European Financial Markets Lawyers Group

- THE VICE-CHAIRMAN -

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Copy to **Valdis Dombrovskis**
Vice-President for the Euro and Social Dialogue
also in charge of Financial Stability,
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Dear Sirs,

Proposed Revision of the Bank Recovery and Resolution Directive (BRRD II)

On 23 November 2016, the European Commission presented a comprehensive package of reforms containing a set of legislative proposals to amend, amongst other instruments, the Directive 2014/59/EU[1] on the recovery and resolution of credit institutions and investment firms (the Bank Recovery and Resolution Directive or BRRD). The European Financial Markets Lawyers Group (EFMLG)[2] acknowledges the Commission's efforts to make the financial system more stable and resilient. However, the EFMLG identified several shortcomings in the proposed amendments to the

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173, 12.6.2014, p. 190–348.

2 The European Financial Markets Lawyers Group is a group of senior legal experts from the EU banking sector dedicated to undertaking analyses and initiatives intended to foster the harmonization of laws and market practices and facilitate the integration of financial markets in Europe. The Group is hosted by the European Central Bank. More information about the EFMLG and its activities is available on its website at www.efmlg.org.

BRRD[3] (the "BRRD II Proposal"), which may pose significant compliance and implementation risks for both Member States and institutions.

For ease of reference, we have listed below the most significant issues in relation to the BRRD II Proposal, as well as potential solutions.

1. Article 55 of the BRRD – Contractual Recognition of Bail-in

The BRRD II Proposal seeks to revise Article 55 of the BRRD on the contractual recognition of the resolution authority's write-down and conversion powers (so-called "Bail-in Recognition Clauses"). The current version of Article 55 of the BRRD requires institutions to include Bail-in Recognition Clauses in all agreements, which create liabilities that are subject to the write-down and conversion powers, provided they are governed by the laws of a third country. Article 55 of the BRRD does not distinguish between the various types of liabilities and whether it is impossible or impracticable to apply the write-down and conversion powers, or whether its application would rather destroy value instead of preserving it.

In order to reduce undue regulatory burden, the BRRD II Proposal introduces the resolution authority's right to grant a waiver from the requirement to use Bail-in Recognition Clauses. This new waiver right was initially limited to liabilities where all of the following conditions are met: (i) the write-down and conversion powers of the relevant resolution authority are recognized under the laws of the third country that governs the agreement, (ii) the application of the write-down and conversion powers is legally, contractually or economically impracticable and (iii) waiving the requirement of using Bail-in Recognition Clauses would not create an impediment for the resolvability of the institution.

The revised Article 55 of the BRRD proposed by the Commission raised the following issues:

- By requiring that all of the conditions in Article 55(2) s.1 lit.(a) to (c) of the BRRD are met for a waiver, the Commission effectively tightened the requirements of the original Article 55 of the BRRD which would not leave any room for granting waivers.
- Article 55(2) s. 3 of the BRRD II Proposal requires that waived liabilities shall be senior to liabilities which count towards the minimum requirement for own funds and eligible liabilities (MREL). This would have meant –at least in some jurisdictions - that institutions could not use Article 55(2) of the BRRD for liabilities that share the same rank as MREL liabilities.

On 22 May 2017, the Presidency of the European Council proposed a compromise text, which would introduce an automatic waiver for institutions that have notified its resolution authority of the impracticability of Bail-in Recognition Clauses, unless the notification was challenged by the resolution authority within reasonable time. The compromise text now provides for only two conditions – the impracticability and the absence of impediments to resolution – which, if not met, would require the institution to use Bail-in Recognition Clauses. It is further provided that EBA will prepare regulatory

[3] Proposal for a Directive amending Directive 2014/59/EU on loss-absorbing and recapitalization capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EC, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC, dated 23 November 2016, COM(2016)852 final.

technical standards (RTS) that specify the conditions under which it would be legally, contractually or economically impracticable to use Bail-in Recognition Clauses.

Whilst it is welcome that the Commission and the Council acknowledge the difficulties arising from the current Article 55 of the BRRD, the new waiver-mechanism – as proposed by the Council Presidency - is still not satisfactory. First, it is not clear whether it would be permissible for institutions to notify their resolution authority and benefit from the automatic waiver, even if the RTS have not yet been adopted by the Commission. Second, even if it was possible to hand-in notifications during the interim period, how would resolution authorities ensure that they construe and apply the conditions for using the waivers consistently in all Member States. Third, how do we achieve a level playing field if EBA and Commission have no right to specify the circumstances that constitute an impediment to resolution or the period time that is "reasonable".

To address this issue, we would suggest replacing the waiver with a general exemption of all liabilities that do not count towards the MREL.

2. <u>New Articles 27(1)(i), 29a, 63(1)(n)(1a) and (1b) of the BRRD – Suspension of Certain Obligations</u>

The BRRD II Proposal seeks to introduce new suspension powers, which would authorize the competent authority or the resolution authority[4] to stay all payment and delivery obligations of an ailing institution that are subject to the stay (so-called "moratorium"). The Commission proposes to introduce a pre-resolution moratorium (Articles 27(1)(i) and 29a of the BRRD II Proposal) as well as a moratorium to be exercised during resolution (Article 63(1)(n)(1a)(1b) of the BRRD II Proposal). Each such moratorium can take up to five working days. If applied in combination, they could result in a stay that, depending on how the drafting is interpreted, takes up to 25 working days or, if combined with the stay provided for under Article 69(1) of the BRRD, up to 27 working days, i.e., more than five weeks. The consequence of the moratorium is that all payments and delivery obligations subject to the stay that would have become due during the stay period are deferred until the expiry of such period.

The main consequence of the proposed stay is that counterparties of the ailing institution will not be able to terminate and close-out agreements for a period of up to 27 working days. This would conflict with the regulatory framework established through Regulation (EU) No 575/2013 (CRR)[5] and Regulation (EU) No 648/2012 (EMIR)[6] and, to the extent the ailing institution's obligation is collateralised, with Directive 2002/47/EC[7]. It would also impact on the effectiveness of the 2015 ISDA Universal Stay Protocol.

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[4] Member States that make use of the option laid down in Article 32(2) BRRD (determination of the point of non-viability by the resolution authority) have to ensure that the suspension power referred to in Article 27(1) BRRD new can also be exercised by the resolution authority.

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013, p. 1–337.

[6] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, OJ L 201, 27.7.2012, p. 1–59.

[7] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168, 27.6.2002, p. 43–50.

A long-term stay – i.e., a stay longer than the 48 hours stay provided for under Article 69(1) of the BRRD - will have considerable impact on credit institutions and investment firms that enter into financial contracts like derivatives, repurchase, securities lending and margin lending transactions ("Financial Contracts") and that use contractual netting agreements for risk mitigating purposes. Financial Contracts expose counterparties to considerable market risk and associated potential future counterparty credit risk (potential future exposure, PFE). Important instruments for mitigating counterparty credit risk are contractual netting and margin arrangements. Article 11(3) of the EMIR and Article 2(2) of the associated Regulation (EU) 2016/2251 require all counterparties that are subject to the EMIR clearing requirement to use contractual netting and margin arrangements for its uncleared OTC derivatives.

The above mentioned Article 69(1) of the BRRD is based on the Financial Stability Board's (FSB) Key Attributes of Effective Resolution Regimes of 4 November 2011 (recast 15 October 2014, the "Key Attributes"), which have been implemented by other FSB members (like the United States of America) as well. The Key Attributes recognize the importance of contractual netting and margin arrangements for the risk management of counterparties and clarify (under I-Annex 5 on page 51) that the short-term stay proposed by the Key Attributes should not affect other rights of counterparties under its contractual netting and margin arrangements: "*If a firm in resolution fails to meet any margin, collateral or settlement obligations that arise under a financial contract or as a result of the firm's membership or participation in an FMI, its counterparty or the FMI would have the immediate right to exercise an early termination right against the firm in resolution.*"

Articles 206 and 296 of the CRR govern the regulatory recognition of contractual netting. They require credit institution and investment firms to ensure that the contractual netting agreement and the termination and close-out of Financial Contracts supported by them are operative upon the event of default and in a timely fashion. More explicit are the final rules of the Office of the Comptroller of the Currency (OCC) and the Board of Governors of the Federal Reserve System on the Regulatory Capital Rules (U.S. Basel III), as amended by the Interim Final Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, which govern the regulatory recognition of contractual netting agreements used by U.S. Banks. The definition of "qualifying master netting agreement" in §.2 of U.S. Basel III clarifies that "*...any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than in receivership, conservatorship, resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs*". It is therefore likely that a stay of more than 2 days (or 48 hours) will impact on the recognition of regulatory netting to the effect that credit institutions and investment firms would have to calculate their capital requirements on a gross basis.

The absence of long-term stays, i.e., stays that take longer than 48 hours, is a precondition for the ISDA 2015 Universal Resolution Stay Protocol (see definition of "Protocol-eligible Regime" on pages 37/38 of the protocol)[8], which has been adhered to by 14 global systemically important banks (G-SIB) and their subsidiaries[9]. The protocol had been developed in coordination with the Financial Stability Board (FSB),

[8] The text of the ISDA 2015 Universal Resolution Stay Protocol has been published on http://assets.isda.org/media/ac6b533f-3/5a7c32f8-pdf/

[9] As of 4 July 2014, 265 entities adhered to the ISDA 2015 Universal Resolution Stay Protocol.

which viewed its execution as a major component of a regulatory and industry initiative to address "too big to fail". The implementation of BRRD 2 Proposal by the Member States would mean that all European G-SIBs that adhered to the ISDA 2015 Universal Resolution Stay Protocol will lose its recognition of stay rights.

A stay of longer than 2 days (or 48 hours) would also impact on the risk management procedures and margin requirements imposed under Article 11(3) of the EMIR and Regulation (EU) 2016/2251 as it would increase the margin period of risk, i.e., the period of time during which the counterparty sees itself exposed to market risk. The amount of initial margin required for covering a longer margin period of risk, would increase exorbitantly.

In August 2017, the International Swaps and Derivatives Association, Inc. (ISDA) published a position paper outlining the challenges that come with the proposed extension of moratoria powers. We share the concerns expressed in the position paper. We strongly recommend deleting the proposed pre-resolution and resolution moratoria or at least ensure that they cannot result in a stay exceeding two working days and cannot be applied in combination.

Finally, from a political perspective, a moratorium power leading to a stay of more than two working days would put European Union banks at a competitive disadvantage as it would deviate from the global policy approach that stays are limited to two working days (*cf.* margin number 4.3 of the Key Attributes). This would undermine the considerable global achievements in the past years to make banks with large derivative portfolios resolvable, as legislation and contracts in different jurisdictions are based on the assumption that stays do not exceed two working days. Furthermore, from an investor's perspective, the mere existence of a moratorium power leads to a loss of confidence that a large bank can be stabilized by applying the bail-in tool, as market participants believe (and past experience has shown) that the imposition of a moratorium is a pre-step of insolvency. As such, a moratorium might be an appropriate tool for a small bank which would be subject to ordinary insolvency proceedings, but it is inappropriate in combination with early intervention or resolution tools to stabilize a large bank.

3. Article 44(2) of the BRRD – Protection of Third Country Clearing and Settlement Systems

We welcome the proposed changes to the scope of the write down or conversion powers provided for in the BRRD II Proposal. However, they may still be insufficient.

The current Article 44(2)(f) of the BRRD exempts all liabilities with a remaining maturity of less than seven days owed to European payment and securities settlement systems, provided they are designated as such in accordance with Directive 98/26/EC (Finality Directive). This exemption covers indirectly - through Article 17(4) of Regulation (EU) No. 648/2012 (EMIR) – all European central counterparties (CCPs) that have been authorized in accordance with Article 14 of the EMIR.

In order to overcome the main shortcoming of Article 44(2) of the BRRD: that it does not cover systems established in third countries, the BRRD II Proposal introduces a further exclusion for third country CCPs, provided they have been recognized by ESMA in accordance with Article 25 EMIR. During the consultation of the BRRD II Proposal, a discussion paper circulated amongst the members of the Council's working groups proposed an additional exclusion for third country payment and securities settlement systems recognized by ESMA or EBA. The discussion paper also proposed that ESMA and EBA define the methodology for recognizing such third country systems.

We consider the broad approach taken by the BRRD II Proposal and the discussion paper as a great improvement. However, the required recognition under Article 25 of the EMIR or under the new procedures developed by ESMA and EBE may not be appropriate. Article 25 of the EMIR was designed for third country CCPs that intend to offer clearing services within the Union. From that angle, the required Commission's equivalency decision and the cooperation agreement established by ESMA were necessary preconditions for ensuring an effective supervisions of the third country CCP's activities in Europe. However, this is not the perspective of Article 44(2) of the BRRD. The purpose of Article 44(2) of the BRRD is to protect the integrity of systemically important clearing and settlement systems and to enable the institution under resolution to continue its membership in such systems and support those business lines that the resolution authority identified as critical functions. We believe that it is desirable to provide exemptions also for those third country systems that have not applied for recognition or that failed to comply with the requirements imposed by Article 25 of the EMIR or similar requirements specified by EBA and ESMA.

We would propose to delete the reference to any recognition proceeding, i. e., cover payment and securities settlement systems and CCPs established in third countries irrespective of whether they are subject to an equivalent legal and regulatory regime or not. Alternatively, we would proposed the approach taken under Article 55 of the BRRD: to authorize the resolution authority to grant a waiver from bail-in. This waiver should not aim at, or be subject to the requirement of, equivalency. It should be granted to all third country systems that are necessary for the preservation of critical functions of the ailing institution and that have indicated to the resolution authority that they are willing to refrain from suspending the ailing institution's membership in case resolution measures are taken.

Article 44 BRRD is not the only provision that protects payment and securities settlement systems designated in accordance with Directive 98/26/EC. To mention are the additional safeguards provided for in Articles 68(1), 69(4)(b), 70(2), 71(3), 80(1) and (2) of the BRRD. A consequential change is needed in Article 83(2)(k) of the BRRD, which requires the notification of the operator of systems.

4. <u>Article 49 of the BRRD – Protecting Netting Sets</u>

Article 49 of the BRRD sets out the conditions that resolution authorities should comply with when bailing-in liabilities arising from derivatives. In particular, resolution authorities should exercise the bail-in power only on or after closing-out derivatives in accordance with the terms of the netting agreement. Neither Article 49 of the BRRD nor the Commission Delegated Regulation (EU) 2016/1401 apply the same safeguards to other Financial Contracts which also rely on close-out netting under master agreements, such as like repurchase, securities lending and margin lending transactions (together the securities financing transactions or SFTs).

Whilst liabilities arising from SFTs are generally collateralized and would therefore benefit from Article 44(2)(b) of the BRRD, they could be eligible for bail-in if and to the extent there would be - after applying the collateral - a net amount payable by the institution in resolution. The absence of explicit protection for close-out netting provisions in SFT master agreements constitutes a considerable issue since relying on the no creditor worse off principle (as carried out under Article 74 of the BRRD) may not be satisfactory to ensure that obligations are treated on a net basis for bail-in purposes.

We would therefore welcome a review of the abovementioned provisions in order to address the shortcomings which may lead to implementation issues, fragmented national solutions and significant challenges for compliance.

We kindly request you to consider our concerns. Our contribution aims at improving the regulatory framework applicable to credit institutions and investment firms by striking a balance between the goals of developing a robust EU resolution regime and the protection of financial stability. We would be pleased to discuss our proposals further with you or your staff and to answer any question you may have.

Yours sincerely,

Holger Hartenfels

Vice-Chairman