POSITION PAPER

ESBG response to the EBA consultation on the contractual recognition of stay powers under the BRRD

ESBG (European Savings and Retail Banking Group)

Rue Marie-Thérèse, 11 - B-1000 Brussels

ESBG Transparency Register ID: 8765978796-80

August 2020

ESBG

We welcome the opportunity to comment on the draft Regulatory Technical Standards (RTS) for contractual recognition of stay powers laid down in the Bank Recovery and Resolution Directive (BRRD). We would like the EBA to consider the following reflections.

Q1: Do you agree with the approach the EBA has proposed for the purposes of further determining the first paragraph of Article 71a of the BRRD?

The approach raises several concerns, most of which we also address in more detail in the responses to questions 2 to 4.

These concerns can be summarised as follows:

- **Failure to address the issue of retroactivity:**

In order to avoid clearly disproportionate burdens for institutions and their counterparties and also in order to avoid considerable disruptions, it is essential that the RTS address the issue of contractual recognition clauses concerning the resolution stays already implemented in existing contractual relationships (legacy agreements) by confirming that the new requirements under Art. 71a BRRD do not have any retroactive effect and that consequently master agreements or other financial contracts which already contain similar contractual recognition clauses regarding resolutions stays need not be renegotiated (grandfathering).

Many institutions have already implemented contractual recognition clauses concerning the suspension rights under the previous version BRRD and the national law implementing the BRRD either because national law already mandated the inclusion of such clauses (as it is the case in Germany in accordance with § 60a SAG which has been in place since 2016) or in accordance with the international regulatory initiative requesting institutions to implement such clauses, or both.

The recognition clause where in many cases included into the relevant financial contracts with the help of ISDA protocols, which represents a very efficient way of complying with this requirement which has also been favoured by the regulatory authorities, or by bilateral agreements, often in the form of standard documentations developed for the relevant standard market documentations.

Without grandfathering for these legacy financial contracts (including master agreements), all the efforts made by the institutions to reach out to their counterparties and to negotiate the inclusion of such clauses over the past years would be invalidated and the relevant institutions would be forced to once again repeat the negotiation and re-papering exercise in relation of the entire population of legacy agreements. in case of the ISDA protocols, new protocols would have to be created s which take into consideration that parties have already included parts of the required language into their agreements by an earlier protocol.

It will be extremely difficult for European institutions to convince their counterparties to accept the adjustment or replacement of these already negotiated/included clauses - not least, because this would require the relevant counterparty to review the new clauses (or protocol element) once again and, in many cases, once again seek legal counsel to assess the legal and regulatory implications of the changes as well as the legal risks from their specific perspective. In particular in light of the current crisis, the counterparties will legitimately have little interest in revisiting this issue and expending time and effort (including incurring further legal cost).

In addition, it will be necessary to establish a phase-in period for the implementation of the contractual recognition requirements under Art. 71a BRRD in view of the fact that institutions will need reasonable time to include these clauses in the contracts (as to the further issue that it will not be possible to include the clauses in every single agreement and in respect of each counterparty: see also below).

- **Unnecessarily detailed, rigid and impractical requirements regarding the specific content and format of the contractual recognition clauses:**

EBA's decision to refrain from prescribing a specific contractual recognition clause is, of course, to be supported.

However, we believe that the key mandatory elements as proposed are too detailed and rigid and are also formulated in such a way that they effectively amount to prescribed clauses or at least can be read to set out a very narrow and rigid framework for the drafting of the contractual clauses with very little room for adjustments. The description of the mandatory components of the contractual term in the draft RTS should avoid prescribing specific legal concepts or terms.
In this context we also note that some elements of the proposed key elements appear to be influenced by common law contractual customs and concepts which cannot always be easily transposed into other legal customs and concepts and can thus could make the clauses to be drafted on the basis of the key elements unnecessarily cumbersome and complex.

We believe that it is of paramount importance to also take into account the legitimate interests and perspective of the counterparties which are expected to accept these clauses and the very significant impact the clauses can have on their contractual rights. In view of the understandable concerns of the counterparties, the clauses to be developed need to be adjusted to the contractual agreement, the applicable contract law and/or relevant contractual customs and standards existing for these agreements under the applicable law in which they are supposed to take effect. This in turn means that institutions (or in the case of standard market documentations, the industry associations developing the standard documentations) must be afforded considerable flexibility regarding the concrete wording and structure of the clauses as long as the clauses set out the core contractual obligations and rights and achieve their intended legal/contractual effect for the purpose of resolution of an institution.

The key elements should therefore be either set out as recommendations or be limited to these core contractual obligations and rights and avoid any unnecessary further aspects, especially purely declaratory, informational or duplicative elements.

In contrast hereto we believe that the contractual clauses should refrain from mixing the actual contractual provisions regarding the recognition of the effects of the measures with purely informational content, not least in order to avoid legal uncertainties and misunderstandings. The clauses should also avoid duplicative and also purely declaratory provisions.
We therefore see the need for a review of the proposed key elements. At the very least, it should be ensured and clarified that these requirements do not restrict the ability to make adjustments as long as the clauses have the intended effect and address the core elements set out above.

In this connection it should be noted that these clauses are intended to support the resolution measures by providing for a contractual right to enact these measures independently from and in addition to the regulatory rights established under the BRRD and the member state laws implementing the relevant BRRD provisions. The regulatory right to enact these measures exists regardless of the contractual recognition clauses: that is, these clauses are not a condition precedent for the legality and enforceability of the regulatory measures.

- **Failure to address the issue that institutions will in some cases not be able to impose the contractual recognition clauses on counterparties:**

The experience with Art. 55 BRRD has demonstrated that it will never be possible to impose the required clauses in all contractual agreements/financial contracts falling in the scope of the requirement, regardless of the efforts undertaken by the institutions.

Especially with regard to already existing financial contracts, counterparties may simply reject the inclusion of such clauses and the institution will have no means to implement them without cooperation from the counterparty. That counterparties will have reservations against the inclusion of such clauses is to be expected since these clauses effectively require a submission to the powers of a foreign regulator and have a significant impact on their contractual rights. The restriction of the contractual rights may also have regulatory consequences. Each counterparty therefore needs to assess the consequences of such restrictions of its contractual rights from its perspective and under the applicable contract law as well as its regulatory laws and rules. There may also be legal impediments: For example, public entities may not be permitted to subject themselves contractually to any measures of a foreign regulatory authority. Some types of financial contracts are also concluded on the basis of international practices, customs and terms which do not foresee the inclusion of such clauses (especially, where these clauses have to conform to specific formats) as they may not be compatible with the accepted standards and contractual customs for these transactions and in the relevant market.

It thus has to be expected that institutions will not be able to implement the clauses with respect to every single financial contract or in each case with the exact content as required pursuant to Art. 1 of the draft RTS. However, this cannot be a concern where and as long as this does not affect the resolvability of the institutions and where the institutions make this transparent to the relevant regulatory authorities. This should be clarified also in the draft RTS.

Q2: Do you agree with the approach the EBA has proposed with regard to the components of the contractual term required pursuant to Article 71a of the BRRD?

First of all, ESBG appreciates the clarification set forth by RTS and the further harmonisation. However, we see the risk that a too detailed approach might create too much burden on the market participants without further improving the level of legal certainty.

In the light of the abovementioned, we see the requirements as defined in Art. 1(1) and (3) of the proposed RTS as unnecessary. In ESBG's view, it should be sufficient when the contracts contains a clause referring to the applicability of the resolution stay powers as defined in the BRRD 2/national law implementing the directive. The level of detail as proposed in the draft RTS would result in burdensome contract modifications and would – due to the complexity of the proposed approach – have a negative impact on the legal certainty (e.g. by explicitly referring to a local law in a contract with foreign party(ies). Furthermore, the explicit acknowledgements as proposed in the RTS would lead to complex contractual constructions without any material benefits, in our opinion.

Specifically this means:

- Art. 1 (1) - Acknowledgement and acceptance

As the requirements may have to be implemented in contractual agreements in other languages and may also be subject to a contract law and contractual practices which do not have a direct equivalent to a formal "acknowledgment" we assume that this requirement is not intended to require a provision setting out a formal acknowledgment in a narrow/literal sense. Instead we believe that any clause with the same

effect setting out that the counterparty is aware, recognises or accepts the relevant regulatory measure is sufficient for the purposes of Art. 71a BRRD.

In order to avoid any misunderstandings this understanding should be confirmed, for example by replacing the words "the acknowledgment and acceptance"

by the words

"the acknowledgment, acceptance, recognition or any other provision or declaration with the same effect".

- Art. 1 (2): Description of powers

The requirement to provide a description of the resolution powers raises serious concerns as it can be understood as an obligation to not only specify the powers and measures but also as an obligation to provide a general explanation in the form of general/background information. This cannot be intended because it would mix contractual elements with purely informational elements which in turn could seriously affect the effectiveness of the clause.

A contractual agreement is not and should not be an instrument to provide information to the other counterparty, especially not on such a complex matter as regulatory powers granted by a European directive and implemented by the laws of a member states: The information conveyed by contractual clauses can never be complete and comprehensive as it is impossible to condense all information on the regulatory measures, the relevant laws granting the powers and their interpretation into a contractual clause. Contractual clauses as a means of information will always be insufficient and potentially misleading. In any event, the information provided by a party to a contractual agreement cannot and never should replace the independent assessment and analysis by the counterparties, especially not with regard to such a complex issue as resolution measures. The same applies to a replication of the statutory text of the BRRD provisions and the national implementing laws as these, by themselves, are also incomplete without an understanding of the interpretation of the provisions and the resolution regime as a whole. In addition, a description or replication of statutory provisions in a contract could be considered in some jurisdictions as an advice provided by the party upon whose request the clause has been included to the other party. This could raise issues of liability and adversely affect the validity and enforceability of the contractual recognition clause in general.

We therefore assume that - pursuant to this requirement - the contractual clause needs to specify as precisely as possible the resolution powers the counterparty is recognising. This will in practice best be achieved by naming the specific measures including a reference to the relevant provisions, e.g. as in Art. 1(3)(a) of the draft RTS.

In order to clarify this and to avoid any misunderstanding, we therefore propose to replace the word

"description"

by the word

"specification".

- Art. 1 (3): Requirement for a declaration to be bound by the effects and requirements

The requirement under Art. 1 (3) to include a provision under which the counterparty recognises to be bound by the effects of the measures or requirements is, to some extent, duplicative or at least significantly overlaps with the requirements under Art. 1 (1) and (2): Where a counterparty has already contractually recognised the effects of the measures and the consequences resulting therefrom, there is no need for a further additional/separate declaration to be bound by them (the recognition is already contractually binding and does not need to be reinforced). It should be entirely sufficient and would also make the contractual clauses simpler and shorter, if these elements can be combined in one clause recognising the measures and powers listed in Art. 1 (3) (a) and (b). Please also see our comments relating to the disadvantages of the prescribed use of legal terms in the required clause.

This should be clarified.

- Art. 1 (4): requirement to acknowledge and accept that no other contractual term impairs the effectiveness and that the agreement is exhaustive.

As to the understanding of the term "acknowledgment and acceptance", the comments on Art. 1 (1) apply correspondingly. Furthermore, we would like to point out that the provision required is primarily of a declaratory nature and thus necessarily of limited practical relevance: The clause would not prevent any subsequent further agreement negating or contradicting this declaration (which, of course, would be a breach of regulatory requirements on the part of the institution subject to the BRRD).

The requirement in Art. 1(4) has therefore no added value. As such, the requirement is largely redundant and would not justify a change in the market standard clauses already in use to which the market participants are already accustomed to.

Q3: Do you believe that having the art.71a BRRD clause governed by the laws of an EU jurisdiction would improve the likelihood that it would be effective and enforceable before the courts of the relevant third country jurisdiction? Please provide your reasons for this view. Further, what do you consider to be the advantages or the disadvantages of using the provision proposed under art 1(5) of the draft RTS?

Unfortunately we do not believe in an improvement. Conversely, this requirement will significantly increase risk of unenforceability of the clause and, in addition, significantly make it more difficult for counterparties to accept these clauses:

As mentioned above, it is essential that the contractual recognition clauses are adjusted to the contractual agreements and the applicable law. This necessarily means that the contractual recognition clause will, in general, be subject to the same contract law as the rest of the agreement. This not only ensures that the clause operates correctly together with the contractual rights under the relevant agreement it is intended to suspend or amend but also avoids discrepancies and/or inconsistencies in the interpretation and application of the contractual agreement and the clause.

In addition, a split choice of law resulting in the application of a different law for the contractual agreement on the one hand and another for the contractual recognition clause on the other significantly increases the complexity for the counterparties which will further reduce their willingness to accept such clauses.

We have doubts as to how the application of a different law to the contractual recognition clauses (other than the law of the relevant contractual agreement) shall improve the legal effectiveness: It rather could

be expected that such split choice of law will actually invite and facilitate challenges or at least prolong the process.

Furthermore, such a split choice of law regarding the contractual recognition of regulatory stays may have unintended regulatory consequences: Under the new ECB guidance on the notification of netting agreements, any change affecting the governing law of a netting agreement used for regulatory purposes is to be deemed to be a change leading to a "new type of netting agreement" resulting in a de-recognition of the agreement for regulatory netting unless and until re-notified as a new agreement.

Lastly, it is unclear whether such split choice of law has an effect on the choice of jurisdiction/venue (where such choice has been made in the agreement or is otherwise possible): Commonly, in a financial contract parties would submit all disputes arising out of such contract to the jurisdiction of the courts located in the jurisdiction of the law applicable to such financial contract. One aim of this practice is to avoid a situation where courts of one jurisdiction would have to decide upon a matter governed by the laws of another jurisdiction. However, in case of a split choice of law applicable to a financial contract as requested in the draft RTS, a judge in the third country would be deciding upon the validity and enforceability of the recognition clause governed by the laws of a member state.

The clearly most appropriate and safest approach is therefore to submit the contractual recognition clause to the same governing law that also applies to the financial contract it relates to.

In addition, in accordance with the standard contractual recognition clause regarding regulatory stays already in use, the counterparty accepts/recognises limitations resulting from the regulatory stays on its contractual rights in the same manner and/or to the same extent as if the agreement/s were governed by the laws of a member state. Such a requirement should provide sufficient comfort.

Q4: What are the standard clauses you are likely to use for your financial contracts pursuant to this requirement? Will the clause differ for various types of financial contracts (please detail if yes)?

Here, we would like to refer to the market standards, e.g.: https://www.isda.org/protocol/isda-resolution-stay-jurisdictional-modular-protocol/ , and in particular to the German Jurisdictional Module: http://assets.isda.org/media/f253b540-113/3ab6c85c-pdf/

ESBG believes that a similar wording (with similar granularity) should be considered as sufficient also for the purpose of the BRRD 2. The acceptance of these standards would also not require adjusting bilateral agreements or ISDA protocols and therefore would operationally be the most efficient and at the same time sufficiently prudent approach.

Regarding the business relationships with EU-platforms and central counterparties (CCPs), it is worth noting that the creation of a contractual relationship is often not based on a "bilateral contract", but the contractual relationship is established by an execution of a transaction. Therefore, any contractual obligation is regulated only on the level of the standards of the respective CCP/Platform. Therefore, a contractual recognition as proposed by the draft RTS would not be accessible for the institutions in scope.

- Preference for use of standard clauses developed for standard market documentations where available:

With regard to financial contracts entered into under standard market documentations, institutions will generally rely on standard clauses/agreements developed for the relevant standard market documentation (which, in many cases, have been discussed with regulators).

Institutions may, in some cases, also develop individual solutions for other types of financial contracts, especially for financial contracts not based on standard market documentations.

- Contract type specific rather than one single clause for all types of financial contracts:

In general, institutions will use clauses developed for a certain type of financial contract and/or contractual documentation or certain sub-groups of financial contract types (for example derivatives and securities finance transactions under certain types of master agreements), wherever possible in the form of the above mentioned standard clauses developed for the standard market documentations.

Institutions are not likely to use one single contractual recognition clause for all types of financial contracts. Experience has shown that such all-encompassing clauses are difficult to apply from the perspective of the counterparty and also may be difficult to apply to the potentially broad range of types of contractual agreements and transactions they would have to cover.

Q5: Do you agree with the draft Impact Assessment?

We disagree with certain aspects of the impact assessment:

- Item 6:

While we believe that contractual recognition clauses can support the implementation of resolution measures it needs to be recognised that they – as any contractual instrument – can never ensure that resolutions measures will be recognised in every jurisdiction under all circumstances: A residual risk of challenges will always remain. The only instrument which would provide the desired legal certainty are international agreements on the reciprocal recognition of resolution measures. We therefore reiterate once again our urgent call to intensify the efforts to conclude such intergovernmental agreements.

- Items 8 to 16:

We believe that the impact assessment on the one hand, significantly overstates the risks associated with less uniform approaches to the contractual clauses and the advantages of uniformity/convergence and on the other hand, does not sufficiently take into account the clear disadvantages of too rigid/formalistic requirements:

The experience over that past four years has clearly demonstrated that institutions and industry associations need to focus on developing clauses tailored to the contractual agreements and counterparties involved by addressing the core elements (see Q1), and also taking into account the need to make the clauses easily understandable, operable and acceptable to the counterparties. The specification of the content of the required clause should not include any legal concepts, but should state the intended result that the clause is to accomplish.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

European Savings and Retail Banking Group – aisbl
Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax: +32 2 211 11 99
Info@wsbi-esbg.org ■ www.wsbi-esbg.org

Published by ESBG. August 2020.