European Financial Markets Lawyers Group

Bank Resolution Tools
Impact on Derivatives

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Introduction

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- European Commission‘s proposal for a Directive for the recovery and resolution of credit institutions and investment firms of 6 June 2012 (“Directive”)
- The European Banking Authority (EBA) is required to draft 23 technical standards and 5 guidelines supporting the implementation of the new Directive.
- Drafts are to be submitted to the Commission within 12 months from the date of entry into force of the Directive.
- Member States are required to apply the provisions from 1 January 2015
- The presentation provides an overview on the impact on derivatives.

Bail-in Tool

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- **"Bail-in Tool" means the exercise of the write-down and conversion powers in relation to liabilities of an institution (Article 2(49) Directive).**
- **Article 38(1) Directive requires Member States to ensure that the bail-in tool applies to all liabilities of an institution.**
- **Excluded are, amongst other items, (i) secured liabilities and (ii) liabilities with an original maturity of less than one month (Article 38(2) Directive).**
- **The effect of a bail-in must be immediately binding on the institution and the affected creditor (Article 48(1) Directive).**
- **The affected liability shall be treated as discharged for all purposes and shall not be provable in any subsequent proceeding (Article 48(3) Directive).**

Bail-in Tool

- Article 44 Directive governs liabilities arising from derivatives.
- The term "derivative" means the financial instruments listed in points (4) to (10) of Section C of Annex I to Directive 2004/39/EC (MiFID) (see Article 2(56) Directive).
- Article 44(3) Directive requires the resolution authority to determine the value of the liabilities in accordance with the technical standards adopted by the Commission.
- Derivatives subject to a netting agreement are to be valued on a net basis in accordance with the terms of the agreement (Article 44(2) Directive).

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ISSUES:

- **The net value determined by the resolution authority is not a "liability". The net value is unstable, uncertain or difficult to ascertain in a timely manner (see Staff Working Document (SWD(2012) 166 final, page 44).**
- **"Bail-in-able" is only the close-out amount determined by the non-defaulting party upon termination and close-out.**
- **The net value deviates inevitably from the close-out amount especially because of the narrow definition of "derivatives".**
- **Bail-in of derivative exposure conflict with the policy decisions in Article 29(1)(f) Directive ("no creditor worse off") and Article 38(2) Directive (secured liabilities).**
- **Interplay with Regulation (EU) No 638/2012 (EMIR) should be considered.**

Stay of Termination Rights

- **Article 63(1) Directive requires Member States to ensure that the resolution authorities have the power to suspend termination rights under financial contracts.**
- **The term "financial contract" is defined in Article 63(6) Directive and includes derivatives (including physically settled or commercial fx forwards), repurchase transactions, securities loans and spots.**
- **Eligible for being suspended are termination rights that arise "solely by reason of an action by the resolution authority".**
- **The suspension must be possible for the period of time between (i) the resolution authority's notification of chosen resolution actions and (ii) 5 p.m. of the business day following such notification (the "suspension period").**

Stay of Termination Rights

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- **Termination rights may be exercised <u>before the end</u> of the suspension period if the resolution authority notifies the parties that transfers are not intended (Article 63(3) Directive).**
- **Termination rights may be exercised <u>upon expiry</u> of the suspension period in accordance with the agreement**
  - provided the recipient of the transferred financial contract or (if no transfer occurs) the institution is in default (Article 63(4)(a)(ii) and (b) Directive) and
  - provided the termination right is <u>not triggered</u> by the resolution action (unless the resolution action is a transfer tool and the financial contract was not transferred (Article 63(4)(a)(i) and 77(1) Directive).

Stay of Termination Rights

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- **Article 63(2) Directive provides that resolution authorities shall make all reasonable efforts to ensure that all margin requirements and settlement obligations of the institution during the suspension period are met.**
- **Special safeguards apply to collateral and netting agreement in case of partial transfers (Articles 68(2), 69, 70 Directive):**
- **Resolution authorities must not transfer some, but not all, rights and liabilities under a netting agreement or transfer financial collateral and the related assets without the secured liability.**

Stay of Termination Rights

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ISSUES:

- **Article 61 Directive requires Member States to ensure that the resolution authorities have the power to suspend any payment or delivery obligation pursuant to any contract.**
- **The interplay of such moratorium with Article 63(2) Directive (reasonable efforts to ensure that all margin and settlement obligations are met) and Article 63(4) Directive (no termination if triggered by resolution action even after the expiry of the suspension period) is unclear.**

Non-EU Governing Law

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- If rights and liabilities of an institution are governed by the laws of a jurisdiction that is not a Member State, the following principles applies:
- In order to facilitate a bail-in, institutions are required to include contractual provisions in their agreements to the effect that the creditor recognizes that the liability may be subject to bail-in (Article 50(1) Directive).
- Where resolution authorities purport to transfer rights and liabilities to another entity but the transfer is or may not be effective because of the third countries governing law, the resolution authority shall not proceed to the transfer and any ordered transfer shall be void (Article 73 Directive).
- Some Member State considered an obligation to include contractual provisions in agreements to facilitate transfers.

Non-EU Governing Law

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ISSUES:

- **Are contractual clauses facilitating a bail-in or transfer enforceable under the governing substantive contract law?**
- **Will there be protocol approaches that facilitate the amendment of financial contracts?**