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**FINANCIAL MARKETS LAW COMMITTEE**

**ISSUE 149 – Recovery and Resolution**

# Discussion of legal uncertainties arising from the Council General Approach to the Commission proposal for a Recovery and Resolution Directive

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**FINANCIAL MARKETS LAW COMMITTEE**

**ISSUE 149 WORKING GROUP**

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## 1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. The FMLC wishes to draw attention to legal uncertainties arising from proposals for a Recovery and Resolution Directive (the "RRD"). In particular, this paper considers the Council General Approach to the Commission proposal for the RRD (the "General Approach").[1] The FMLC welcomes a number of changes introduced by the General Approach. These are outlined in section 2 below. This paper also highlights areas where legal uncertainty persists.

1.3. This is the FMLC's second paper on the subject of the RRD. An earlier paper ("RRD Paper I", appended hereto) responded to the Commission's Proposal for a Recovery and Resolution Directive (the "Commission Proposal").[2]

## 2. IMPROVEMENTS INTRODUCED BY THE GENERAL APPROACH

2.1. The FMLC takes the view that a number of changes introduced by the General Approach provide for greater legal certainty. The Committee is grateful for these developments.

**Financial contracts**

2.2. Paragraph 8 of RRD Paper I discussed provisions of the Commission Proposal dealing with financial contracts. A number of the points raised by the FMLC have been resolved in the General Approach by the deletion of provisions (i.e. Article 77 of the Commission Proposal) applying stringent restrictions on the exercise of termination rights under a financial contract. In their place, the General Approach

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1 Council General Approach to the proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 (dated 28 June 2013).

Unless otherwise stated, references to legislation are to provisions in the aforementioned General Approach.

This paper also makes reference to the Commission proposal for the RRD (see footnote 2 below) and the Report of the Committee on Economic and Monetary Affairs of the European Parliament regarding the RRD, which is dated 4 June 2013 and which has been adopted by the European Parliament (the "ECON Report").

2 Commission Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms [...] (dated 6 June 2012).

introduces a revised approach to financial contracts prohibiting the characterisation of a resolution measure as a contractual "enforcement event" (see Article 60a, *Exclusion of certain contractual terms in early intervention and resolution*). In effect, this provision aims to preclude reliance on bespoke Events of Default whereby contracting parties agree to terminate their contract on, say, the exercise of a resolution power or the application of a resolution tool by a resolution authority.

2.3. This approach obviates some of the difficulties and uncertainties outlined in Section 8 of RRD Paper I. In particular, it resolves interpretative uncertainty which resulted from differences in the respective drafting of Articles 77 and 63 of the Commission Proposal.[3] (This uncertainty is discussed in paragraph 8.3 of RRD Paper I.)

2.4. The revised approach to financial contracts also avoids the unpredictable consequences of applying resolution tools in circumstances where some derivatives are subject to close-out and some are not. RRD Paper I made the point (at paragraph 8.4) that derivative contracts may variously represent an entitlement to future income streams, an asset of mark-to-market value, or either a contingent or non-contingent entitlement to payment of a close-out amount. This was said to be particularly problematic for the development of technical standards on valuation, which will be part of the resolution framework (applying to bail-in, in particular). It would appear, now, that valuation will not proceed on a close-out basis, since terms by which parties agree to terminate and close-out their contract in the event of resolution will be of no effect while payment and delivery obligations continue to be performed. (Under Article 77 of the Commission Proposal, the exercise of termination rights was prohibited but contractual termination provisions would nevertheless have been of residual contractual effect, as explained in RRD Paper I.)

2.5. Importantly, Article 60a(2d) of the General Approach provides that the Article's provisions shall be of "overriding effect" (i.e. considered overriding mandatory provisions for the purposes of Article 9 of the Rome I Regulation 593/2008). This has the effect that a court in any European Member State is bound to reject the parties' characterisation of a resolution measure as a contractual "enforcement event" in their contract, notwithstanding that the applicable law of the contract is the law of a third country. It does not, however, eliminate the risk of incompatible

[3] It is noted that related changes have been made to Article 63(4) to accord with Article 77's conversion into Article 60a.

parallel judgments in cases where the resolution forum is an EU Member State and the solvent counterparty brings an action to enforce contractual termination provisions in the court of a third country. That is, if the parties have chosen the law of that third country as the applicable law of the contract.

2.6. In such a case, the provisions of Title VI of the General Approach (discussed further below at paragraph 7) may be of indirect assistance. Pursuant to those provisions the Commission may propose the negotiation of agreements with one or more third countries regarding means of cooperation between resolution authorities and third country authorities. Although it is clear that these agreements will chiefly be concerned with information-sharing and the effective use of resolution tools in circumstances where foreign financial institutions have a branch or subsidiary in the EU and *vice versa*, it is conceivable that such agreements could provide a basis for the mutual legal recognition of mandatory provisions of the sort set out in Article 60a.

2.7. If an "enforcement event"—such as an Event of Default caused by non-payment—does then occur after an institution is placed into resolution, the close-out netting provisions of a financial contract will receive protection under Article 25 of Directive 2001/24/EC on the Winding Up of Credit Institutions ("CIWUD"). CIWUD has been extended to cover resolution measures, now defined as "reorganisation measures", by virtue of Article 106 of the General Approach. This has the welcome effect that netting agreements will be governed exclusively by their applicable law in any EU resolution forum.

**Solvent subsidiaries**

2.8. The new Article 83a (*Group resolution*) provides greater clarity on the treatment of the subsidiary of a parent company which is in resolution, where the subsidiary itself does not require resolution (referred to here as a "solvent" subsidiary).[4] Article 83a provides that any group resolution scheme must be agreed between the group level authority and the authorities responsible for subsidiaries covered by the scheme (Article 83a(3)) and provides that the authority of a subsidiary can elect to take action independently from the scheme (Article 83a(4)). These provisions (and the other supporting subparagraphs of the Article) resolve uncertainty identified in RRD Paper I (Section 7) as to whether and how the rights and assets of a solvent

[4] This is an area of uncertainty raised in paragraph 7 of RRD Paper I.

subsidiary in one jurisdiction can be used by a resolution authority in another jurisdiction for the benefit of the parent company or the group as a whole.

**The bail-in tool**

2.9. The new Article 38(3c) of the General Approach sets out exceptional circumstances in which a resolution authority may exclude or partially exclude liabilities from the application of bail-in. Subparagraph (ii) provides that liabilities may be excluded for the purposes of ensuring business continuity—and, as a consequence, business recovery—can be achieved. Subparagraph (iii) provides that liabilities may be excluded in order to ensure financial stability. These provisions appear to address uncertainties (explained in paragraph 5 of RRD Paper I) which arise from the fact that circumstances can be identified in which the exercise of the bail-in power might appear inconsistent with the objectives of business recovery and financial stability—these being two aims which appear to have prominence under the bail-in objectives in Article 37 and (some of) the resolution objectives in Article 26.

## 3. THE TOOLKIT: BAIL-IN

**The conversion of debt to equity and the writing-down of debt**

3.1. The RRD does not provide a set of principles to guide a resolution authority's choice as to whether to convert debt to equity or whether to write-down debt,[5] which appears to be a matter of discretion exercisable by the resolution authority.[6] Presumably, resolution authorities are bound by the objectives and principles of resolution (see Articles 26, 29 and 31)[7] and these will dictate the choice which is made between conversion and write-down. Further determination of the choice between these two forms of bail-in is a matter of policy. However, should legislators think it important that the bailed-in creditors of a bank receive the benefit of any future improvement in the value of that bank on the grounds of

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5 A resolution authority has the power to do both pursuant to Article 56 (*General powers*).

6 Article 45 is the only provision concerned with the approach to be taken to conversion. That Article deals with the rate or rates to be used if a conversion takes place. However, Article 45 does not actually introduce a guide as to whether a conversion should take place.

7 It is noted that Recitals (47) to (49) appear inconsistent with some of the RRD's provisions on bail-in. Recital (48a), to consider one case, appears to set out a principle according to which the hierarchy of creditors in bail-in should operate only to the extent that it produces a better outcome for other creditors—this principle is not reflected in the relevant Articles of the General Approach (Article 38 regarding the scope of bail-in and Article 43 regarding the sequence of write down and conversion of bail-in).

As a minor drafting point, the meaning of the final sentence of Recital (48) is incomprehensible in its current terms.

fairness, such policy could be implemented by way of a principle that conversion should be favoured over write-down.[8] If other policy aims prevail, these will be implemented in other ways.[9]

**Statutory and contractual bail-in**

3.2. The FMLC noted in paragraphs 5.9 to 5.13 of RRD Paper I—found in the Annex—that legal uncertainty is likely to arise from the fact that contractual bail-in provisions may not operate in the same way as statutory bail-in provisions under the RRD. It does not appear that the General Approach has resolved this area of uncertainty.

**Bail-in of derivatives, as proposed by the European Parliament**

3.3. The General Approach does not take up the proposed Article 38(3) of the ECON Report. Pursuant to that provision, certain derivatives which are cleared through a central counterparty (or referred to in Article 382(4) of the Regulation on prudential requirements for credit institutions and investment firms ("CRR"))[10] are to be treated as senior to derivatives which are not so cleared. The FMLC considers that the General Approach is right to omit this Article. The following paragraphs explain why.

3.4. First, and most saliently, the ECON Report does not explain how such seniority is to be achieved. Secondly, the Regulation on OTC derivatives, central counterparties and trade repositories ("EMIR")[11] mandates clearing of classes of derivatives. However, EMIR acknowledges that certain derivatives will not be subject to the mandatory clearing requirement either because they are insufficiently standardised or because there is no recognised central counterparty which is able to clear them. In this context, the effect of Article 38(3) in the ECON Report would be to penalise the counterparties to derivatives contracts which are not eligible for clearing. It is not clear that this is within the intent of the legislators.

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8 This could be complemented by a principle that there should be a conversion (or grant of rights of equal value) in any case where the affected creditor has suffered loss by virtue of the exercise of the write-down and conversion power.

9 The "no creditor worse off" principle may be of relevance as regards the choice between the use of conversion or write-down. However, the provisions which deal with bail-in (Section 5 of Chapter III) do not clearly cross-refer to the provisions which set out the "no creditor worse off" principle.

10 Regulation (EU) No 575/2013.

11 Regulation (EU) No 648/2012.

3.5. The distinction between cleared and non-cleared derivatives gives rise to some uncertainty regarding the effect of the exclusion from bail-in for "secured liabilities" which is created by Article 38(2)(b) in the General Approach and of the ECON Report. It is inferred that the exclusion of "secured liabilities" takes effect with respect to derivatives so that only any unsecured portion of a derivative may be bailed in; the discretionary exclusion for derivatives under the first paragraph of Article 38(3) of the ECON Report is overridden.[12] However, the distinction between cleared and non-cleared derivatives, introduced into the second paragraph of Article 38(3) of the ECON Report, creates some uncertainty as to the whether the exclusion for "secured liabilities" takes effect differently for non-cleared derivatives.

## 4. ARTICLE 30: VALUATION

4.1. Article 30 requires that a valuation of the assets and liabilities of the company or group in resolution (provisional at least) takes place prior to the application of a resolution tool.[13] It is noted, however, that the resolution objectives (set out in Article 26) simultaneously imply a need for resolution actions to be carried out with some urgency.[14]

4.2. It is unclear on what basis the valuation (which must be independent) is to be carried out, notwithstanding that Article 30 provides that the valuation should be fair and realistic. One may infer that the valuation is intended to identify a company's going-concern value in view of the resolution objectives—an aim

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12 A cleared derivative appears, to the extent that it is subject to the margin requirements of a central counterparty, to conform to the definition of "secured liability" found in Article 2(58) of the General Approach and ECON Report. In practice, there are unlikely to be circumstances in which a portion of a cleared derivative is not a "secured liability". This is because, in broad terms, one can say that the margin requirements of a central counterparty are intended to ensure that it is overcollateralised.

Similarly, non-cleared derivatives are increasingly subject to a collateralisation requirements under EMIR and would, as such, represent "secured liabilities" to the extent covered.

13 Recital (48ab) states specifically that the minimum bail-in of 8%, which is required pursuant to Article 38(3cab), should be calculated on the basis of the Article 30 valuation.

14 Recitals such as (33), (34) and (57) support the inference that resolution actions are intended to be carried out with some urgency. Recital (33) says that a valuation pursuant to the Directive should be able to be carried out rapidly for this purpose, though it is not clear that such rapidity is achievable.

There appears to be a risk that rapid intervention may be hardest to secure when it is likely to be most needed—in the event of serious mismanagement or fraud. This is because available management accounts to assist a speedy valuation are likely to be far from adequate for that purpose.

Recital (32) includes an expectation that the assets and liabilities of an institution can be fairly and realistically valued before resolution action. A valuation to such a standard is likely to be impractical in many cases and reliance will inevitably be placed on recovery plans and management accounts, for example.

underlying a number of the objectives seems to be the salvation of all or part of a business. The basis for the valuation would, however, be clearer if stated explicitly.

4.3. The terms in which Article 30 is drafted give rise to legal uncertainty as to the status of a resolution action which is taken when a valuation at the proscribed standard has not been carried out, owing to practical difficulty or impossibility. Article 30(1a) seems to be intended to address this situation of impracticability. It does so by allowing in certain circumstances for a "provisional valuation" to be carried out in accordance with Article 30(5). Unfortunately, however, this provision still does not resolve the uncertainty identified because it fails to clarify the status of a non-compliant resolution action, which may have proceeded on the basis of an inadequate "provisional valuation". Certainty would be increased if the legislation were to make it clear that in some circumstances (i) a resolution action that had been taken would be valid, notwithstanding a failure to carry out a valuation at the prescribed standard and (ii) that a valuation could in those circumstances be carried out *ex post*. For example, in the event that a company is unable to pay its debts as they fall due (during a cash flow crisis, perhaps)[15] intervention would be justified and valid, notwithstanding that the relevant valuation did not comply with minimum standards.

4.4. It follows from the above that the valuation requirement, as currently framed, may prove litigious. A party which has been negatively affected by a resolution action may choose to challenge the action on the basis that the valuation exercise did not meet minimum standards.

4.5. It is inferred that the legislative intent behind Article 30 is for the valuation to: (i) help with the calculation of the value of shares to be written-off and debt to be written-down or converted to equity; and (ii) provide a safeguard against the misapplication of the resolution tools. In light of the uncertainties outlined above, some consideration might be given to the replacement of the valuation requirement with a requirement that a preliminary report be produced. Such a report would outline the changes needed in order either to restore the company in question to financial health or to rescue part of it by way of a bridge bank. A requirement could be put in place that the report be prepared on the basis of all information

[15] Note that an inability to pay debts as they fall due is part of the test for determining whether a company is failing or likely to fail—which is a condition for resolution—under Article 27.

reasonably available and that reference in the report be made to assets and liabilities, audited and management accounts and other records. The report, where possible, should be provided by an independent person. A further report could be conducted on an on-going/*ex post* basis to inform the completion of the overall resolution process. Nevertheless, it would be possible for resolution actions to be carried out during this process.[16]

4.6. A report of the type proposed would better reflect the fact that the current value of a company's assets and liabilities represents only part of the equation when determining the value of shares to write-off or debt to write-down or convert to equity. Such determination needs to be made with reference to a company's prospective capital needs. As a result, the identification of performing assets and overall relationships and the calculation of their nominal amounts is likely to be more important, in many cases, than a company's balance sheet or overall net value.

**Interaction between Article 30 and the sale of business tool (Article 32)**

4.7. Article 32(4) requires that all reasonable steps be taken by the resolution authority to obtain commercial terms for a transfer in conformity with the relevant valuation.

4.8. Uncertainty arises if, to produce a better return, a business is transferred in several parts. It is not clear how the terms of each sale could conform to the single and definitive institutional business valuation required under Article 30.

4.9. Moreover, a partial transfer of this kind may take place in stages over a relatively long period. As a result, the relevant valuation may become out of date (the company which had been valued may, for example, cease to operate as a going concern).

4.10. One may infer that the intention behind Article 32(4) is that a transfer takes place at the best price. It is suggested that an alternative way to achieve this aim would be to rely on the requirements of Article 33 regarding the fairness of the sale process. If a further guarantee of best price were necessary, that Article could introduce a requirement that independent advice on a sale be sought.

16 The provisions of Article 30(5a) may be helpful here. Article 30(5a) describes the *ex post* valuation which must be carried out in the event that a provision valuation has been carried out pursuant to subparagraph (5) of Article 30.

## 5. POWERS AND SAFEGUARDS

### Article 56 - General resolution powers

5.1. Articles 56(1)(h) and 56(1)(l) give a resolution authority the power to cancel or amend the terms of "debt instruments".[17] The definition of "debt instruments" (see Article 2(41)) is wider than that of "capital instruments",[18] which term is used to describe instruments that can be bailed-in (see, for example, Article 31(1a) concerning the principles of resolution tools).[19]

5.2. It is not clear why different terms have been used in these contexts. However, the effect (perhaps unintentional) is to create a very broad power under Article 56 pursuant to which an authority can cancel or change the terms of secured debt and, possibly, other non-bailable obligations. As a result, all forms of claim against a bank (i.e. including those which are not bailable) will be affected by uncertainty as to their treatment in resolution.

5.3. One might infer that the true legislative intent is for the powers under Article 56 to be fettered so that they can be used only in a manner ancillary to the exercise of resolution tools in a way envisaged by the RRD.[20] However, because this is not stated expressly in Article 56, it is not certain. (Further uncertainty is arguably created by the fact that Article 57 is entitled "Ancillary powers", which could imply that the powers in Article 56 are not ancillary.)

5.4. If the intent is for the powers under Article 56 to be fettered in the way described above, this could be made clear by the insertion of a general qualification as a second sentence to the lead paragraph in Article 56(1). Such qualification might be comprised of the following:

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17 The term "debt instruments" is only used in Articles 56(1)(h) and Articles 56(1)(l).

18 The definition reads as follows: "'Debt instruments' referred to in points (h) and (l) of Article 56 mean bonds and other forms of transferable debt, instruments creating or acknowledging a debt, and instruments giving rights to acquire debt instruments."

This definition seems capable of including loans under loan agreements (whether individual or syndicated) and deposits evidenced by a deposit certificate or some other acknowledgement (it also includes secured debt, although the significance of this is reduced by the fact that secured debt is safeguarded from being subject to the bail-in and other resolution tools).

It is unclear whether the definition may also extend to debt claims, such as: unpaid bills, trade receivables and derivatives payments.

19 It is assumed that the term "capital instruments" means the same as "relevant capital instruments", which is defined in Article 2(65), but it would improve clarity if the actual defined term were used.

20 As a further alternative they could only apply to capital instruments, except for the purpose of any temporary moratorium permitted by the Directive.

> "These powers may be used only for the purpose of taking resolution measures envisaged by this Directive and do not create independent resolution measures".

**Article 59 – Enforcement of crisis management measures across Member States**

5.5. The intention behind Article 59 seems to be to ensure that challenges to actions taken by a resolution authority should be brought only in the home Member State of that authority. Several provisions in the Article appear to seek to achieve this aim. It is suggested that the language in Article 59(4) (and returned to in Article 59(5)) which draws a distinction between Member State "A" and Member State "B" achieves this aim in the clearest manner.

## 6. THIRD COUNTRIES

**Transfers and ineffectiveness under foreign law**

6.1. Article 73 of the Commission Proposal is concerned with property, rights and liabilities which are governed by the law of a territory outside the European Union. It provides that, in such a case, a resolution authority must not proceed with the purported transfer and that it should void the transfer if it has already been ordered. This provision has been deleted from the General Approach, which creates uncertainty as to the action to be taken by a resolution authority in the event that the transfer of the property, rights and liabilities of a company are or may be ineffective under foreign law.

6.2. The deletion seems to imply that a resolution authority can proceed with a transfer notwithstanding its ineffectiveness. However, there is no clear, discernible reason why such a transfer should take place. It would increase legal certainty for the RRD to prescribe the path to be taken by a resolution authority in the event of a transfer's ineffectiveness. This will be particularly important in the event that the transfer relates to a significant subsidiary or a branch of an EU institution. In such a case there may be consequential effects on the business of the EU institution, which could give rise to financial stability and other related concerns.

**Competing insolvency proceedings**

6.3. The possibility of multiple, competing insolvency proceedings taking place with respect to the same institution or group in resolution (inside and outside the territory of the EU)[21] is not adequately addressed by the General Approach. This is

[21] Pursuant to CIWUD, the concerns described here do not arise where the institution or group is based entirely within the territory of the EU.

a point touched on but not resolved by Article 85(5). That Article provides that a Member State must recognise and enforce a third country's resolution proceedings. It further stipulates that such recognition and enforcement must be without prejudice to the Member State's normal insolvency proceedings under national law. The implication is that the relevant third country must subordinate its resolution proceedings to a Member State's national insolvency law. It is, however, unlikely that a third country would be willing to do so.

**Refusal to recognise third country proceedings: public policy justification**

6.4. Article 86 sets out justifications for the refusal by a Member State of third country resolution proceedings. One of these is that their recognition or enforcement would be contrary to public policy. The breadth of this justification will make it difficult to predict when the proceedings of a third country are likely to be recognised or enforced. The provision may also allow Member States to rely on matters outside the objectives of the RRD—and the range of legitimate factors underpinning decisions related to resolution—in justifying a refusal. (The Committee recognises the need to ensure that a Member State will not be obliged to breach Union law—the SFD or FCAD,[22] for example—in recognising or enforcing third country resolution proceedings.)

## 7. THE TREATMENT OF NETTING

7.1. Paragraph 6 of RRD Paper I drew attention to legal uncertainties arising from the Commission Proposal's treatment of netting, in particular in the context of wider European legislation concerned with netting. The General Approach appears to contain some improvements in this regard but uncertainties remain.[23]

**"Netting arrangement" concept and its definition in Article 2(85)**

7.2. The General Approach employs the term "netting arrangement" in Article 68 (*Safeguard for counterparties in partial transfers*), Article 69 (*Protection for financial collateral, set off and netting agreements*) and Section B of the Annex (*Information that*

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22 The SFD means the Directive on settlement finality (Directive 98/26/EC).

The FCAD means the Directive on financial collateral arrangements (Directive 2002/47/EC).

23 For example, "netting arrangement" has been deleted from Article 63(3) of the RRD (concerned with the suspension of termination rights), in line with paragraph 6.2.3 of RRD Paper I. The Article had appeared premised on a necessary connection between a termination right and a netting arrangement—a premise not supported by the earlier definition of "termination right" in Article 2—but this has been resolved by the deletion of "netting arrangement".

*resolution authorities may request […]*). It is, therefore, important to consider the definition of this term in Article 2(85). The definition reads as follows:

> "netting arrangement" means an arrangement under which a number of claims or obligations can be converted into a single net claim, including close-out netting arrangements under which, on the occurrence of an enforcement event (however or wherever defined) the obligations of the parties are accelerated so as to become immediately due or are terminated, and in either case are converted into or replaced by a single net claim. This definition includes "close-out netting provisions" as defined in Art 2(1)(n)(i) of Directive 2002/47/EC and "netting" as defined in Article 2(k) of Directive 98/26/EC.

7.3. This definition of "netting arrangement" is new and welcomed by the FMLC.[24] It helps to compare and contrast the term to similar concepts: "close-out netting arrangement" is a subset of "netting arrangement"; "close-out netting provision", as defined in Article 2(1)(n) of the FCAD, is included in the definition; and "netting", as defined in Article 2(k) of the SFD, is also included in the definition.

7.4. However, the definition does not differentiate "netting arrangement" from, or help to explain the meaning of, "netting agreement". This term, which appears in the RRD, can be traced to the capital adequacy *acquis* and the insolvency *acquis* (see further below).

7.5. RRD Paper I noted (at paragraph 6.2.4) that the term "netting arrangement" may have been transposed into European law from the UK's Resolution Regime which is set out in the Banking Act 2009.[25] The apparently *ad hoc* introduction of terminology into the European *acquis* should be approached with caution. The meaning of terms in European law can have effect across legislation, not only prospectively but also by raising implicit questions about the meaning of terms which are closely related in existing legislation. As a result, the introduction of a new term can bring about the layering of similar word-concepts, which may create uncertainty.

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24 In the Commission Proposal the term was simply described in Article 68(d), a provision regarding safeguards for counterparties in partial transfers.

25 See the definition of "netting arrangement" found in Section 48(1)(d) of the Banking Act 2009.

7.6. A range of terms related to netting are still in use throughout the General Approach. It is not always easy to discern any justification for this inconsistency. References to "netting" include:

a) Recital (60) – "close-out netting agreement" and "netting agreement". Recital (60) makes reference to the Directive relating to the taking up and pursuit of the business of credit institutions (recast) (the "Recast Consolidated Banking Directive")[26] with a view to ensuring that the regulatory capital treatment of exposures covered by netting agreements are unaffected by partial property transfers under the RRD. This arguably justifies the use of the term "netting agreement" which is a concept that is used in the Recast Consolidated Banking Directive. However, "close-out netting agreement" appears nowhere else, to the FMLC's knowledge, in the *acquis* or in the RRD. It would seem sensible for the term "netting arrangement" to be used here instead, since Recital (60) appears to describe the concept of a "netting arrangement" as defined by Article 2(85). Alternatively, it may be intended that the Recital refer to "close-out netting arrangement", a subset of "netting arrangement".

b) Article 44 (*Derivatives*) – "netting agreements". As noted in paragraph 6.2.2 of RRD Paper I this Article makes reference to "netting agreements".

c) Article 68 (*Safeguard for counterparties in partial transfers*) – "netting arrangement" and "close-out netting arrangement". Both terms appear in the Article.[27]

d) Article 69 (*Protection for financial collateral, set off and netting agreements*); – "Netting arrangement". As stated in RRD Paper I, Article 69 itself refers to "netting arrangements" whereas the title refers to "netting agreements".

7.7. The FMLC's view is that the inconsistent use of netting-related terms in the RRD is unfortunate.

[26] Directive 2006/48/EC.

[27] "Netting arrangement" also appears in Section B of the Annex to the General Approach (*Information that resolution authorities may request* […]).

## 8. CONCLUSION

8.1. The FMLC believes it important to draw attention to these legal uncertainties. The Committee does so in the hope of helping to ensure that a robust resolution regime—which achieves the objectives of the proposed RRD and legal certainty—can be put in place for the benefit of the financial markets and the wider economy.

**FINANCIAL MARKETS LAW COMMITTEE MEMBERS**[28]

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[28] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

**ANNEX**

*See overleaf*

**February 2013**

**FINANCIAL MARKETS LAW COMMITTEE**

**ISSUE 149 – Recovery and Resolution**

Discussion of certain legal uncertainties arising from the proposal for a Recovery and Resolution Directive

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## 1. EXECUTIVE SUMMARY

1.1. This paper discusses legal uncertainties arising from the Commission Proposal for a Recovery and Resolution Directive (the "RRD").

1.2. The first part of the paper (Sections 3-5) addresses issues of legal uncertainty which may arise from the actual wording of the RRD. The second part of this paper (Sections 6-8) considers issues which may arise from the application of the RRD in specific situations.

1.3. In Section 3 the definitions, objectives and general principles of the RRD are considered and recommendations are put forward with a view to achieving greater legislative consistency with MiFID.

1.4. In Section 4 the powers and safeguards of the RRD are assessed. This involves an analysis of the power of resolution authorities temporarily to suspend an institution's payment and delivery obligations (Article 61), the power to suspend termination rights (Article 63) and the power to restrict the enforcement of security interests (Article 62). Recommendations are made, *inter alia*, with respect to the time period for which such powers are to be exercised.

1.5. The bail-in power conferred by the RRD is discussed in Section 5. The paper revisits concerns previously expressed by the FMLC as to whether considerable uncertainty may arise in relation to determining which obligations are bailable. This section also makes the observation that legal uncertainty is likely to arise from the fact that contractual bail-in provisions may not operate in the same way as statutory bail-in provisions under the RRD.

1.6. In Section 6 the various netting-related terms used in the RRD are analysed and attention is drawn to the inconsistent use of these terms in the RRD. The various references to netting in European law are reviewed and it is concluded that the RRD's inconsistent treatment of netting-related concepts represents a lost opportunity to cure uncertainty in the insolvency *acquis*, to harmonise legislation around the provisions of the FCAD and to create greater clarity generally.

1.7. In Section 7 concerns regarding the situation of an insolvent holding company or parent company with a solvent subsidiary are raised. The effect of the tools conferred by the RRD on a solvent subsidiary in such circumstances is not well defined in the Directive. The application of resolution tools by a resolution authority in circumstances where the interests of a parent or holding company in resolution—or the interests of a group in circumstances where the majority of group companies are in resolution—conflict with the interests of a solvent subsidiary should be addressed directly in the RRD.

1.8. Section 8 examines the stringent restrictions on counterparties' rights to exercise termination rights under a financial contract under the RRD. The slightly different wording on the restriction on exercising termination rights as provided by Article 63(4) and that of Article 77(1) creates an issue of interpretative uncertainty. The application of the RRD's bail-in provisions to derivatives is also considered. Considerable operational uncertainty for the counterparties of institutions within the contemplation of the RRD is likely to arise due to the difficulty of determining contingent liabilities on a net basis. However, the most challenging area of legal uncertainty generated by the application of the RRD to derivatives transactions may be the interaction of the law of the resolution forum and the applicable law of the contract, particularly where the applicable law is the law of a third country outside the EU. A concern is raised as to conflict of laws issues which may arise when Member States' laws implementing the RRD override the express terms of parties' contracts notwithstanding those contracts are governed by the laws of third countries.

## 2. INTRODUCTION

2.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee"), established by the Bank of England,[2] is to identify issues of legal uncertainty or misunderstanding in the framework of the wholesale financial markets which might give rise to material risk and to consider how such issues should be addressed.

2 For the avoidance of doubt, the views expressed in this paper do not represent the views of the Bank of England.

2.2. This paper highlights a number of core legal uncertainties arising from the proposal for a Recovery and Resolution Directive (the "RRD"),[3] published by the European Commission on 6 June 2012. References to the RRD in this paper are references to the Commission Proposal and not references to later texts from the Presidency of the Council of the European Union or the European Parliament.

2.3. The first part of the paper examines specific issues of legal uncertainty which may arise from the drafting of the RRD. The paper provides an analysis of the definitions, objectives and general principles of the RRD (Section 3), the powers and safeguards within the RRD (Section 4) and the use of the bail-in tool which is granted by the RRD (Section 5) in its consideration of drafting issues. The second part of this paper addresses issues which may arise from the application of the RRD in certain situations. The application of netting (Section 6), the effect on solvent subsidiaries (Section 7), and the effect on financial contracts (Section 8) are considered.

## 3. DEFINITIONS, OBJECTIVES AND GENERAL PRINCIPLES

3.1. Legal certainty is promoted by the harmonisation of core concepts across legislation. Where definitions cannot be harmonised—for example, because the particularisation of a familiar concept in a legislative definition would not necessarily be fruitful—cross-references can aid interpretation by providing the necessary consistency.

3.2. In this regard, the FMLC takes the view that Article 26(2)(f) of the RRD—which provides that one of the objectives to which resolution authorities must have regard when exercising resolution powers is "to protect client funds and client assets"—should expressly refer to certain relevant provisions of the Markets in Financial Instruments Directive **(**"MiFID") to maintain legislative consistency.[4] (See the

3 Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010.

4 Articles 13(7) and (8) of MiFID (Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC) and Article 16 of the MiFID Implementing Directive (Commission Directive 2006/73/EC implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive) establish a framework to protect client funds and assets.

section of the Appendix entitled "Drafting comments in relation to resolution objectives and general principles within the RRD" for suggested drafting solutions.)

3.3. However, in certain circumstances concepts borrowed from other European legislative measures will not serve the intended purposes of the RRD. Arguably, the definition of "derivatives" in Article 2(56) of the RRD is such a case. The definition of "derivatives" is limited to the MiFID definition, which does not cover the full scope of derivatives traded, but only those considered necessary to include within the scope of regulation under MiFID. It is noted that the definition of "financial contracts" in Article 63(6) of the RRD will capture derivatives falling outside the definition in Article 2 for certain purposes but not for the purposes of Article 44 and the protection afforded by that Article in the cases of the exercise of the bail-in tool. Derivatives likely to be affected by this oversight include: currency forwards, certain OTC bullion options, certain physically-settled commodity contracts and certain contracts for differences that refer to asset or risk classes not specified in the MiFID definition of "financial instrument", for example, longevity and mortality derivatives. It is not clear whether this omission is intentional or has arisen as a result of legislative oversight.

3.4. A related point is that the definition of "termination right" (Article 2(73) of the RRD), need not include the existing reference to close-out, set off or netting or any related provision, since if a party is not permitted to terminate (or accelerate), then none of the other rights are invoked.[5]

## 4. POWERS AND SAFEGUARDS

### Powers of suspension

4.1. Article 61 of the RRD contemplates that resolution authorities will have the power temporarily to suspend an institution's payment or delivery obligations, following the implementation of the Directive by Member States. An exercise of this power is

5 See footnote 23 for a further discussion in relation to the definition of "termination right".

likely to be a source of considerable operational uncertainty for market participants.[6] In particular, this power is unlikely to achieve its objective to provide wholesale relief for the institution under resolution from the pressures of the daily trading environment, where the institution in question operates in third countries in which the suspension is not legally effective. Even where the operations of an institution or group only extend across different EU Member States, legal uncertainty may arise as a result of the failure to specify the time zone which determines the 5 pm time limit.

4.2. The power of suspending termination rights to be conferred on a resolution authority by Article 63 of the RRD is likely to prove less problematic,[7] although the systemic effect of the impact on back-to-back derivative arrangements should be considered. (Arguably, some consideration should be given to whether the performance of obligations under a linked contract (e.g. a "hedge") between the affected counterparty and a third party should be suspended for the same period that Article 61 of the RRD prevents the counterparty enforcing its rights against the institution under resolution. This would require careful consideration and may be a matter that can be better addressed by a market solution.) In general, systemic problems may be relatively minor (given the short duration of the suspension) compared with the difficulties arising from the exclusion of termination rights imposed by Article 77 (discussed further below in Section 8). Indeed, there is an unresolved tension in the RRD between provisions that appear to invalidate termination rights triggered by a resolution and provisions that empower the authorities to suspend those rights. This is an important source of uncertainty. The relationship between Articles 57(5) (and perhaps also Article 52(5)), 63 and 77 might usefully be reviewed with a view to deciding whether invalidity or suspension is the appropriate approach and consolidating this consequence in a single provision.

4.3. As regards the limited circumstances in which the exercise of termination rights by counterparties is permissible under Article 64(4) of the RRD following the expiry of a

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6 A temporary suspension was not considered to be necessary when the UK introduced its own bank resolution regime under the Banking Act 2009.

7 The UK Banking Act 2009 relies on similar provisions to disapply termination rights.

period of suspension, it is recommended that termination rights should be enforceable in the event of any default by the recipient of a transfer of the relevant asset, or, where there is no transfer, in the event of a second, or further, default by the institution under resolution. Consequential drafting changes might make this clearer.[8]

4.4. If the power of suspension is retained in the RRD, it will assist in minimising any operational uncertainty that the suspension period is kept short as contemplated in Article 61(1) of the RRD: namely, between one and two business days depending on precisely when the notice of suspension is given.[9]

**Power to restrict the enforcement of security interests**

4.5. Under Article 62 of the RRD a resolution authority will have the power to restrict secured creditors of a failing institution from enforcing security interests in relation to assets of a failing institution for such "limited period" as the authority determines to be necessary.[10] An open-ended period during which the enforcement of commercial rights is suspended will cause widespread operational uncertainty and it would logically assist in minimising this uncertainty if an upper limit could be given. The reasoning for the stay on enforcement being longer than the suspension of payment and delivery obligations is not entirely clear.[11]

4.6. The FMLC welcomes the exclusion in Article 62(2) of the RRD for security interests held by a central counterparty.

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8 It is important to make sure that if there is a default by the failing firm immediately prior to resolution that it is not somehow "wiped clean" by Article 63(4), Therefore, some further re-drafting of Article 63(4) is required to account for this. It is suggested that the word "subsequent" before "default" in the second line of Article 63(4)(a)(ii) might be deleted and the words "subsequent default" placed in front of the phrase "by the institution" in the last line of the Article.

9 The FMLC assumes that the cross-reference in Article 61(1) of the RRD should be to Article 74(7) of the RRD and not Article 75(7) of the RRD.

10 For the avoidance of doubt, it should be made clear that a "security interest" excludes a right of set-off or close out netting provisions.

11 The FMLC acknowledges that a suspension of security rights is common in a rehabilitation statute (e.g. the automatic stay in the US under Chapter 11 of the US Bankruptcy Code or in the UK under Part II of the Insolvency Act 1986). However, it is noted that under national law safeguards are provided which are absent in the RRD (e.g. in the UK there is an ability to apply to the Court for an Order permitting enforcement where there is a danger that the value of the security assets will deteriorate).

**Safeguards for counterparties in the case of partial transfers**

4.7. Subject to the comments below, the FMLC welcomes the safeguards against partial transfer which are established by the RRD and, in particular, the approach adopted in Articles 68(2) and 72.

4.8. The provision of greater clarity as regards the meaning of "structured financial arrangements" in Article 68(2)(e) is desirable. Each of the other sub-paragraphs listing an arrangement to be safeguarded provides a definition which offers some point of reference for identifying the arrangements concerned, albeit minimally. In contrast sub-paragraph (e) establishes no definition and merely offers a non-exhaustive list of two of the arrangements which may be contemplated. This lack of clarity may give rise to an approach which restricts safeguards to certain types of arrangement in a way which creditors will likely regard as unacceptable. Yet there is no guidance as to whether such an approach on the part of Member States is justified or whether the safeguard must be extended beyond the listed arrangements. (See the section of the Appendix entitled "Drafting comments in relation to the Safeguards within the RRD" for suggested drafting solutions.)

4.9. Further clarity is also desirable as to the fundamental concept of "adequate protection" (which appears in Articles 68, 69, 70 and 71). In particular, the FMLC considers that it is important to establish exactly which rights within an agreement incorporating a netting arrangement are to be "adequately protected" under Article 68(2).

**Protection for trading, clearing and settlement systems**

4.10. The safeguard in Article 72 of the RRD for the protection of trading, clearing and settlement systems applies only in relation to a partial transfer or ancillary action taken under Article 57(1)(f). This limitation is regrettable given the disruption that could be caused in this context by, for instance, a suspension of an institution's payment and delivery obligations under Article 61. It is essential that a clearing house be able, where a member defaults or is likely to default, to take immediate steps (if it chooses) to enforce its default rules, including exercising close out netting, realising collateral and applying this against any resulting net single amount then due. Otherwise, the clearing house could have a major liquidity problem in ensuring overall settlement on the business day affected, unless: (i) it called on other members of the clearing house to provide additional collateral and/or default fund contributions and these calls were promptly met in full, (ii) emergency funding was provided by a central bank or (iii) emergency funding was provided by another source.

4.11. In this regard, it is particularly important to clarify whether the power of suspension under Article 61 of the RRD is intended to suspend the operation of a portability procedure under which a client of a clearing member of a central counterparty can request that the central counterparty transfer his segregated client accounts to a non-defaulting clearing member pursuant to Article 48(5) of the Regulation on OTC derivatives, central counterparties and trade repositories, also known as the European Market Infrastructure Regulation ("EMIR").[12]

4.12. Article 72(2) of the RRD protects "transfer orders", "collateral security" and netting under the Settlement Finality Directive (the "SFD").[13] It is recommended that consideration is given to extending this safeguard to "default arrangements" within the meaning of the SFD. Default rules lie at the heart of recognised clearing houses, recognised investment exchanges and designated systems. Whilst Article 72(2) of the RRD provides a measure of protection for set-off and netting, default rules include other powers to enable a central counterparty or system operator to take swift and effective action to achieve an orderly close out.[14]

**Property rights and liabilities governed by the law of a territory outside of the EU**

4.13. Article 73 of the RRD is likely to create operational uncertainty given the difficulty that may arise in determining whether a purported transfer under the resolution regime

12 Regulation (EU) No 648/2012.

13 Directive 98/26/EC as amended by Directive 2009/44/EC.

14 Typically default rules provide a range of options, including powers: to cancel or reverse any outstanding instructions for the payment of cash or delivery of investments; to realise and apply all or any of the defaulter's collateral or margin; to transfer the defaulter's position under any unsettled clearing contract to another willing participant; to arrange to make one or more contracts on behalf of the defaulter for the purpose of hedging market risk to which the defaulter is exposed; to close out or otherwise discharge the rights and obligations of the defaulter then outstanding with respect to accepted trades; to buy in or sell out instruments deliverable by or to the defaulter; to effect corresponding contracts in relation to the defaulter's unsettled contracts; to take such other action with regard to any unsettled clearing contract of the defaulter as the central counterparty may deem necessary to effect an orderly discharge of the defaulter's obligations; and, where the default results in a net loss, to allocate that loss amongst other participants to the extent that it cannot be met out of the defaulter's margin or its default fund contribution and the central counterparty's own dedicated resources.

is effective under relevant foreign law. Further operational uncertainty is introduced as a transfer may be invalidated on the grounds that it "may not be effective" under relevant foreign law.[15]

## 5. THE TOOLKIT: BAIL-IN

5.1. Aspects of the sale, bridge and asset separation resolution tools are discussed in the sections below entitled "specific issues I-III".

### The bail-in tool and resolution objectives

5.2. Article 37(2) sets out the objectives of the bail-in power. It states that the power may be applied for either of the following purposes:

a) to recapitalise an institution which meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation and to carry on the activities for which it is authorised under Directive 2006/48/EC or Directive 2004/39/EC; or

b) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred to a bridge institution with a view to providing capital for that bridge institution.

5.3. The objectives set out in Article 37(2) make clear that central to the use of the bail-in tool is the existence of an institution to be rescued, in whole or in part, which needs to continue servicing its customers as a going concern (in the case of a bridge institution after transfer from the failing institution).

5.4. Three of the six resolution objectives, which are set out in Article 26 of the RRD, appear relevant in this regard: (i) the assurance of the continuity of critical functions, (ii) the avoidance of significant adverse effects on financial stability and the prevention of contagion and (iii) the avoidance of unnecessary destruction of value.

15 It is noted that the approach adopted in Section 39 of the Banking Act 2009 avoids the problem (which may occur under Article 73) that a netting arrangement that encompasses both local law and foreign law rights and obligations (which sometimes happens, for example, under master or umbrella netting agreements) could be split.

These objectives appear to reinforce the importance of business recovery and financial stability as the overall aims with which an application of the bail-in tool is to be aligned.

5.5. The FMLC acknowledges that the remaining resolution objectives in Article 26—the protection of public funds, the protection of creditors and the protection of client monies/assets—are not linked clearly to business recovery and financial stability and that Article 26(3) provides that the resolution objectives are of equal significance and should be balanced appropriately. Nevertheless, the apparent prominence given to the aims of business recovery and financial stability under the bail-in objectives in Article 37 and (some of) the resolution objectives in Article 26 is significant because these aims might appear inconsistent with the exercise of the bail-in tool. Such inconsistency might conceivably prove litigious if creditors challenge the validity of the use of the bail-in tool on the basis of it.

5.6. Two possible circumstances in which the exercise of the bail-in power might appear inconsistent with the objectives of business recovery and financial stability are as follows:

5.6.1. Obligations are bailed-in which an institution operating on a going concern basis would need to meet in full if it was to remain commercially viable (eg. deposits outside the guarantee scheme limit and other unsecured liabilities with an original maturity of more than one month).[16]

5.6.2. Future financial obligations which are contingent and/or unquantified are bailed-in.[17] It is, in practice, difficult to ascertain the value of such liabilities and the accuracy of any estimation could change over time. Moreover, future

16 The FMLC notes that the draft report of the Committee on Economic and Monetary Affairs of the European Parliament (dated 11 October 2012) extends the exception found in Article 38(2)(d) of the RRD from liabilities with an original maturity of less than one month to those with an original maturity of less than six months.

17 Maturity is not defined in the RRD. On its face, the term catches most future financial obligations of a bank, including those which are contingent and/or unquantified (unless excepted). For example, when a bank is requested by a customer to provide a third party with a guarantee, standby letter or bond, the bank's liability will be contingent unless and until it receives a valid demand for payment.

contingent obligations include those vital to the trading activities of customers (for example, to honour presentations under a letter of credit or a guarantee).

**The exemption for essential supply side contracts**

5.7. Pursuant to Article 38(2)(d)(ii) of the RRD, essential supply contracts are exempted from the bail-in power. There is, however, a lack of clarity as to whether certain supply contracts which are not clearly essential but which may be important from a continuation of business perspective (for example catering services or cleaning services) fall within this exception. It is likely that the process of resolution will place considerable stress on the concept of "essential" services, a concept which has a significant penumbra of uncertainty.[18]

**Discretion with regard to derivatives**

5.8. Under Article 38(3) of the RRD, national authorities have some discretion with regard to the exclusion of derivatives from bail-in. Such discretion is however likely to lead to divergence in the practice of Member States. This would create uncertainty for counterparties who will have to be familiar with a range of national approaches in deciding on the risk assumed under their contracts.

**Statutory and contractual bail-in**

5.9. Legal uncertainty is likely to arise from the fact that contractual bail-in provisions may not operate in the same way as statutory bail-in provisions under the RRD. The governing law of a contractual bail-in provision will be the applicable law of the contract. The law governing statutory bail-in is, in contrast, the law of the resolution forum. This may give rise to a situation where two different laws are applicable to the bail-in of a single claim. The effect of this could be to give rise to conflicting rights and obligations; it can be expected, in any case, to lead to complexity and uncertainty.

5.10. The way in which contractual bail-in provisions are triggered is fundamentally different to the way in which statutory equivalents are. A contractual provision will trigger automatically once an objective value has been reached. This value is

18 Contingent and future obligations under derivative contracts are discussed further below at paragraphs 8.3 and 8.4.

generally a minimum capital ratio for the issuer of the bail-able instrument. In contrast, statutory bail-in will be triggered by the exercise of a resolution authority's discretion.

5.11. The trigger-point for contractual and statutory bail-in provisions is likely to be quite different. Contractual bail-in is normally enforceable well in advance of an institution approaching insolvency. Article 27 of the RRD, in contrast, requires that the bail-in power be exercised when the institution is failing or likely to fail.

5.12. As a consequence of these differences, contractual and statutory provisions are likely to be applied at different times and it will likely be the case that contractual provisions will be activated first. What will happen if, for example, a claim has been written down contractually (by 30%, for instance) and is then subject to statutory bail-in? It is unclear whether that claim would be subject to the application of the bail-in tool during resolution in the same way as the others. Such an eventuality would appear to represent a double penalty for the creditor. Article 53 of the RRD (contractual write-down or conversion of capital instruments) prevents the application of bail-in, in certain circumstances, to claims which are subject to contractual bail-in. However, this does not appear to resolve the difficulty described since the Article applies only where the contractual bail-in takes effect when the bail-in authority exercises its discretionary bail-in power and where the contractual provisions meet certain requirements (including the requirement that the provision reduces the principal amount to zero).

5.13. Holders of debt instruments already in issue which are not agreed to be bailable (for example ordinary unsecured bonds or loan stock issues, as opposed to the instruments commonly called "co-cos" which provide for contractual bail-in) may argue that their instruments are not susceptible to bail-in without their consent (such as would be required under a UK scheme of arrangement reconstructing a company in financial difficulties): to submit such debt instruments to bail-in without consent could be perceived as a challenge to creditors' legitimate expectations. Unless transitional or regulatory measures are put in place to tackle the issue, legal uncertainty and litigation can be expected to exist for some time.

**Wide and narrow regulatory powers**

5.14. The FMLC has previously made the point that where a narrow policy objective is adopted, the statutory or regulatory power which implements this objective should itself be narrowly defined in order to target the policy objective to the exclusion of other outcomes.[19] Legal powers which exceed the purpose for which they are given tend to give rise to legal uncertainty in a variety of ways. For example, *ipso facto,* (i) such powers are capable of giving rise to unintended consequences and (ii) wide powers mean that legal opinions supporting transactions are sharply qualified and this may have a significant impact on market activity for both regulatory and cost-related reasons.

5.15. Therefore, the FMLC continues to take the view that the specific classes of claim to which the bail-in power can apply should be explicitly set out in positive terms. The FMLC recommends that, ideally, Article 43(1)(d) of the RRD be removed and that Article 38 be restructured to apply only to debt in the categories covered by Articles 43(1)(a) to (c) of the RRD (equity Tier 1 instruments, Tier 1 instruments that are liabilities and Tier 2 instruments and other subordinated debt) plus instruments agreed to be bailable that fall outside any of those categories.

## 6. SPECIFIC ISSUES I: THE TREATMENT OF NETTING

6.1. The RRD does not define "netting". Terms such as "netting agreement", "netting arrangement" and "close-out netting agreement" are used variously throughout the proposed text and it is not always easy to discern any justification for the inconsistency. Of these terms, only "netting arrangement" is the subject of further elaboration or description.[20]

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19 FMLC paper entitled "Observations on legal uncertainties which may arise from the introduction of bail-in powers" and dated March 2012.

20 In Article 68(2)(d) of the RRD.

6.2. References to “netting” in the RRD include:

6.2.1. Recital (60) of the RRD: “close-out netting agreement” and “netting agreement”. Recital (60) makes reference to the Directive relating to the taking up and pursuit of the business of credit institutions (recast) (the “Recast Consolidated Banking Directive”)[21] with a view to ensuring that the regulatory capital treatment of exposures covered by netting agreements are unaffected by partial property transfers under the RRD. This justifies the use of the term “netting agreement”. However, “close-out netting agreement” appears nowhere else, to the FMLC’s knowledge, in the *acquis* or in the RRD. It would be desirable if the term “netting arrangements” was utilised here, since the Recital appears to be reiterating the list of protected arrangements which appears in Article 68 of the RRD. Alternatively, it may be intended to say “close-out netting arrangements”, which is a term that appears in Article 68 as a sub-set of “netting arrangements”.

6.2.2. Article 44 of the RRD (*Derivatives*): “netting agreements”. The use of “netting agreement” here and the injunction to determine liability on a “net basis” is reminiscent of the use of “netting agreement” in the Directive regarding the recognition of contractual netting by the competent authorities (the “Netting Directive”),[22] where regulatory capital requirements are to be allocated against derivative instruments “on a net basis”. However, the analogy is a false one for the obvious reason that the application of write-down provisions and the allocation of regulatory capital are entirely different exercises. Further, while capital adequacy treatment is largely a question addressed by the regulators of solvent institutions, a resolution authority will be addressing a situation in which close-out netting will have either been triggered or is about to be triggered (in other words the “net basis” will either have crystallised or be about to crystallise). There is, therefore, no obvious justification for aligning this Article with the text of the Netting Directive and ignoring the need for the consistent use of netting-related concepts in the RRD itself.

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21 Directive 2006/48/EC.

22 Directive 96/10/EC.

6.2.3. Article 63(3) of the RRD (*Power to temporarily suspend termination rights*): "netting arrangement". Here "netting arrangement" appears incongruously in advance of its description and elaboration in Article 68(2)(d). The paragraph makes provision for a person to exercise a termination right once notified that certain rights and liabilities will not be the subject of a transfer by the resolution authority. The provision appears to be premised on a necessary connection between a termination right and a netting arrangement which is not supported by the earlier definition of "termination right" in Article 2. A termination right means a right to terminate a contract and includes associated rights of netting, set-off, acceleration etc but the definition may be satisfied where these associated rights are not present. Thus the question arises when a person is entitled to exercise a termination right which is not associated with a netting arrangement and if so, whether he may exercise it: immediately or following notice of some kind (and, if the latter, what that notice might be).[23]

6.2.4. Article 68(d) of the RRD (*Safeguard for counterparties in partial transfers*): "netting arrangement". An inclusive description of the term is given here. It is not clear, however, whether this description is to be read back into Article 63. The FMLC notes that "netting arrangement" appears in the provisions of the UK's Resolution Regime, which are set out in the Banking Act 2009;[24] it may be inferred that the concept has been imported from UK legislation. A note of caution should be sounded about what appears to be, the *ad hoc* introduction of new terminology on netting into European law. The meaning of terms in European law can have effect across legislation, not only prospectively but also by raising implicit questions about the meaning of terms which are closely related in existing legislation. The introduction of new terms can thus bring about the layering of similar word-concepts, which may create uncertainty, particularly in the absence of careful definition and differentiation. In this case,

23 It is noted that the International Swaps and Derivatives Association ("ISDA") in its own comments has taken the position that *strictu sensu* "termination right" does not "include" the right to net or set off, but it is true that such rights are normally associated with the termination right in a close-out netting provision, which is normally comprised of three steps: (i) termination or acceleration; (ii) valuation of terminated or accelerated positions; and (iii) the determination of a net balance, either under a flawed asset approach or via set off. An ISDA Master Agreement close out involves termination, valuation, calculation of a net amount (flawed asset). A Global Master Repurchase Agreement involves acceleration, valuation, set off. Both approaches are encompassed by the definition of "close out netting provision" in the Collateral Directive. ISDA makes this point in order to say that it is sufficient to suspend the right to terminate (and, by analogy, the right to accelerate). It is not necessary, however, to suspend any other rights, in particular, the rights to determine a close-out valuation and to determine a net balance. (ISDA also argues that it is not necessary to achieve the intended policy objective to suspend payment or delivery obligations.)

24 See the definition of "netting arrangement" found in Section 48(1)(d) of the Banking Act 2009.

"netting arrangement" and "close-out netting arrangement" in Article 68 must be differentiated from "netting agreement" in the capital adequacy *acquis* and the insolvency *acquis* and from "close-out netting provision" in Article 2(1)(n) of the Directive on financial collateral arrangements (the "FCAD").[25] The fact that it is difficult to perceive any intuitive or evident differences has the consequence that the boundaries of the various terms may become blurred in a way which fosters uncertainty.

6.2.5. Article 69 of the RRD: "netting agreements" in the title. The FMLC notes that the provision itself, however, refers to "netting arrangements", not "netting agreements".

6.3. The inconsistent use of netting-related terms in the RRD referred to above is unfortunate, particularly in light of the discussion below regarding the lack of clarity surrounding the meaning of "netting agreement" and other netting-related provisions in the existing *acquis*.

**References to "netting" in European law**

6.4. The term "netting agreement" is likely to have first appeared in European law in 1996 with the passage of the Netting Directive, amending Directive 89/647/EC on a solvency ratio for credit institutions ("the Fifth Banking Directive") as regards recognition of contractual netting by the competent authorities. Today, the term is included, without apparently any significant alteration as to its intended manner of application, in the Recast Consolidated Banking Directive.[26] This use of the term for prudential purposes in EU banking legislation pre-dates its later co-option into insolvency law in the insolvency *acquis*. Crucially—because resolution under the RRD is most likely to result in the winding-up of a credit institution—Article 25 of the Directive on the reorganisation and winding-up of credit institutions (the "CIWUD")[27] uses the term and provides that "netting agreements" are governed, not

25 Directive 2002/47/EC.

26 Also briefly in Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions ("the Recast Capital Adequacy Directive", as amended).

27 2001/24/EC.

by the law of the insolvency forum, but by the law applicable to the agreement. The term also appears in Recital (27) to the Regulation on insolvency proceedings (the "EUIR")[28] and the Commission's proposal for a Regulation to amend the EUIR introduces a new Article 6a into that Regulation which will employ the term.

6.5. The transposition of the concept of a "netting agreement" from the Netting Directive into the CIWUD has been unfortunate because the concept, as it has been adopted in the former context, is not necessarily best-adapted to achieve the objectives of the framers of the CIWUD. The role of the concept in the Netting Directive is to establish a threshold beyond which contracts may qualify for preferential capital treatment. The provisions of the Directive are permissive and discretion-conferring, rather than mandatory; policy-driven rather than rights-driven; and principles-based rather than rules-based. Above all, the purpose of the Netting Directive is to guide regulation, not to define private law rights.[29]

6.6. The Netting Directive makes it clear that it is a condition of recognition that a netting agreement covers "all included transactions" and reduces them to a "single legal obligation" to pay "only the net sum of the positive and negative mark-to-market values" of the transactions, which effectively requires that the agreement in question must have the features of close-out netting. But in making that provision, the Directive implicitly acknowledges that these features (including termination and valuation provisions) are a further condition which not all netting agreements will satisfy. Whilst it is clear that close-out netting agreements are a paradigmatic example of netting agreements, as that concept is developed in the Netting Directive, when the term "netting agreement" is transposed into the CIWUD, it is not necessarily self-evident that the protective provisions of Article 25 of the CIWUD must extend to

28 Regulation (EC) No 1346/2000.

29 Notably, the Netting Directive also appears to distinguish between a netting agreement and the contract into which it is incorporated. Paragraph 3(b)(ii) of Annex II (as it was inserted in the Fifth Banking Directive) refers to "any contract or agreement necessary to effect the contractual netting". Confusingly, paragraph 3(c)(ii) then refers to "contracts included in a netting agreement" but it is clear from the context that, here, "contract" means "Transaction" as that concept is commonly understood in the context of an ISDA Master Agreement. (This itself appears inconsistent, however, with the use earlier in the Annex of the term "transaction".)

all the features and provisions of netting agreements upon which recognition for regulatory capital reasons depends.[30]

6.7. In 2004, the European Financial Markets Lawyers Group established by the European Central Bank, in its Report on Protection for Bilateral Insolvency Set-Off and Netting Agreements under EC law, suggested (at paragraph 35) that there was uncertainty as to whether the term "*compensation*" in French legislative texts is necessarily to be construed to cover the entire close-out netting procedure—at least as that term appears in Article 6 of the EUIR and, specifically, that the term may not cover the termination and valuation processes which form part of close-out netting but merely any final set-off of amounts due following valuation. Their work raised similar questions about virtually identical terms in other Romance languages. "*Compensation*" appears in the French text of Article 25 of the CIWUD followed by the English words "netting agreements" in parentheses.[31]

6.8. Other questions which have been raised about the meaning of "netting agreement" in Article 25 of the CIWUD include the question of whether it is exclusively intended to refer to payments netting within payments and settlement systems. Support for this point of view may derive from Recitals (25) and (26):

> Transactions carried out in the framework of a payment and settlement system are covered by Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems ["the Settlement Finality Directive"].
>
> The adoption of this Directive does not call into question the provisions of Directive 98/26/EC according to which insolvency proceedings must not have any effect on the

30 The purpose of this paper is not to discuss Article 25 of the CIWUD. However, for the avoidance of doubt, the FMLC recognises that the policy underlying Article 25 of the CIWUD must be to protect all of the features and provisions of netting agreements upon which recognition for regulatory capital reasons depends.

31 See footnote 30.

enforceability of orders validly entered into a system, or on collateral provided for a system.

6.9. It would be regrettable if these issues of interpretive uncertainty are transposed into the RRD.

6.10. Turning to the remaining netting-related provisions of the European *acquis*, the legal protection of close-out netting provisions is mainly regulated by Article 7 of the FCAD. That Article provides that a close-out netting provision can take effect according to its terms, notwithstanding the onset of insolvency or other similar proceedings and events and without regard to certain other matters that might otherwise affect close-out netting. The adoption of the FCAD marked an important step forward in the protection of close-out netting because, until then, close out netting arrangements were not recognised or enforceable in all Member States.

6.11. It is somewhat unfortunate, from the perspective of interpretive continuity, that the FCAD uses different terminology to establish netting protection than does the CIWUD (and now the RRD). Article 7 of the FCAD refers to the "recognition of close-out netting *provisions*" (emphasis added) rather than "netting *agreements*", and provides that "Member States shall ensure that a close-out netting provision can take effect in accordance with its terms". In addition, Recital (14) of the Directive refers to bilateral close-out netting as a "mechanism". It is not clear how "netting provisions" or "netting mechanisms" might compare and contrast to "netting agreements".

6.12. The introduction of a new netting-related concept in the FCAD has already raised questions about the interpretation of "netting agreement" and "*compensation*" (in the French text) in the CIWUD. It is perhaps arguable that the additional phrases "close-out" and "*déchéance du terme*" in the FCAD are required in the respective English and French texts to implement a legislative intention to extend protection to provisions which are not covered by the concept of "netting agreement" alone in the CIWUD.

6.13. In fact, the move from "netting agreement" to "netting provisions" in the year between the CIWUD and the FCAD is more likely to reflect the final stages of the evolution of legislative references to netting as Community law adapted to increasing regulatory and market reliance on master agreements than to reflect any differences in legislative intent. However, in view of the existing uncertainty, it is to be regretted that the RRD refers not only to "netting agreements" and (in one Recital) "close-out netting agreements" but also to the new concepts of "netting arrangements" and "close-out netting arrangements" without once explaining how these various concepts interrelate or how any of them relate to the definition of "close-out netting provision" in the FCAD.

6.14. It is also to be regretted, perhaps, that no attempt has been made in the RRD to clarify the meaning of "netting agreement" in the CIWUD and to make it clear beyond doubt that the term refers inclusively—among other kinds of netting—to close-out netting provisions (as that term is used in the FCAD), including related termination, acceleration and valuation provisions. This represents a lost opportunity to address the uncertainties identified by the European Financial Markets Lawyers Group in its 2004 Report; to avoid incorporating the same uncertainties into the RRD itself; to ensure continuity of application between the RRD and the CIWUD to the resolution of credit institution and to link the concept of "netting agreement" to that of "close-out netting provision" in the FCAD.

6.15. If this were done, consideration might then be given to using the established terms "netting agreements" and "close-out netting provisions" in Article 68 of the RRD instead of "netting arrangements" and "close-out netting arrangements". This would add to certainty by improving consistency with the existing *acquis* and it is not yet apparent that the definition of "netting arrangement" adds anything to the concept of "netting agreement", inclusively defined.

6.16. The RRD's inconsistent treatment of netting-related concepts represents a lost opportunity to cure uncertainty in the insolvency *acquis*, to harmonise legislation around the provisions of the FCAD and to create greater clarity generally.[32]

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32 It is noted that the European Commission has been considering proposals for legislation to deal specifically with netting. It is also noted that the International Institute for the Unification of Private Law (the "UNIDROIT") is currently undertaking a project at a global level which is due to finalise their "Principles of Netting" in the near future.

## 7. SPECIFIC ISSUES II: SOLVENT SUBSIDIARIES

7.1. The consequences for the solvent and robust subsidiary (i.e. a subsidiary not requiring resolution under the terms of Article 27 of the RRD, hereafter simply "solvent") of a parent company in resolution of the use of the tools conferred by the RRD are not wholly clear. The confusion arises as a result of the coupling of the resolution authority's wide-ranging powers to deal with the shares of the subsidiary with its overriding objective to ensure that the business in resolution is wound down in an orderly manner. In practice, the resolution authority will be able to assume full control of the subsidiary and it is not clear whether the normal provisions of company law and insolvency law in Member States' legal systems will be enforceable to protect the subsidiary from action to exploit its rights and assets for the benefit of the parent company in resolution. The uncertainty will be of particular concern to national competent authorities in the Member State where the subsidiary is located and does business, if the parent company–and thus the resolution authority–is located in another Member State. This is the situation considered below.

7.2. The position of a solvent subsidiary in a group which requires resolution at the level of a holding company or parent company is not well-defined in the RRD. Article 28 of the RRD deals with the conditions for resolution of financial institutions in a group context but its provisions are mainly concerned with the resolution of holding companies. By virtue of Article 28(1) of the RRD, a subsidiary financial institution can only be placed into resolution if the resolution conditions are met both for the subsidiary institution and for the parent institution. Thus the RRD contemplates that a parent or holding company may satisfy the conditions for resolution without the subsidiary doing so and in these circumstances the subsidiary may not be placed into resolution. (However, and as a matter of interest, by virtue of Article 28(4) of the RRD, a subsidiary may satisfy the conditions for resolution without the parent company doing so and yet the parent company may nevertheless be placed into resolution by virtue of the fact that its subsidiary alone satisfies the conditions.)

7.3. It is, perhaps, then all the more strange that the Recitals to the RRD, which deal (at Recitals (63) to (67)) comprehensively with the need for cooperation between different resolution authorities in the case of group resolution, do not deal at all with the need for cooperation between those resolution authorities and the competent authorities who are concerned with the stability of any solvent subsidiaries. This omission should be of concern to such competent authorities. The only observation made with respect to such competent authorities is that "they should not have the power to object to resolution tools applied at group level".

7.4. Under Chapter III of the RRD, the resolution authority is given the tools with which to transfer property belonging to a company in resolution to a third party: in the case of the sale of business tool, to a purchaser; in the case of a bridge institution tool, to a bridge institution; and, in the case of the asset separation tool, to an asset manager. In the case of the latter tools, the transferees may be owned and/or controlled by the resolution authority itself. Thus, all the shares of a solvent subsidiary in another Member State may be transferred to an asset manager or a bridge institution owned by the resolution authority and located in the resolution forum.

7.5. Ownership of those shares will give the bridge institution or the asset manager concerned *de jure* ownership and *de facto* control of the solvent subsidiary. It will be possible for the owners and managers of the bridge institution or the asset management vehicle to appoint themselves as directors of the solvent subsidiary.

7.6. Normally, it is to be expected that provisions of local company and insolvency law in the place where the subsidiary is incorporated and/or located will prevent the wholesale exploitation of the assets of the subsidiary by its directors for the benefit of shareholders (or connected third persons) at what will, ultimately, be the expense of creditors. However, the RRD must be implemented in the Member State where the subsidiary is located and there is a risk that the implementing legislation will override the relevant provisions of company and/or insolvency law.

7.7. This override may occur because, first, those to whom the shares of the subsidiary are transferred and who thereby obtain *de facto* control of that company are given new objectives in the RRD which are inconsistent with the objectives which they must traditionally observe if acting as directors or shadow directors of a company. For example, in the case of assets (i.e. shares) transferred to the asset management vehicle, the asset managers are expressly given the overriding objective of managing the assets "with a view to… ensuring that the business of the institution under resolution" is wound down in an orderly manner (Article 36 of the RRD). Unless it is made clear in the RRD that those managers are, if and when acting *qua* shareholder, shadow director or director of that subsidiary, required to act in accordance with the relevant objectives and requirements laid down by local law, there is always a risk that the implementation of Article 36 of the RRD will override pre-existing provisions of local law to require the asset managers to prioritise the interests of the institution in resolution (and its creditors) over those of the subsidiary (and its creditors).[33] Given that the subsidiary may be a systemically important financial institution in its own right in the Member State where it is located, the consequences of this override could be very serious indeed.

7.8. Second, the override may occur because certain provisions of local law are, as the RRD expressly provides, to be disapplied upon implementation of the RRD in Member States. Among the provisions of local law to be disapplied are, by virtue of Article 31(6) of the RRD, "rules under national insolvency law relating to the voidability or unenforceability of legal acts detrimental to creditors". This has the consequence that rules commonly to be found in Member States' legal systems on the avoidance by liquidators of "transactions at an undervalue" or "preferences" occurring in the period leading up to insolvency, will no longer apply. The disapplication only relates to "transfers of assets, rights or liabilities from an institution under resolution to another entity" and, thus, in our example, initially probably only to the transfer of shares from the parent institution to the bridge institution or asset management vehicle. However, it is not entirely clear whether it may also subsequently encompass, in the case of a group which is being resolved at the parent level, the transfer of assets from a solvent subsidiary to another entity, particularly where that transfer is the direct consequence of the earlier transfer of shares from the parent under resolution.

7.9. Third, it is possible that the wide powers set out in the RRD enabling a resolution authority to "manage and dispose of the assets and property of the institution under

33 According to the principles *lex posterior derogat legi priori* and/or *lex specialis derogat legi generali*.

resolution" (Article 64, see also Articles 31-36 and 56 of the RRD) will be held to extend to assets and property in which the institution under resolution has an indirect interest through the ownership of subsidiaries. It may be said that a broad interpretation of "assets and property" is justified by the clear legislative intent to confer upon resolution authorities as much room for manoeuvre as possible, subject to the express safeguards. A wider interpretation may also be justified by the terms of Recital (65) which makes it clear that national authorities should not have the power to object to resolution tools applied at a group level and, crucially, talks about "the power to apply… burden-sharing arrangements" to stabilise the group as a whole as well as the transfer of ownership of subsidiaries "to a bridge bank [sic]" (as hypothesised above). However, there could undoubtedly be differing views on how widely or otherwise Article 64 of the RRD should be interpreted.

7.10. The national competent authorities for solvent subsidiaries (and creditors of the latter) may, perhaps, take comfort from Article 29(2) of the RRD which provides that:

> Where an institution is a group entity, resolution authorities shall apply resolution tools and exercise resolution powers in a way that minimises the impact on affiliated institutions and on the group as a whole and minimises the adverse effect on financial stability in the Union and, in particular, the countries where the group operates.

7.11. Unfortunately, where the group entity is a parent company, the objective of minimising the impact of resolution on one particular affiliated institution (such as a subsidiary) may run counter to the objective of minimising the impact on the group as a whole. Nor is it clear how the objective of minimising the effect on financial stability in the Union is to be pursued where there is a conflict of interests between a parent company in resolution and a solvent subsidiary. The provision is, therefore, uncertain as to its meaning and effect in these circumstances.

7.12. The FMLC is of the view that the application of resolution tools by a resolution authority in circumstances where the interests of a parent or holding company in resolution—or the interests of a group in circumstances where the majority of group companies are in resolution—conflict with the interests of a solvent subsidiary be addressed directly in the RRD. At the very least, Recitals (63) to (67), dealing with group resolution, should be amended to require the cooperation between resolution authorities, on the one hand, and the competent authorities responsible for solvent subsidiaries, on the other. Article 29(2) of the RRD should also be amended to clarify that that resolution tools cannot—no matter what the benefit to the group as a whole—be applied directly or indirectly to shares issued by, or the property or assets of, solvent financial institutions within the group in a way which increases the likelihood that those institutions may themselves require resolution in the future.

## 8. SPECIFIC ISSUES III: FINANCIAL CONTRACTS

8.1. Article 77(1) of the RRD has the effect of applying stringent restrictions on counterparties' rights to exercise termination rights under a financial contract, including any swap agreement. Termination rights are, in fact, only exercisable if the resolution action is the sale of business tool or the bridge institution tool and the financial contract in question is not transferred to a third party or bridge institution—in which case, presumably, the temporary suspension contemplated by Article 63 may apply. If the financial contract is transferred to the third party purchaser or the bridge institution, the counterparty may not exercise termination rights at all on the basis of the resolution action. (Although it may subsequently exercise termination rights against a defaulting third party purchaser or bridge institution, according to Article 63(4).)[34]

8.2. Equally, if the primary resolution tool is, in fact, bail-in, termination rights may not be exercised at all. Under the strict terms of Article 77(1), this would appear the case even where the asset-separation ancillary resolution tool is used in conjunction with the bail-in tool and other valuable assets are transferred to a third party, namely the asset manager, whilst the financial counterparty's contract in question remains in the institution under resolution. If this interpretation is correct, presumably this approach has been adopted because an exercise of the bail-in tool will necessarily represent an attempt to preserve corporate value, as provided by the terms of Article 37(2), which

34 See footnote 8.

attempt would be undermined by counterparties' exercise of termination rights. Nevertheless, the slightly different wording of Article 63(4) which specifies that a person may not exercise termination rights "as a result of the resolution action" following the application of the bail-in tool, leaves it marginally arguable that termination rights triggered on their terms by asset separation may be exercised on that basis, so long as they are not exercised "as a result" of the bail-in. Differences in the drafting of Article 77(1) and of Article 63(4) have, therefore, created an issue of interpretive uncertainty.

8.3. However, this is not the only issue of uncertainty that arises in the application of the RRD's bail-in provisions to derivatives. Whether or not Article 77(1) applies and notwithstanding any other legislative suspension of termination rights, the close-out or settlement entitlement to which an "in the money" counterparty has a claim under a master agreement or other derivative contract may not have crystallised prior to the exercise of the bail-in resolution tool under the terms of the contract. This may be because neither satisfaction of the conditions for resolution nor the application of the tool qualifies as an Event of Default (as they may not do under many existing master agreements) or because, although an Event of Default has occurred, the nominated date for early termination falls after the date on which bail-in occurs or for some other reason. In other cases, the parties may have provided in the terms of their derivative transaction that the satisfaction of the conditions for resolution by one party to the transaction is an Event of Default by that party and the non-defaulting party may have taken all the steps required by the contract to terminate the derivative but, notwithstanding the contractual position, the general purport of Articles 63 and 77 is that the counterparty's exercise of termination rights is likely to be unenforceable—either "excluded" or "suspended" (subject to conflict of law issues)—under the law of the resolution forum. The point has already been made above that the application of the bail-in tool to contingent obligations is particularly difficult to apprehend or predict (paragraph 5.6.2) and a creditor's "in the money" rights under a derivative contract arguably fall into this category in these circumstances.

8.4. It can readily be seen that the derivative assets held by counterparties may represent variously, for the counterparty in question, either an entitlement to future payments by the institution under resolution or an entitlement to a close-out payment upon the default of the institution under resolution and also that this latter entitlement may be contingent or may have crystallised, depending on the terms of the contract, the provisions of the applicable law and, almost certainly, the law of the insolvency forum. In these circumstances, it is impossible conclusively to determine the meaning of the provision, in Article 44, that "resolution authorities shall determine the liability… on a net basis" for the purposes of applying the bail-in tool and the coming into force of that provision a full twelve months before the European Banking Authority is required to develop draft regulatory technical standards specifying valuation methodologies is likely to lead to considerable operational uncertainty for the counterparties of institutions within the contemplation of the RRD.

8.5. However, the most challenging area of legal uncertainty generated by the application of the RRD to derivatives transactions is likely to be the interaction of the law of the resolution forum and the applicable law of the contract, particularly where the applicable law is the law of a third country outside the EU. The fact that the resolution forum will have implemented the RRD's provisions on the exclusion and suspension of termination rights may have no effect whatsoever if the counterparty is in a position to claim under the terms of the contract, applying the law of a third country, in a third country jurisdiction against assets in that jurisdiction of the institution under resolution. In other cases, e.g. where the counterparty's rights are governed by the law and jurisdiction of a third country but any judgment in favour of a counterparty must be enforced against assets in the resolution forum, laws implementing the RRD's provisions on the suspension and exclusion of termination rights will *prima facie* conflict with the international obligations of the resolution forum to recognise the foreign judgment. And in cases where the counterparty's rights are governed by the law of a third country but fall to be adjudicated in the courts of an EU Member State (whether or not this is the resolution forum), the approach adopted by the adjudication forum to resolving the conflict between the terms of the contract and legal provisions implementing the RRD will presumably depend on the interpretation and application of the provisions of EU Regulation 593/2008 on the Law Applicable to Contractual Obligations ("Rome I Regulation") regarding the overriding mandatory provisions and public policy of the *lex fori*, and will be affected by those provisions' inherent tendency to lead to unpredictable and varying outcomes between different *fora*.

8.6. It is no doubt, *inter alia*, for these reasons that Directive 2001/24/EC on the reorganisation and winding-up of credit institutions provides, in Article 25, that netting agreements are to be governed not by the law of the insolvency forum (or "*lex concursus*") but solely by "the law of the contract which governs such agreements". One of the more curious outcomes of the provisions of the RRD, which do not defer to the law governing the netting agreement, is that a counterparty's immediate election for early termination under the terms of a financial contract containing a netting agreement, as soon as the conditions for resolution are satisfied (assuming the bespoke terms of the agreement so provide), will not take effect within the resolution forum for so long as the institution is under resolution but will then take effect once it enters an insolvency process in the same forum. In these circumstances, it is certainly arguable that the effective early termination date under the terms of the agreement is the date, chosen by the counterparty as the early termination date, at which the institution entered resolution. One logical corollary of this is that, by the time the election for early termination becomes legally effective under the law of the forum, the credit institution in question—which has been relying hitherto on laws which implement the RRD's provisions on the exclusion of termination rights—could already be in breach of contractual terms which may have the effect of requiring it to deliver a close-out or settlement payment before the RRD permits enforcement rights to be exercised.

8.7. A similarly curious result may obtain in the case of the transfer of a financial contract containing termination provisions to a third party purchaser or to a bridge institution. Nominally, Article 63(4) excludes the exercise of termination rights in these circumstances unless and until the transferee defaults. However, where the contract itself provides that termination rights are exercisable as soon as the conditions for resolution are satisfied (or upon the application of resolution tools) and the contract is governed by the law and jurisdiction of a third country, it is difficult to see how the implementation of the RRD in Member States' legal systems can prevent the counterparty seeking a declaration in the foreign forum that it is entitled to exercise its contractual termination rights. Whether or not that judgment is enforceable will then depend on the location of any assets held by the transferee as well as on the effect of international law on the recognition of foreign judgments.

8.8. The FMLC does not consider that there is any simple way to resolve these conflict of laws issues which occur because the RRD (or rather Member States' laws implementing the RRD) will purport to override the express terms of parties' contracts notwithstanding those contracts are governed by the laws of third countries.[35]

## 9. CONCLUSION

9.1. There are aspects of the drafting of the RRD which are to be commended, including what appears to be a fairly comprehensive regime of safeguards against partial property transfers. Nonetheless, there are some legal uncertainty issues which arise from the drafting of the Directive as referred to in the sections of this paper entitled "specific issues I-III". In view of the foregoing, the FMLC believes that clarification of the points raised by way of amendments to the RRD, will provide for greater legal certainty to the market.

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35 It is noted as regards write-down or conversion that Article 50 of the RRD provides for contractual recognition of bail-in but it does not appear to go further or address the issues under discussion in this Section.

## 10. APPENDIX

**Drafting comments in relation to Article 23 of the RRD**

10.1. It is noted that Article 23(1)(g) refers to confidentiality provisions as laid down in Article 77. It seems that this should in fact be a reference to the confidentiality provisions as laid down in Article 76.

**Drafting comments in relation to the resolution objectives and general principles within the RRD**

10.2. Following the comments made above in paragraph 3.2, Article 26(2)(f) of the RRD might be amended to provide that a resolution authority must have regard to the following objective:

> to safeguard clients' ownership rights in accordance with Articles 13(7) and (8) of Directive 2004/39/EC and Article 16 of Directive 2006/73/EC.

10.3. Further, Article 29(f) sets out what is widely known as the "no creditor worse off" principle. The Article provides that resolution tools should be exercised in accordance with the principle that:

> no creditor incurs greater losses than would be incurred if the institution would have been wound down under normal insolvency proceedings.

10.4. The reference to the process of winding-*down* is curious. Further, Article 29(f) should arguably refer inclusively to both creditors and clients, as follows:

> no creditor or client incurs greater losses than if the institution had been wound up under the insolvency law otherwise applicable to it.

10.5. There would be merit in introducing a new principle into Article 29 in contemplation of Article 13(7) of MiFID, pursuant to which a client's instruments should not be used on the institution's account except with the client's express consent.

10.6. Finally, Article 29(f) would likely be clearer in its intended effect if it were amended to state that no creditor should incur "greater losses than if the institution *had been wound up under the insolvency law otherwise applicable to it*".

**Drafting comments in relation to the Safeguards within the RRD**

10.7. In relation to Article 68, given the structure of sub-paragraph (e), it is natural to assume that the final clause of sub-paragraph (e) ("…*which involve the granting and holding of security*…") describes a defining feature of the "covered bonds"—or, possibly, "covered bonds and securitisations"—which will qualify for the safeguard. If, on the other hand, it offers a characteristic of "structured finance arrangements" the syntax of the sub-paragraph should be revised.

10.8. Clarity would also be improved, and consistency with the presumed intended effect of the Directive enhanced, if the expression "set-off arrangements" in Article 68(2)(c) of the RRD were amended by substituting "institution" for "bank" in order to make clear that the safeguard is not limited to an arrangement to which a bank is party. Further, the words "of the security" appear to be missing after the word "benefit" in Article 70(c) of the RRD.

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*End of annex*