Extending the moratorium tool – a detriment to resolution

January 2023

Executive Summary

- There are a number of significant concerns with regards to the possibility of extending the length of the moratorium tool.

- We are concerned that any such extension would undermine the objectives of the resolution framework, are inconsistent with the internationally agreed standards, endanger financial stability, and increase the risk of contagion.

- We do not believe that an extension to the length of the moratorium tool is necessary or appropriate and would undermine the adoption of the Risk Reduction Measures package on 20 May 2019 by the Council of the EU and the European Parliament as well as the ECB who agreed to not extend the moratorium to more than 2 days.

- In any event, financial contracts should be carved out from any potential adoption of the moratorium tool.

Introduction

As set out in our position paper[1], AFME[2] does not believe that any further extension of a moratorium in resolution is necessary or appropriate, and gives rise to a number of significant concerns. This paper provides additional detail on the concerns and potential impacts of any such extension which we believe has not been fully assessed.

Moratorium powers, i.e. the ability to freeze the flow of payments for a period of time, can have significant impacts on the orderly functioning of financial markets due to their interference with the rights of counterparties and the incentives they create. This is true in the event of their use but also by virtue of their existence, and as such any proposal that introduces new or extended powers must be considered very carefully with the impact fully assessed. This note highlights our significant concerns with the SRB's intention to initiate a dialogue with the Commission on the possibility of extending the length of the moratorium tool.[3]

[1] **AFME** – See https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20CMDI%20Position%20Paper%20-%2020221018%20FINAL-1.pdf

[2] The Association for Financial Markets in Europe (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. AFME is listed on the EU Transparency Register, registration number 65110063986-76.

[3] See page 36 - https://www.srb.europa.eu/system/files/media/document/2022.3702_Work%20Programme%202023_Final%20version_web_0.pdf

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Background

The BRRD introduced, under Article 69, a power that enables resolution authorities to suspend any payment or delivery obligations pursuant to any contract to which an institution under resolution is a party. This power enables such moratoria to last no more than two business days, as international standards provide, but does not include within its scope eligible deposits[4], obligations owed to payment and settlement systems, central counterparties, central banks, or eligible claims under investor-compensation schemes. This is accompanied by further powers to place restrictions on the enforcement of security interests (Article 70) and on the temporary suspension of termination rights (Article 71). These powers implement, and are consistent with, the international standards on resolution stays established in the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions ("Key Attributes")[5] (see annex for extracts). All these powers are only exercisable in resolution, and only for a limited time period, i.e. not exceeding two business days. The industry has supported the cross-border effectiveness of these stays through contractual recognition of key contracts such as through the ISDA Resolution Stay Protocols. This has involved a very significant exercise by the industry whose efforts have been acknowledged and welcomed by the FSB[6].

A legislative proposal to amendment the BRRD, known as BRRD II, was put forward by the Commission on 23 November 2016. Significantly, two additional powers were introduced: (i) a pre-resolution moratorium power and (ii) contractual recognition of resolution stay powers, as detailed in Annex I. Further to these additions, the possibility of extending the length of the moratorium tool was discussed, however, the ECB confirmed, and co-legislators agreed that the existent 2 days was appropriate. This decision took into account that any further extension of a moratorium in resolution would cause significant contagion for financial stability, contract uncertainty resulting in global imbalances and an unlevel playing field, cost for pricing-in the related risks and affects especially the international competitiveness. Moreover, the Council of the EU and the European Parliament adopted the Risk Reduction Measures (RRM) package on 20 May 2019, which included agreeing to a moratorium tool with a length of 2 days. As such, the CMDI review should not seek to revisit the length of the stay and should avoid undermining the decisions of the co-legislator in this area[7].

Below we set out our concerns with regards to any proposal to extend the current moratorium, the potential impacts, and that co-legislators should have a heightened concern around any such proposals because of the implications they may have on financial stability, the day-to-day operation of financial markets, and the increased likelihood of contagion and resolution occurring.

Impacts of extending moratorium tool

We do not believe that it is necessary or appropriate to extend the moratorium tool, and are very concerned with the substantial risks to financial stability (and minimal benefits, if any). We have significant concerns regarding: (i) the capital required to be held by counterparties; (ii) the compatibility of the powers with an effective recovery and resolution framework and the resolution objectives; (iii) the impact on incentives,

[4] Eligible deposits are defined under the Deposit Guarantee Scheme Directive, 2014/49/EU, Article 2 (1) (4)

[5] **FSB –** see http://www.fsb.org/wp-content/uploads/r_141015.pdf, Annex IV, page 43

[6] See http://www.fsb.org/wp-content/uploads/20151111-Contractual-stays-press-release.pdf

[7] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019L0879&from=EN

contagion and financial stability; and (iv) global consistency and the interaction with the progress made in ensuring contractual recognition of resolution stays.

(i) Capital impact

With an extended moratorium tool, there is a greater period of risk of non-payment to counterparties should there be powers available to relevant authorities to impose stays for a prolonged period of time. It is therefore to be expected that there will be an impact on the regulatory capital position of counterparties due to this increased margin period of risk (MPOR). One area where this is particularly acute is in the ability for European banks to be deemed as qualifying for netting purposes.

Netting is a very important part of modern international financial markets to ensure exposures between counterparties take into account the various flows of monies owed by and to counterparties. This is only permitted where monies owed or due are payable/callable in short time – else netting may not provide a reasonably accurate representation of the overall position of the balance due between counterparties. Jurisdictions take this into account within their approaches to permitting netting in given markets.

The standard in most markets is 2-days, and this is reflected in the Financial Stability Board's '*Principles for Cross-border Effectiveness of Resolution Actions'*[8] where reference is made to a stay period not exceeding 2 business days. This is true for major jurisdictions where European banks operate and for key counterparties that European banks engage with. The U.S. for example requires derivative contracts to operate under a Qualifying Master Netting Agreement to benefit from netting. In order that such a contractual arrangement qualify, any rights under the agreement cannot be stayed or avoided under applicable law other than in resolution where such local laws are substantially similar to the U.S. laws. The U.S. under Dodd-Frank restricts stay periods, including under resolution, to a maximum of 48-hours (or 5pm on the following business day after the commencement of the stay if this is later) [9].

A longer moratoria tool than is already provided for in the BRRD would prevent European banks from being able to continue to net such exposures with U.S. (and likely many other) third country banks.. The impact of gross exposures needing to be taken into account would inflate exposures as well as Risk Weighted Assets (RWAs), and consequently impact capital and leverage ratios significantly. Being forced to hold capital against exposures with European Banks on a gross basis would make current netting arrangements prohibitively expensive potentially locking European banks out of critical global markets, with significant knock-on impacts to end-users.

We believe these impacts should be fully assessed, and the significant costs of such changes weighed against the limited perceived benefit that any extended moratorium could provide in the event of a bank failure.

(ii) Compatibility with an effective framework and resolution objectives

Resolution is predicated on the objective of ensuring that the critical economic functions of the bank continue prior to and throughout resolution. This is key to ensuring the success of resolution in minimising the impact on financial stability.

[8] **FSB** – https://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf - Page 7, footnote 4
[9] See 12 CFR Part 324, §324.2, 12 CFR Part 47.5(g)(1) and 12 CFR Part 252 § 252.81

An extended moratorium tool would run directly contrary to the stated objectives of ensuring the continuity of critical functions (such as cash payments and transfers) and avoiding significant adverse effects on the financial system[10]. The broad scope of the moratoria includes a number of critical economic functions of banks which are intended to be maintained prior to and throughout resolution, including uninsured deposits and other critical economic functions. As such, extending the moratorium tool (either pre-resolution or in resolution) could undermine the resolution objectives, signalling to creditors and the market that a particular bank is in distress, and create financial instability by incentivising runs ahead of a possible moratorium being implemented, and through the possible increase in contagion.

Further to this, the lack of transparency on exactly when such moratorium tools would be applied creates additional uncertainty that counterparties will take into consideration at the earliest signs of financial distress.

Extending the moratorium tool is also inconsistent with the international standard agreed by the G20 in the Key Attributes. The Key Attributes emphasised the importance of stays being strictly time limited (for example, for a period not exceeding two business days), and only arising for reasons of entry into resolution or in connection with the use of resolution powers (See Key Attribute 4.3).

We view the existing moratoria under the BRRD as sufficient to enable the authorities to conduct an effective resolution and as consistent with the Key Attributes.

As discussed below, we are also concerned that an extension of the moratorium tool, and the prospect of counterparties not being paid for a significant period of time, will incentivise such counterparties to run and/or cease further business with the bank at an earlier stage, increasing the possibility of contagion effects. This could make recovery from stressed situations less likely and increase the likelihood of the bank failing and the speed of its deterioration. This would also clearly be contrary to the objectives of increasing resilience in financial institutions.

(iii) Impact on the stability of financial markets

We are concerned about the impact that an extended moratorium tool would have on the ability of banks to recover in stressed situations and the market impact. In particular, customers and counterparties would be incentivised to run at an earlier stage making recovery more challenging and potentially increasing the likelihood of failure in a stressed situation. The possibility of an extended stay could increase concern in markets prior to their application, and increase contagion both through market reaction and also due to the impact that a stay would have on counterparties if utilised, which include other financial institutions that may be reliant on the income to meet their own obligations. For example, once a pre-resolution stay is enforced, it signals to the market that an institution is extremely vulnerable to collapse. If it is lifted following the extended e.g. 5-day period without the authorities putting the institution into resolution, at best it will weaken the institution (e.g. through greater cost of funding, risk of deposit flight, and franchise damage), and at worst destabilise the institution and tip it into resolution. Additionally, there is the contagion impact of such an action, and increased wariness in the market from lenders to institutions in a similar position.

We are also very concerned about the potential reaction that counterparties would have to the extended moratorium. This may for example consist of demands for higher pricing for lending to European institutions during times of stress, which reflects a competitive disadvantage that could be destabilising in such periods.

[10] As set out in article 31(2)(a),(b) BRRD

We believe that the potential adverse impact of a extending the moratorium tool has not been sufficiently assessed.

The existence of the tool, even if not exercised, could itself create uncertainty in the market and incentivise counterparties, including uninsured depositors (but also potentially insured depositors who are unwilling to rely on deposit insurance) to run at an earlier stage than they otherwise would. The trigger for early intervention is vague and therefore markets could react at the first sign or rumour of difficulties. Further to this, the triggers for the use of the pre-resolution tool as an "early intervention measure" are neither sufficient nor appropriate given the far-reaching effect and impact the tool may have.

This could be counterproductive and make recovery actions less likely to succeed.

We firmly believe that the likely adverse consequences of an extended moratorium tool far outweigh the mere benefit of granting the authorities more time to make their assessment. Given the far-reaching and counterproductive implications, it would be difficult for to justify an extension on these grounds. Where the pre-resolution tool is utilised to make an assessment as to whether the firm is failing or likely to fail, we would challenge whether the use of the tool is necessary given the information already available to supervisors that should enable them to make this assessment. Where the tool is used to provide time for a resolution authority to make an assessment of whether the firm is failing or for the purposes of valuation, we would highlight that the value of an institution is not static during a moratorium, and that the use of such a tool would be counterproductive to maintaining value in the institution in question. Further to this, under Article 36 (2) and (9) of the BRRD, there is scope for a provisional valuation in cases where there is no time for a full assessment to be undertaken. As such, this scenario is already considered and the pre-resolution tool is not necessary or indeed sufficient to perform a final valuation.

Where the tool is utilised to stem liquidity outflows, we would highlight that liquidity concerns can be addressed through existing liquidity planning and central bank access in accordance with FSB guidelines on temporary funding to support the orderly resolution of a G-SIB[11]. Much to the contrary, if the pre-resolution moratorium does not result in putting the institution into resolution, it will most likely lead to a substantial deterioration in its liquidity position once the pre-resolution moratorium is lifted.

(iv) Global consistency and interaction with the progress made in ensuring contractual recognition of resolution stays

The implications for the competitiveness of European markets and the interaction with requirements for contractual recognition of the existing moratoria also require very careful consideration. As discussed above, an extension of the moratorium tool would go beyond the global standard under the FSB Key Attributes of Effective Resolution Regimes, broadly implemented under the BRRD, which provide for a limited stay on termination rights in certain circumstances (see Key Attribute 4.3 and I-Annex 5); the consistent and effective application of which has been supported by industry through the ISDA Resolution Stay Protocols. This could have an adverse impact on European banks which would be subject to additional uncertain powers prior to resolution which do not apply globally. Ensuring a level playing field is important in the global financial marketplace, and the proposed moratoria powers would disadvantage EU banks by making them less attractive as counterparties.

[11] **FSB** – See http://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%9CG-SIB%E2%80%9D-Overview-of-Responses-to-the-Public-Consultation.pdf

Additionally, a number of jurisdictions have introduced requirements for firms to amend certain contracts to give contractual recognition of resolution stays. These contracts would include not only a significant number of legacy agreements between adhering parties to the ISDA protocols[12] but also a larger number of legacy and possibly new agreements with parties - such as corporate entities - who have not directly adhered to such ISDA protocols. If these requirements were changed to reflect an extended moratorium duration, this would create a significant burden on firms including the need to amend again contracts which have already been amended to recognise existing stays. Such an exercise would be burdensome and could create significant confusion in the market.

In addition, under the ISDA 2015 Resolution Stay Universal Protocol, which includes provisions by which parties opt-in to the resolution regimes of their counterparties in order to ensure the enforceability of stays on a cross-border basis, parties have the ability to opt-out of a special resolution regime if the length of the applicable stay is amended. Similar amendment rights are granted to the parties also under the ISDA Resolution Stay Jurisdictional Modular Protocol and relevant Jurisdictional Modules ("IRSJMP") (French Module, German Module, Italian Module etc.). Therefore, any proposed extension to the moratorium tool would risk numerous parties that have previously opted-in to BRRD-based special resolution regimes no longer contractually recognizing stays in such jurisdictions. This would undermine the significant advances in cross-border certainty and the reduction of systemic risk achieved by the ISDA Resolution Stay Universal Protocol.

We do not believe that these issues have been sufficiently considered or the impact assessed. We therefore oppose any extension to the moratorium tool.

Should any proposals be put forward, including those currently under consideration, these should be accompanied by a full quantitative and qualitative impact assessment. Very special care should be taken in evaluating any changes to the current moratorium tool, in particular, as it is this type of moratorium tool that carries the greatest risks, and the smallest perceived benefits.

Perceived benefits of extending the Moratorium tool

We understand that the perceived benefits for resolution authorities of extending the moratorium is providing resolution authorities more time to conduct the necessary valuations to inform the public interest assessment (PIA) and the choice of resolution action. Given the significant progress made in advanced resolution planning over the last 7 years since the establishment of the BRRD, we believe that the PIA can be frontloaded in the regular resolution planning phase prior to any potential resolution, as preliminary data and analysis required by resolution authorities should be available.

Furthermore, the impact of an extended moratorium, with the ability under Article 33a (see Annex I for details) for resolution authorities to apply the tool to eligible deposits has material implications for the PIA. With respect to the PIA, it should be assessed if meeting the resolution objectives under BRRD Article 31 are better met under resolution compared to insolvency. Considering, as part of the PIA, the application of the moratorium tool in resolution with the ability to extend this to eligible deposits, the resolution objective of depositor protection, as well as avoiding contagion under Article 31(2)(b) could not be insured; consequently,

[12] As defined under the ISDA Resolution Stay Universal Protocol and the ISDA Resolution Stay Jurisdictional Modular Protocol and relevant Jurisdictional Modules.

insolvency would need to be applied. Applying insolvency instead of resolution to a large, significant bank would contradict the original purpose of the BRRD and hence would be against the interest of resolution authorities and outweigh the perceived benefits.

All in all, the BRRD and DGSD were established to re-build trust and confidence in the banking sector after the 2008 crisis. With a moratorium extension, this trust by clients and counterparties will deteriorate due to the given contract uncertainty.

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ANNEX I – Moratorium tool in BRRDII

Within BRRD II, two significant new elements were introduced:

Pre-resolution moratorium power

A pre-resolution moratorium power was established through the new Article 33a. This article sets out that the resolution authority shall have the power to suspend payment or delivery obligations regarding any contract to which a firm is a party, once the firm is deemed to be 'failing or likely to fail' but before that firm has entered into resolution.

As such, Article 33a sets out that this 'pre-resolution' moratorium power is available to resolution authorities, subject to all of the following conditions being met:

- a determination has been made that a firm is failing or likely to fail
- there is no immediately available private sector measure that would prevent the failure of the firm
- the exercise of the suspension power is considered necessary to avoid further deterioration of the financial conditions of the firm
- the exercise of the suspension power is either necessary to determine that resolution action is necessary in the public interest or is necessary to ensure the effective application of one or more resolution tools

When employing this pre-resolution moratorium power, resolution authorities must take into account the circumstances of each individual case and the potential impact of the exercise of this power on the functioning of financial markets.

In terms of duration of any suspension, it should be limited to a maximum of two business days. Up to that maximum, the suspension could continue to apply after the resolution decision is taken. The in-resolution moratorium power set out in Article 69 must not be applied subsequently to the pre-resolution moratorium power.

The suspension power does not apply to systems and operators of systems, central counterparties (CCPs) and central banks.

As with the amended 'in-resolution' moratorium power, the resolution authority may apply the power to suspend eligible deposits. Resolution authorities should similarly assess carefully the appropriateness of applying this power to eligible deposits, and in particular covered deposits held by natural persons and micro, small and medium-sized enterprises.

As set out within Article 69, states subject to BRRD may provide that resolution authorities ensure that depositors have access to an appropriate daily amount of funds to ensure that they do not enter into financial difficulties.

Note: *It is important that the ability to apply the moratorium power to eligible deposits is removed altogether due to the fact that if deposits cannot be withdrawn due to a moratorium i) the critical function of deposit taking and ii) the resolution objective of depositor protection are endangered.*

Contractual recognition of resolution stay powers

Under the new Article 71a, BRRDII introduces a requirement for in scope entities to include a contractual term within financial contracts governed by third-country law, recognising that the contract may be subject to the exercise of resolution powers by the resolution authority to suspend the firm's payment or delivery obligations, or to suspend a counterparty's termination or security enforcement rights.

Where an entity does not include the contractual term, this should not prevent the resolution authority from applying their moratorium powers to suspend payment or delivery obligations or applying their powers to restrict the enforcement of security instruments, or suspend termination rights.

States subject to the BRRD may also require that parent undertakings ensure that their third-country subsidiaries include, within relevant financial contracts, terms to mandate that they cannot engage in early termination, suspension, modification, netting, the exercise of set-off rights or the enforcement of security interests on those contracts, should the resolution authority apply resolution powers to suspend or restrict obligations at the parent undertaking level.

Below we set out our concerns with regards to these proposals, the potential impacts, and that co-legislators should have a heightened concern around any such proposals because of the implications they may have on financial stability, the day-to-day operation of financial markets, and the increased likelihood of contagion and resolution occurring.

ANNEX II – extracts from FSB Key Attributes

4.2. Subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed.

4.3. Should contractual acceleration or early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers. The stay should:

(i) be strictly limited in time (for example, for a period not exceeding 2 business days);

(ii) be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty to counterparties (see I-Annex 5 on Conditions for a temporary stay); and

(iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of the stay (for example, failure to make a payment, deliver or return collateral on a due date). The stay may be discretionary (imposed by the resolution authority) or automatic in its operation. In either case, jurisdictions should ensure that there is clarity as to the beginning and the end of the stay.

I-Annex 5: Temporary stay on early termination rights

1 Objectives

1.1 Under standard market documentation for financial contracts and absent any statutory or regulatory provisions to the contrary, contractual acceleration, termination and other close-out rights (collectively, "early termination rights") in financial contracts may be triggered upon entry of a firm into resolution or in connection with the use of resolution powers. In the case of a SIFI, the termination of large volumes of financial contracts upon entry into resolution could result in a disorderly rush for the exits that creates further market instability and frustrates the implementation of resolution measures aimed at achieving continuity.

1.2 The Key Attributes (see Key Attribute 4.3) stipulate that, subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not constitute an event that entitles the counterparty of the firm in resolution to exercise early termination rights provided the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed. Should early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the use of resolution powers and provided that the substantive obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed.

1.3 Limited in this way, the restrictions on early termination rights set out in paragraph 1.2 do not affect other rights of counterparties under a netting and collateralisation agreements and do not interfere with payment or delivery obligations to FMIs. 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. The counterparty and the FMI could not terminate and close-out the contract based solely upon the entry into resolution or the exercise of resolution powers. They would have such right if the firm in resolution or the resolution authority failed 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.

2 Conditions for a temporary stay

2.1 A temporary stay of the exercise of early termination rights should be subject to the following conditions:

(i) The stay only applies to early termination rights that arise for reasons only of entry into resolution or in connection with the use of resolution powers (including, for example, a change in control of the relevant firm or its business arising from such proceedings);

(ii) The stay is strictly limited in time (for example, for a period not exceeding two business days);

(iii) The resolution authority would only be permitted to transfer all of the eligible contracts with a particular counterparty to a new entity and would not be permitted to select for transfer individual contracts with the same counterparty and subject to the same netting agreement ("no cherry-picking" rule);

(iv) For contracts that are transferred to a third party or bridge institution, the acquiring entity would assume all the rights and obligations of the firm from which the contracts were transferred;

(v) The early termination rights of the counterparty are preserved against the firm in resolution in the case of any default occurring before, during or after the period of the stay that is not related to entry into resolution or the exercise of a resolution power (for example, a failure to make a payment or the failure to deliver or return collateral on a due date);

(vi) Following a transfer of financial contracts the early termination rights of the counterparty are preserved against the acquiring entity in the case of any subsequent independent default by the acquiring entity;

(vii) The counterparty can exercise the right to close out immediately against the firm in resolution on expiry of the stay or earlier if the authorities inform the firm that the relevant contracts will not be transferred; and

(viii) After the period of the stay, early termination rights could be exercised for those financial contracts that are not transferred to a sound firm, bridge institution or other public entity.

Operation of the stay

2.2 The stay may be discretionary (imposed by the resolution authority on a case-by-case basis) or automatic in its operation. In either case, jurisdictions should ensure that the counterparties to the firm in resolution have clarity as to the beginning and the end of the stay.

2.3 As part of the resolution planning process and resolvability assessments, authorities should consider the implications of a temporary stay on the exercise of early termination rights for FMIs and other counterparties of the firm (see I-Annex 3, 4.8; I-Annex 4, 4.1).