5 February 2015

European Banking Authority
Floor 46
One Canada Square
London
E14 5AA

Submitted via the EBA website

Consultation paper on draft RTS on contractual recognition of write-down and conversion powers under Article 55(3) of the BRRD

Dear Sir / Madam

Please find enclosed AFME's response to the EBA consultation paper on draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive (EBA/CP/2014/33).

Please do not hesitate to contact us if you have any questions or wish to discuss these issues further.

Yours faithfully

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Director, Recovery and Resolution

AFME

Consultation response

EBA consultation paper on RTS on contractual recognition of write-down and conversion powers under Article 55(3) of the BRRD (EBA/CP/2014/33)

5 February 2015

The Association for Financial Markets in Europe ("**AFME**") welcomes the opportunity to comment on the European Banking Authority ("**EBA**") Consultation Paper (the "**CP**") on draft Regulatory Technical Standards ("**RTS**") on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive (the "**BRRD**") (EBA/CP/2014/33).

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.[1]

We set out below our comments in response to the CP. Unless otherwise indicated, references to articles are to articles of the BRRD.

A. General comments

AFME supports the objective of bail-in being effective in relation to liabilities governed by foreign law. The industry is committed to achieving the objective of credible cross-border resolution and has, for example, worked with the FSB in developing the ISDA Resolution Stay Protocol (the "**ISDA Protocol**").

As noted in the CP, the Financial Stability Board (the "**FSB**") has undertaken further work in this area to develop guidance on the cross-border recognition of resolution action.[2] As proposed by the FSB, the preferred approach to ensuring cross-border recognition of resolution actions should be through the implementation of statutory recognition and support mechanisms. However, until such mechanisms are put in place, we agree with the FSB that contractual recognition can be helpful.[3]

However, the scope of article 55 is very broad and (subject to clarification) appears to capture a variety of operational liabilities which, while not expressly excluded from bail-in, in practice are highly unlikely to be bailed in. The scope of article 55 is significantly broader than that proposed

[1] AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

[2] FSB Consultative Document "Cross-border recognition of resolution action", 27 September 2014 (the "**FSB Consultation Paper**").

[3] See the joint GFMA and IIF response to the FSB Consultation Paper, available at http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=12152.

in the FSB guidance, which would apply only to "debt instruments". This gives rise to a number of practical, operational and legal difficulties that banks will face in seeking to comply with these requirements. For example, article 55 could, subject to clarification, require banks to include contractual recognition provisions in contracts relating to:

- corporate deposits which are not preferred under article 108;
- derivatives;
- operational liabilities such as general expenses including contracts on standard terms;
- contingent liabilities eg letters of credit, guarantees;
- liabilities of banks as payment agents; and
- membership of clearing and settlement systems outside the EU.

Banks are unable to unilaterally impose contractual terms in relation to many of these categories of liabilities. This issue is also particularly relevant in respect of contracts entered into with non-EU financial market utilities ("FMU"). It is highly unlikely that non-EU FMU will agree to rewrite the rules of their system to accommodate the contractual recognition requirement. Therefore the feasibility of bilaterally agreeing such contractual amendments is likely to be highly problematic, potentially preventing European banks from conducting business outside the EU. This is also an issue in trade financing, where the counterparty is often a third party beneficiary who is not the client of the bank.

Counterparties would also often lack the incentive to contractually agree to subject the liabilities to bail-in, particularly in jurisdictions which are unfamiliar with the concept of bail-in and where non-EU banks operating in the jurisdiction do not do so. They may also have fiduciary duties not to accept such amendments. These difficulties were seen, for example, in the challenges with obtaining buy-side adherence to the ISDA Protocol.

There are also aspects of article 55 which are contrary to the principle set out in the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions[4] that creditors should be treated equally regardless of nationality, for example the exclusions for liabilities to EU FMUs which do not apply to FMUs outside the EU.

Including contractual recognition provisions in contracts governing secured liabilities and operating liabilities also sends a confused message to counterparties and could cause undue concern as to the risk of bail-in, again particularly in jurisdictions where bail-in is a foreign concept.

It should be recognised that the preference, as stated by the FSB, should be for a statutory or cross-border cooperation agreement solution to cross-border recognition and that a contractual approach, while helpful, should be balanced in its application. It should also be recognised that the absence of contractual recognition wording does not necessarily mean that the liability will not be bail-in-able. We therefore suggest that the focus of contractual recognition should be to ensure the credibility and feasibility of the resolution plan and we suggest that the position of liabilities governed by non-EU law which are likely to bear losses should be considered as part of the resolvability assessment rather than a blanket requirement applicable to every liability that could theoretically be bailed in.

AFME's members are very concerned about the impact of these requirements to include contractual recognition provisions in such a broad range of contracts governed by non-EU law without any proportionality requirement. The scope of the requirements raises a number of significant practical and legal issues which are likely to adversely impact the ability of European

[4] Key Attribute 7.4.

banks to access markets and do business outside the EU.[5] This is a significant problem in terms of its importance and its scope. A sample of just 6 banks identified a total of 230 branches of EU institutions located in 47 different non-EU jurisdictions. Customers of these branches are likely to be affected as their contracts will, most likely, be covered by local and not EU law. The number of jurisdictions to be addressed is indicative of the scale of the issues and in addition to branches, EU institutions have significant other contracts governed by non-EU law which will also have to be considered.

We are therefore disappointed that the EBA has taken a narrow interpretation of its mandate under article 55(3) and that the draft RTS does not resolve these issues. If these concerns cannot be addressed through the level 2 process, we urge the EBA to raise these issues with the European Commission with a view to making the necessary amendments to the level 1 text.

B. Responses to the questions raised in the CP

Q1. Do you agree with the approach the EBA has proposed for the purposes of further determining points (a) and (d) of the first subparagraph of Article 55(1) of the BRRD (which form part of the list of liabilities to which the exclusion in Article 55(1) of the BRRD applies)? In particular, it is to be noted that Article 3(2) of the draft RTS refers to liabilities that 'may' become unsecured. Respondents are invited to comment on this approach and, should they disagree with this proposal, suggest possible alternative approaches.

Secured liabilities

We do not agree with the proposed approach to the exclusion of secured liabilities. We assume that by "becoming unsecured" the RTS is intended to refer to the circumstances where the value of the security becomes less than the value of the liability such that there could be an unsecured claim for all or part of the value of the secured liability[6]. If this is correct, then requiring contractual terms in all secured liabilities that "may" become unsecured, in full or in part, even where the liability was fully secured when it was created would in practice extend article 55 to all secured liabilities. This is because there could be a shortfall in the value of the security for any secured liability regardless of the extent of the security if the value of the collateral were to fall far enough.

Requiring contractual recognition clauses in contracts governing all secured liabilities including those which are fully collateralised when created is likely to cause confusion amongst counterparties which expect to be excluded from bail-in. It is also contrary to the intention of the level 1 text which clearly anticipates that contractual terms should not be required in liabilities excluded from bail-in. Instead we propose that secured liabilities need not contain the contractual recognition provision where they are fully secured at the time of their creation.

We are also concerned that the proposed wording of article 3(2) of the draft RTS could be read as requiring contractual recognition provisions in contracts governing unsecured liabilities which are excluded from bail-in under subparagraphs (a) and (c)-(g) of article 44(2). We understand that the intention behind article 3(2) of the RTS is to capture possible shortfalls in

[5] See AFME's paper on this issue dated April 2014, available here: http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=10726

[6] Technically, in such circumstances the liability does not become unsecured; rather there is a shortfall in the value of the security.

the value of security for liabilities that do not fall within any of the other exclusions from bail-in under article 44(2). Article 3(2) of the RTS, to the extent it is retained, should therefore be clarified to ensure that it only relates to the interpretation of the exclusion under article 44(2)(b).

We suggest that the above points should be clarified by the following amendment to article 3(2) of the RTS:

"For the purposes of point (a) of the first subparagraph of Article 55(1) Directive 2014/59/EU, a liability shall not be excluded under subparagraph (b) of Article 44(2) of Directive 2014/59/EU to the extent that it is ~~or may become~~ unsecured in part ~~or in full even if the liability was~~ at the point of its creation ~~fully secured~~."

Liabilities issued or entered into after the date of transposition

The proposed approach to requiring contractual recognition terms in contracts where liabilities are created after the transposition date under agreements entered into prior to the transposition date raises a number of concerns. We support the comments raised by the City of London Law Society in their response to the CP in respect of this question.[7]

We would also add that if the EBA determines that such contracts should be within the scope of the requirement, firms will need to put in place procedures to monitor whether new liabilities are entered into under existing contracts – this will be a significant challenge for banks with a significant non-EEA presence. Such monitoring procedures will also be required to ensure that contractual recognition terms are included where the relevant contract is amended (see below regarding our response on amendments to agreements after the transposition date).

Liabilities under agreements amended after the transposition date

The proposed approach in article 3(3)(b) of the RTS to require the contractual recognition provision to be included in agreements entered into prior to the transposition date when they are subject to any amendments, regardless of their materiality, also raises concerns. Again we support the comments raised by the City of London Law Society in their response on this issue.[8]

Q2. Do you agree with the approach the EBA has proposed for the purposes of further determining the second subparagraph of Article 55(1) of the BRRD (which forms part of the list of liabilities to which the exclusion in Article 55(1) of the BRRD applies)?

We strongly support the concept of the second subparagraph of article 55(1). We are broadly supportive of the EBA's proposed approach in articles 3(4)(1) and 3(4)(2) of the RTS. However, we query whether article 3(4)(3) of the RTS is overly prescriptive where third country law might be differently worded from the precise exclusions set out in article 3(4)(3). We note that the second subparagraph of article 55(1) refers to a determination that the liabilities "can be

[7] See the section of the CLLS response headed "Issue 3", available at: http://www.citysolicitors.org.uk/attachments/article/106/Article%2055%20draft%20reg%20tech%20standards.pdf

[8] See the section of the CLLS response headed "Issue 4".

subject to write down and conversion powers" and therefore suggest that the RTS should not be too prescriptive in its requirements. We therefore consider that the proposed articles 3(4)(1) and 3(4)(2) should be sufficient for these purposes. If article 3(4)(3) is to be retained, it should be clarified that it sets out examples of the types of grounds for refusal rather than prescriptive requirements as to the wording of the legislation or agreement. These requirements should also be aligned with the final FSB guidance.

Q3. Do you agree with the approach the EBA has proposed with regard to the components of the contractual term required pursuant to Article 55(1) of the BRRD?

We agree with the EBA's proposed approach of setting out the components of the contractual term rather than mandating specific wording because the wording is likely to need to be adapted to the law of different jurisdictions and the type of liability. AFME is considering developing standard terms which would be enforceable in major jurisdictions for the inclusion in debt instruments. This work would build upon the components set out in the RTS and assist with developing standard wording adapted to the relevant governing law.

While we understand the desire of the EBA to be as detailed as possible in establishing key components of the contractual term, we are concerned that some of the proposed components may not be applicable to all jurisdictions. We therefore suggest that proposed components should be made more generic or, if retained, the detailed components are qualified in some manner to permit alternatives that would be applicable in different jurisdictions provided that the term meets its objective of enforceability under the relevant governing law.

For example, the concept of "acknowledgment, agreement and consent by each counterparty" in articles 4(1), 4(4) and 4(5) of the RTS may not be the correct formulation for every jurisdiction. This component should also be clarified to permit such acknowledgment, agreement and consent to be obtained through deemed acceptance of the terms and conditions and should not require any separate express acknowledgment or consent from the counterparty. In relation to debt securities, "acknowledgement, agreement and consent by each counterparty" will in many cases be set out in the relevant terms and conditions, rather than a matter of express consent. Particularly in the context of a global offering in international capital markets, it would be impractical to obtain the express acknowledgement and consent of the bail-in provisions for each counterparty, other than deemed representations from investors purchasing the securities in the secondary market. Again we suggest that the overall focus is on what is required for the enforceability of the provision rather than overly prescriptive requirements.

With respect to article 4(4)(c) of the RTS, which seeks to force investors to "accept shares" etc, as a general principle we are uncertain whether it is possible to force someone to accept a share (e.g. the investor mandate may not allow equity investments; or prior regulatory permissions may be required depending on the size of the shareholding in a regulated institution). Therefore contractually creditors could have difficulty agreeing to such a provision and, moreover, this term might not be enforceable which could call into question the enforceability of the provision generally. In practical terms, it may be that for creditors that could not take delivery of shares the relevant resolution authority could at the time of a resolution provide a mechanism for creditors to have their interest held for them, or for the shares to be sold on the market with cash delivered to the creditors (indeed the market might develop such a solution itself). However, it is well beyond the scope of a contractual recognition clause to provide for such eventualities. We would therefore suggest that the article 4(4)(c) be drafted not as a positive obligation to accept shares, but rather as an acknowledgment that the creditor's claim under the relevant contract will be fully discharged and satisfied upon the conversion of their claim into shares, whether the investor is able to take delivery of the shares or not.

Finally, the proposed component for the inclusion of an "entire agreement" clause in article 4(5) is unlikely to be appropriate for all types of liabilities, particularly debt securities where the inclusion of such a clause would be highly unusual. We support the response of Cleary Gottlieb Steen & Hamilton LLP on this point.

Q4. Do you agree with the draft Impact Assessment? Can you provide any numerical data to further inform the Impact Assessment?

The impact assessment does not consider the impact of a number of the issues raised in this response, for example the approach taken to secured liabilities, the inclusion of liabilities under pre-transposition contracts and amendments of pre-transposition contracts.