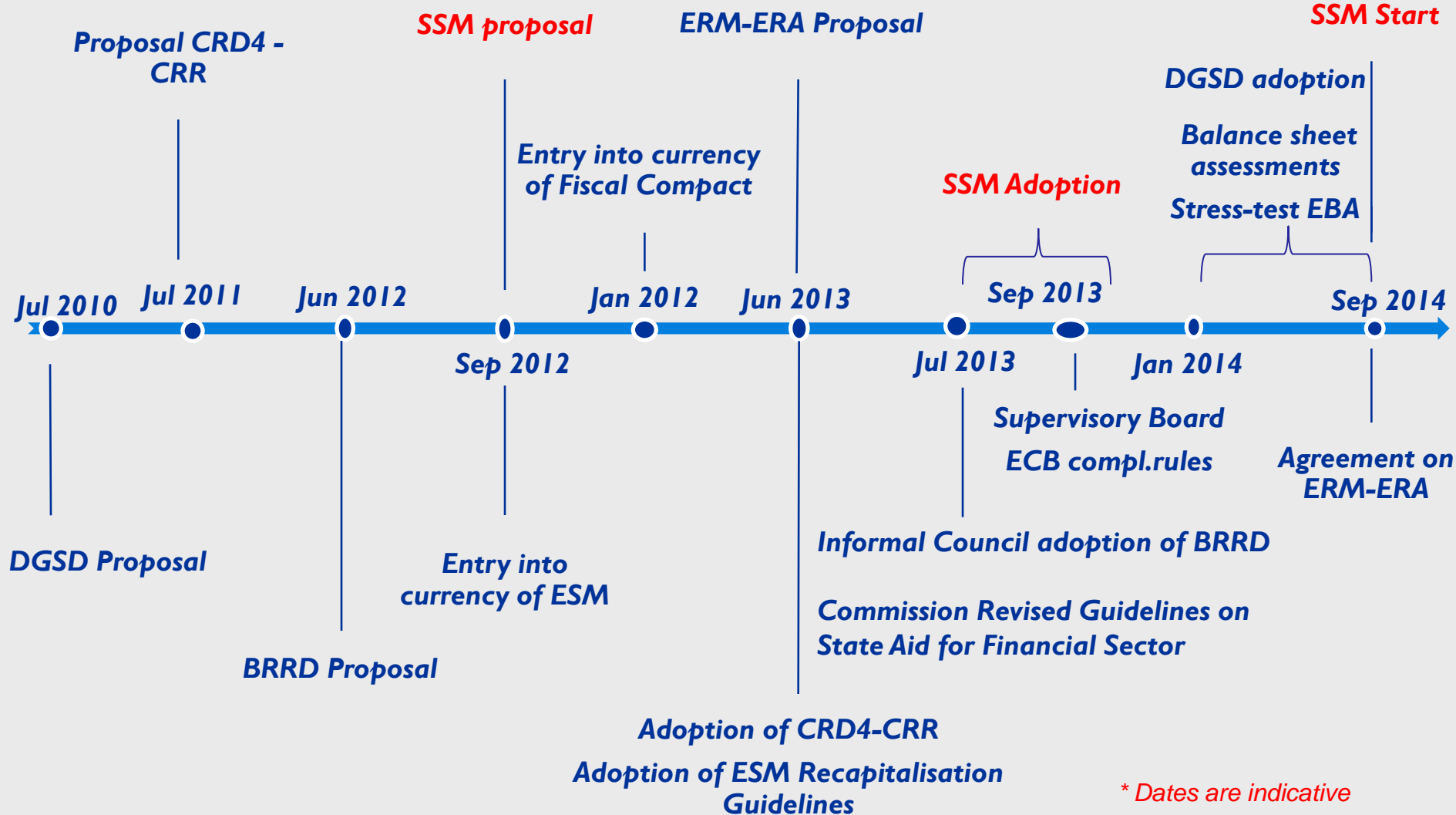
# SSM Legal Framework (I)



## Art. 127(6) TFEU

- **Council Regulation** conferring specific tasks to the ECB concerning the prudential supervision of financial institutions; rule of **unanimity** of the 28 Member States of the EU.
- **Principles** on which the basic framework is based:
  - ECB competence is **exclusive**; NCAs keep non-listed tasks
  - Exercise of vested tasks is **decentralized**: use of national supervisors
  - Encompasses **micro and macro** supervision
  - **Separation** between supervision and monetary policy
  - Respect for the **internal market** and for EBA Standards
  - Non-euro MS may **opt-in** to the SSM
  - Enhancement of **democratic control**: new roles to Council and European and national parliaments
  - Adaptation of voting rules of **EBA** (2<sup>nd</sup> EBA Regulation)

# SSM Legal framework (2): wider picture



# New role for the ECB: task allocation II

- **Direct supervision by ECB:**
  - ‘**significant**’ credit institutions, as defined
  - ‘**less significant**’ credit institutions in certain cases.
- Direct supervision means:
  - ECB adopts supervisory decisions addressed to the supervised entities;
  - NCAs assist the ECB.
- **Indirect supervision by ECB through the NCAs:**
  - ‘**less significant**’ credit institutions, as defined.
- Indirect supervision means:
  - NCAs perform the SSM tasks directly on supervised institutions
  - ECB may issue regulations, guidelines, general instructions to NCAs;
  - ECB oversees the functioning of the system;
  - ECB may collect information directly from the entities;
  - ECB may decide to exercise directly supervisory powers.

# The ECB and the EBA: complementarity I



The **ECB** will apply the Single Rulebook within the SSM; it takes it as a given, no rival normative role.

Within the scope of non-regulated areas, or when the Single Rulebook leaves scope for options, the ECB will aim at a consistent interpretation and implementation of the Single Rulebook by NCAs within the SSM perimeter.

The need for the SSM to operate through Joint Supervisory Teams will smoothly lead to closer supervisory culture and consistent practices (Supervisory Manual).

The **EBA** retains all its existing powers and tasks:

- developing the single rulebook for banking = EU 28 normative action
- contributing to its consistent implementation
- enhancing convergence of supervisory practices across the whole Union.

*Areas of close interaction EBA-ECB:*

- *European Supervisory Handbook (best practices)*
- *Stress testing*
- *Crisis management procedures*

# THE END

## Thank you very much for your attention!



# Bank resolution in light of the Recovery and Resolution Directive

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Guy Morton, FMLC

# Resolution and the RRD

Guy Morton

2<sup>nd</sup> July 2013

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# The Recovery and Resolution Directive: key features

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- Framework for harmonized member state R&R regimes
- Recovery and resolution planning
- Early intervention powers
- Resolution measures: objectives, triggers, general principles, tools and safeguards
- Minimum requirement for own funds and eligible liabilities
- Member state resolution funds
- Cross-border application, recognition and co-operation –
  - within EU
  - between EU and third countries



# RRD: resolution measures

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- Sale of business
- Bridge institution
- Asset separation
- Bail-in
  - exclusions for covered deposits, secured liabilities, employees, commercial claims for key goods/services, short term (< 7 days) inter-bank or payment systems claims
  - (non-covered) individual and SME deposits preferred to other deposits/claims
  - authorities' discretion to exclude other liabilities from bail-in (subject to further negotiation regarding the "resolution triangle")
- Safeguards, including –
  - "no creditor worse off" principle
  - "all or nothing" protection for security, title transfer, netting agreements etc.
  - temporary stay limited to midnight on business day following publication



# Recovery and resolution: cross-border issues

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- FSB Key Attributes, section 7.5 –
  - “Jurisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures, either by way of a mutual recognition process or by taking measures under the domestic resolution regime that support and are consistent with the resolution measures taken by the foreign home resolution authority.”
- Need for clarity on –
  - conflict of laws issues affecting resolution measures (e.g. how measures are characterized, scope of, and limitations on, recognition of foreign law)
  - requirements for an effective mutual recognition regime
  - requirements for an effective “supporting action” regime (including powers needed by supporting “host state” resolution authorities)
- How best are these questions to be taken forward?



# Cross-border resolution: some RRD provisions

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- Within EU, mutual recognition (article 59)
- Liabilities governed by non-EU law –
  - terms of issue of capital instruments to include contractual recognition of EU measures for write-down or conversion (article 50)
  - discretion to exclude pre-2013 liabilities from bail-in (article 38(3ca))
- EU resolution involving property in third state: home state resolution authority to require administrator of institution to take necessary action to ensure that measures have effect (article 60)
- Power for Commission to negotiate EU/third country agreements (article 84)
- Absent/pending agreement, qualified obligation on member states to recognize resolution measures taken by foreign authority in respect of institution with local subsidiary and/or property (articles 85 and 86)
- Member states may refuse recognition on specified grounds (e.g. financial stability, fiscal implications, lack of equal treatment)
- National resolution authorities must be empowered to transfer/perfect transfer of local assets and shares in local subsidiaries



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**Freshfields Bruckhaus Deringer**

# **Bank resolution: issues in achieving effective resolution planning**

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**Francis Dickinson, EFMLG**

**Habib Motani, FMLC**



# Legal Issues around bank resolution

Francis Dickinson

2<sup>nd</sup> July 2013



# Resolution planning

- Key choices: -
  - Effect of risk reduction initiatives
  - Cost of resolution planning
  - Combining parallel projects
- International consensus - or otherwise
- Emerging workstreams



# Competing priorities

- Positive business planning scenarios vs. resolution planning
- Incorporating resolution planning into business as usual
- Key tools to combine objectives

# Trading agreements on resolution

- Termination rights
- Application in practice
- Stays
- Contractual solutions
- Balanced outcome

# Other Legal issues on resolution: -

- Directors' duties
- Timelines/ announcements
- Confidentiality of planning
- Conflicts of law
- Tax, employment, pensions
- Harmonisation going forward
- Conclusion

# RECOVERY AND RESOLUTION

Cross-border Resolution

2 July 2013

C L I F F O R D  
C H A N C E

Habib Motani  
Partner

# Cross-border Resolution

## ■ Branch versus subsidiary

- EU single passport model encourages single legal entity branching
  - Home state resolution authority has sole control over the resolution process although must consult authorities of “significant” branches
  - Creditors have recourse to any asset of the legal entity anywhere
- Increasing trend towards national subsidiarisation model
  - Each national authority has control over resolution in its own jurisdiction
  - National creditors limited to recourse to national assets

■ Subsidiarisation makes it difficult to move assets around the group to manage resolution, unless

- Intra-group guarantees (which themselves complicate resolution)
- Formal support arrangement
  - Support arrangement must be within RRD carve-out, since otherwise corporate benefit rules would generally prevent providing financing to insolvent group members
  - RRD provisions are voluntary, not compulsory

# How will resolution authorities react?

- Art 15 – power to “remove obstacles to resolvability”
- Gives home state regulators power to require any change they desire to the group structure or inter-group financing arrangements provided that the change can be justified as making the group more resolvable
- These powers could include
  - Requiring an intra-group support arrangement to be put in place
  - Requiring subsidiarisation of a branch
  - Requiring branchification of a subsidiary

# RECOVERY AND RESOLUTION

C L I F F O R D  
C H A N C E

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# The new French law on banking

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Olivier Coupard, EFMLG



# **French Law proposal on Ring fencing and regulation of banking activities**

A NEW RESOLUTION REGIME

London Quadrilateral Meeting  
July 1st 2013

Olivier Coupard  
EFMLG

## **A New resolution regime created**

### **Where we are**

French Government proposed on December 19 2012 new law on separation and regulation of banking activities.

Text nearly finalised

Vote on second reading by the SENAT on June the 26th

Final vote by the two assemblies this summer ?

Only a first step before RRD

## **RESOLUTION AUTHORITIES:**

### **Existing Autorité de Contrôle Prudentiel “ACP” appointed as the resolution authority and renamed as the Autorité de contrôle prudentiel et de résolution (ACPR):**

In addition to the addition to the current supervision and sanctioning “colleges”( committees) a new “resolution college” will be created

The resolution college comprises the Governor and a deputy governor of the Bank of France, the director-general of the Trésor, the president of the AMF and the president of the deposit guarantee fund.

### **Existing deposit guarantee fund is also renamed as the Fond de garantie des dépôts et de résolution (FGDR) and is given certain functions in relation to resolution:**

Including powers to acquire or all part of the shares of an entity in resolution, to subscribe for capital of an entity in a bridge institution and to support the financing of the entity in resolution or bridge institution (including by guarantee).

FGDR will act upon instructions from the ACPR.

FGDR financed by banks and other credit institutions, financial holding companies

Moneys paid by the FGDR will benefit from priority protection.

## **NEW POWERS for the authorities**

**New skills for ACPR in order to prevent difficulties of banks and on implementation of resolution measures**

**Right to prohibit the exercise of certain investment transactions and marketing actions that could undermine financial stability or the orderly functioning of financial markets:**

Regulated entities, management, auditors and employees have to provide adequate information necessary for resolution purposes.

Right to appoint an administrator to replace existing management (This appointment cannot be considered as an event of default (agreements provision are overridden)

Remove the senior management of the entity in resolution

Require the FGDR to intervene in accordance with its powers,.

Value the losses that would have been incurred by the assets and liabilities of the entity in resolution disregarding the resolution measures and any public support.

Limit or prohibit temporarily the operations of the entity in resolution.

## **Authorities Must However:**

- Ensure that no shareholder or creditor incurs losses in resolution greater than it would have suffered in a liquidation.

-Determine the issue price of new shares or other instruments and the terms of transfer or conversion on the basis of a valuation of an independent expert or in urgent cases can carry out the valuation itself (taking into account market values).

And any judicial decision annulling a decision of the APCR will not affect the validity of prior actions as against third parties, except in the case of fraud

## **RECOVERY AND RESOLUTION PLANNING**

-Credit institutions and investment firms (other than portfolio management companies) or their groups would be required to submit recovery plans to the ACPR if they are over a size threshold to be fixed by decree (and the ACPR can require other entities supervised by it to prepare such a plan).

-ACPR tasked with preparing resolution plans for these entities or groups and can require them to remove any barriers to resolution.

## SCOPE OF RESOLUTION REGIME

Credit institutions, financial holding companies, financial holding companies and investment firms (but not portfolio management companies).

Trigger for resolution action is depending from APCR : if considering considers that there is no prospect of avoiding the failure of the relevant person within a reasonable time other than by use of resolution measures or a recapitalisation plan.( on an individual or group basis)

An institution is considered as failing if there are objective elements which show that in the near future:

its own funds will fall below the level required to maintain its authorisation; it currently is or in the near future will be unable to pay its debts; or

it requires extraordinary public financial assistance.

**ATTENTION POINTS :**

Resolution powers not extend to all financial institutions within a group (only the bank/investment firm and holding companies).

Bail-in power limited to capital and subordinated instruments

No power to require affiliates to continue to provide services or facilities to entities in resolution. No general moratorium power.

Existing deposit guarantee fund would provide resolution funding, rather than a dedicated resolution fund.

Impact on derivatives?

Recognition issues of resolution actions taken by non-EU authorities in relation to non-EU banks.



# Q&A and Chair's Summary

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Joanna Perkins, FMLC

# QUADRILATERAL CONFERENCE

## BENCHMARKS

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**Ed Murray, FMLC**

**Keisuke Hasegawa, FLB**

**Joanna Perkins, FMLC**

**Chris Allen, FMLC**

# Chair's Introduction

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**Ed Murray, FMLC**

# A central bank perspective on better reference rate practices

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Keisuke Hasegawa, FLB

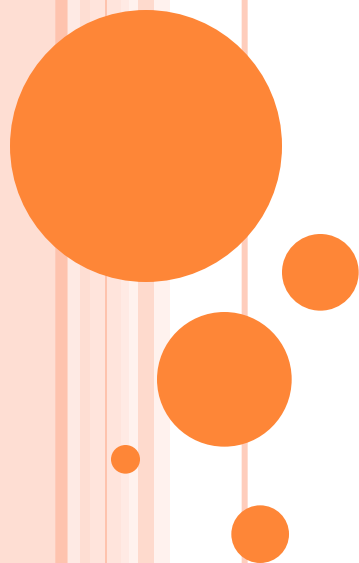
# **CENTRAL BANK PERSPECTIVE TOWARDS BETTER REFERENCE RATE**

**July 2, 2013**

**Keisuke Hasegawa**

**FLB**

**(Secretariat: Bank of Japan)**



# 1. SCOPE OF THE BIS REPORT

◆ Economic Consultative Committee (ECC) of the **BIS** set up the working group (**WG**) on financial market reference rate in September 2012

◆ The WG (chaired by Hiroshi Nakaso, Assistant Governor of BoJ) distinguished its work from others by focusing on the role of reference rate from central banks' perspectives

(i.e. **not** focusing on administration, governance and oversight of production process of reference rate, **but** on how reference rates could be more robust under various states of financial markets)

◆ Based on the work, the WG published the **BIS report** in March 2013



## 2. KEY FINDINGS

### Not only:

- ◆ Market manipulation raised concerns about reliability of key reference rate and appropriateness of methodologies
  - Urgent need to strengthen **reliability and robustness** of existing reference rates

### but also:

- ◆ Increased use of collateralized loan and central clearing of OTC derivatives (i.e. funding with little or no credit risk, which does not ‘match’ reference rate reflecting bank’s credit risk) may add to demand for reference rates not reflecting credit risk
  - strong case for enhancing **reference rates choice** suitable for different purposes



### 3. CBS' INTEREST IN BETTER REFERENCE RATES

#### ◆ Monetary policy perspective:

Reference rates may behave in unexpected ways in periods of stress and such risk could be exaggerated when market participants heavily rely on a single reference rate

#### ◆ Financial stability perspective:

Loss of confidence in reference rates could market functioning disruption (especially as some transactions do not have robust fallback arrangements)

→ Sound framework for producing reference rates is essential for well-functioning markets





## 4. POSSIBLE MEASURES TAKEN BY CBS

### ◆ **Moderate** measures

Promoting improvements to transparency of markets from which reference rate are derived

### ◆ **Intermediate** measures

Promoting development and improvement of (near) credit-risk free reference rates such as GC repo rates

### ◆ **Active** measures

Becoming directly involved in reference rate design and production (actual form of involvement depends upon country-specific circumstances)



# Thank you!

**For full text of BIS Report:**

<http://www.bis.org/press/p130318a.htm>



# The reform of LIBOR and contractual continuity

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Joanna Perkins, FMLC

# A supervised institution's response to benchmark reform

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Chris Allen, FMLC

# Q&A and Chair's Summary

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**Ed Murray, FMLC**

# QUADRILATERAL CONFERENCE

## CLOSING

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