Bank Recovery and Resolution Directive: Legal Uncertainties in the Proposal to Amend Moratorium Powers

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Financial Markets Law Committee

This paper has been prepared by the FMLC Secretariat.

In view of the role of the Bank of England as the U.K.’s resolution authority, Sinead Meany took no part in the preparation of this paper and the views expressed should not be taken to be those of the Bank of England.

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1. EXECUTIVE SUMMARY AND 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. On 23 November 2016, the European Commission published a package of reforms proposing fundamental changes to E.U. legislation on bank resolution and bank capital (the “Banking Reform Package”). In response, the FMLC resolved to establish a Banking Scoping Forum to provide a space for discussion on issues of legal uncertainty related to the Banking Reform Package and the wholesale banking sector. In December 2017, members of the Banking Scoping Forum recommended that the Committee consider issues of legal complexity arising in the context of the European Commission’s legislative proposal, included within the Banking Reform Package, to amend certain moratorium provisions in Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the “Bank Recovery and Resolution Directive” or the “BRRD”).

1.3. This paper sets out the details of legislative proposal to amend the moratorium powers in section 2, below. In section 3, the FMLC considers four sets of uncertainties caused by the interaction of provisions in the legislative proposal with (1) existing moratorium powers; (2) financial collateral arrangements; (3) custody requirements; and (4) back-to-back contracts involving central counterparties (“CCPs”). The FMLC recommends, by way of conclusion, that further thought is given to synchronise these new moratorium powers with international standards.

1.4. As the proposal has made its way through the European legislative process, the FMLC observes that the European Council has put forward a series of compromise proposals which have suggested a reduction in the duration of the new moratorium powers proposed. It is, however, outside the FMLC’s remit to engage in the legislative process and to comment on issues of policy.

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4 The legislative proposal can be found at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM-2016-0852-FIN

2. BACKGROUND: THE LEGISLATIVE PROPOSAL

2.1. As it currently applies, the BRRD provides in Article 69 the power for resolution authorities to suspend payment or delivery obligations pursuant to any contract to which an institution in resolution is party for a fixed period of two business days (the “Article 69 moratorium power”). The scope of the Article 69 moratorium power excludes eligible deposits, obligations owed to payments and settlement systems, CCPs, central banks and eligible claims under investor-compensation schemes.

2.2. The legislative proposal, intended to harmonise approaches to moratoria by resolution authorities across the E.U., recommends, inter alia, the introduction of two additional moratorium powers which give relevant authorities new abilities to freeze the flow of payments. The proposed amendments will expand authorities’ pre- and in-resolution moratorium powers, primarily through the introduction of a new Article 29a and through amendments to Article 63(1) of the BRRD. The existing moratorium powers in Article 69 will continue to apply.

2.3. The legislative proposal first expands the pre-resolution moratorium powers available to competent authorities. Article 27(1) of the BRRD (Early intervention measures) currently provides competent authorities in Member States with the powers to implement eight measures in relation to financial institutions in a deteriorating financial or liquidity situation. These measures range from the power to require the management body of the institution to implement any arrangements set out in the institution’s recovery plan to the power to request changes to the institution’s business strategy. The legislative proposal adds a ninth measure which enables competent authorities to suspend any payment or delivery obligations. Concurrently, a new Article 29a (Power to suspend certain obligations) is added, granting competent authorities the power to suspend payment or delivery obligations in pre-resolution for a period of up to five working days. The European Commission has indicated that this power is to be used in the determination of whether early intervention measures are necessary or whether an institution is failing or is likely to fail.

2.4. Through amendments to Article 63(1)—which provides resolution authorities with the “general powers” necessary to apply resolution tools to failing institutions—paragraphs 63(1)(n), 63(1)(1a) and 63(1)(1b) are added, introducing an in-resolution power by

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5 This pre-resolution power has not been made available to resolution authorities, although a competent authority must consult with the relevant resolution authority before using the power.

6 “Ancillary” and specific powers are provided by subsequent articles.
which resolution authorities might suspend payment and delivery obligations for up to five working days where it is deemed necessary by the authority for the effective application of one or more resolution tools or for the purposes of valuation. By amendment to Article 69(4)(b), Third Country CCPs recognised by the European Securities and Markets Authority (“ESMA”) are also excluded from any suspensions under the Article 69 moratorium power.

3. **ISSUES OF LEGAL UNCERTAINTY**

**Interaction between new moratorium powers and those already available in the BRRD**

3.1. There is a lack of clarity on the interactions between, on the one hand, the proposed Articles 63(1)(n), 63(1a) and 63(1b), which grant resolution authorities the power to impose a moratorium of up to five working days, and, on the other hand, the amended Article 69. It is not immediately clear whether these in-resolution moratorium periods will run concurrently or consecutively. If the in-resolution moratorium periods provided by Articles 63 and 69 were to overlap, an institution in resolution would be subject to a stay for five business days. If the moratoria were to apply consecutively, it is possible that, an institution in resolution could be subject to a stay for seven business days. In both eventualities, the extended moratorium period amplifies market disruption and risk of contagion.

**Impact on financial collateral arrangements and international coordination**

3.2. A degree of uncertainty is also caused by the extension of the moratoria periods in relation to the protections available to financial netting and collateral arrangements from moratorium powers currently available in national insolvency laws; this protection is granted by means of Directive 2002/47/EC on financial collateral arrangements (the “Financial Collateral Arrangements Directive” or the “FCAD”). The FMLC had, in 2013, commented on the interaction of the moratorium powers with the exercise of

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7 The wording of the proposed in-resolution moratorium (by way of amendments to Article 63) suggests the power can be exercised at any time in order to support the application of a resolution tool provided for in the BRRD, including the sale of business (Article 38), the bail-in tool (Article 43), the bridge institution tool (Article 40) or the asset separation tool (Article 42).

8 If, further, these in-resolution moratorium periods are initiated after the institution in resolution has been subject to a pre-resolution stay, introduced by the new Article 29a and limited to a maximum of five working days, the institution might find its payment and delivery obligations suspended for ten or 12 days, respectively.
termination rights by counterparties. Regarding the enforcement of temporary stays on termination rights in financial contracts, the 2013 Paper states

...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.

3.3. The loss of such protections could also negatively impact the recognition of netting arrangements in jurisdictions, such as the United States, where netting is contingent upon parties’ ability to terminate and close out upon default within prescribed timeframes.

3.4. Similar effects are likely to be felt in relation to cross-border cooperation, were the proposed longer moratorium periods to be applied. The E.U.’s rules will be discordant with internationally agreed standards including those previously identified by the Financial Stability Board (“FSB”). The FSB report not only recommends limiting such moratoria to 48 hours but also states that moratorium powers should only be available during resolution.

Custody

3.5. Article 44(2) of the BRRD excludes client assets and client money from the scope of the bail-in tool. This is consistent with FSB Key Attributes and with European laws requiring that managers of regulated funds retain an institution subject to the BRRD regime to act as depositary holding their assets for safe-keeping, arranging settlement of

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11 Ibid., p. 10
their transactions and administering their income. The proposed moratorium tools contain no carve-out to protect cash and assets held by depositaries. If a moratorium can be imposed on payments by depositaries, a degree of incompatibility arises in relation to rules within Directive 2011/61/EU on Alternative Investment Fund Managers (the “AIFMD”) and Directive 2014/91/EU on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (the “UCITS Directive”) which require prompt access to funds and assets held with depositaries. Similar discrepancies arise in relation to regulatory obligations which prevent certain regulated funds, such as E.U. money market funds, from holding deposits with any E.U. institution unless such deposits can be withdrawn at any time.

Residual risks arising out of exemptions to moratorium powers

3.6. As mentioned in section 2, above, liabilities owed to CCPs are excluded from these proposed moratorium powers. While this exclusion applied only to E.U.-authorised CCPs in the BRRD, it is proposed that Third Country CCPs will be brought into the scope of the exclusions by amendment to Article 69(4)(b). The FMLC, in conjunction with the Committee on Capital Markets Regulation (“CCMR”), published a paper in September 2015 in which the Committees highlighted, inter alia, the legal uncertainties arising from the limited ambit of the relevant exclusion for “central counterparties” from the stay provisions in the BRRD. It, consequently, welcomes the proposed amendment to Article 69(4)(b).

3.7. The FMLC also considers, however, that this is an apposite time to raise a related and residual uncertainty concerning stays which apply to CCPs. The exclusion in Article 69(4)(b) is understood to cover liabilities owed by clearing members to CCPs. It is less clear, however, whether liabilities which arise between a clearing member and its clients are also exempt from the proposed moratorium powers as they are not “owed to the CCP”. In practice, such back-to-back arrangements mirror the clearing member–CCP “leg” of the derivatives transaction and significant legal and practical concerns would arise for participants in the cleared derivatives markets were there to be a mismatch in the treatment of different “legs” of a cleared derivatives transaction.

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4. RECOMMENDATIONS AND CONCLUSIONS

4.1. This paper has provided a brief overview of the provisions in the BRRD which allow Member States' competent and resolution authorities to impose a stay on the payment and delivery obligations of a failing financial institution, and the proposals to amend and expand these provisions. It has then highlighted legal and practical risks which arise in the context of these amendments in relation to existing moratorium powers, internationally-agreed standards for financial netting and collateral arrangements, requirements within other E.U. regulations for depository holding, and back-to-back contracts in cleared derivatives transactions.

4.2. In light of the legal complexities outlined above—and the substantial market and practical uncertainties they might cause—the FMLC recommends that further thought be given to whether the new moratorium powers are synchronized with existing international standards. In the event that a departure from these standards is considered best, the FMLC urges the European Commission to consider clarifying the interaction of the new powers with existing sections of the BRRD and other relevant legislation.
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