

13 August 2014

## **BANK RECOVERY AND RESOLUTION DIRECTIVE (BRRD)**

### **Briefing Note for Member States of the European Union on implementation of Article 77(1) (Protection for financial collateral, set-off and netting agreements)**

#### *What constitutes “appropriate protection”?*

Article 77(1) of the EU Bank Recovery and Resolution Directive (“BRRD”)<sup>1</sup> requires Member States to ensure that there is “appropriate protection” for title transfer financial collateral arrangements and set-off and netting arrangements from:

- the transfer by a resolution authority of some, but not all, of the rights and liabilities that are protected under a title transfer financial collateral arrangement, a set-off arrangement or a netting arrangement (“protected rights and liabilities”) by exercise of a power contemplated, for example, by Article 63(1)(d) of the BRRD (a “partial property transfer power”)
- the modification or termination by a resolution authority of protected rights or liabilities by exercise of a power contemplated, for example, by Article 64(1)(f) of the BRRD (a “contractual modification power”)

The BRRD does not, however, provide any guidance as to what constitutes “appropriate protection” for this purpose.

This Briefing Note has been prepared by the International Swaps and Derivatives Association, Inc. (“ISDA”)<sup>2</sup> to assist EU Member States in implementing this important creditor safeguard under the BRRD.

All of the safeguards set out in Chapter VII (Articles 73 to 80 of the BRRD) are important, not only for the continued integrity, safety and efficiency of the derivatives market, but also for the wider financial market in Europe. In focusing on Article 77(1), ISDA is not suggesting that full implementation of the other safeguards is necessarily straightforward. Implementation of each safeguard will require careful consideration to ensure that the scope of the safeguard is sufficiently broad and its operation sufficiently clear so as to achieve the legal certainty necessary to ensure the continued stability, safety and efficiency of the European financial market.

In relation, however, to Article 77(1), experience of national bank resolution regimes in some countries underlines the importance of ensuring that the safeguard against the exercise of a partial property transfer power or contractual modification power is sufficiently clear and sufficiently robust. This is important, for example, for purposes of protecting the regulatory capital treatment of exposures covered by a netting

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<sup>1</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

<sup>2</sup> Information regarding ISDA is set out in the Annex to this Briefing Note.

agreement for the purposes of CRD IV,<sup>3</sup> as noted in Recital 95 to the BRRD. But, of course, it is important more generally to ensure the robustness and integrity of the credit risk mitigation achieved by title transfer collateral, set-off and netting arrangements in order to reduce systemic risk within the financial market.

What, therefore, is necessary to ensure that title transfer collateral, set-off and netting arrangements are subject to appropriate protection from the exercise by a resolution authority of a partial property transfer power or a contractual modification power?

First, it should be clear how such powers may be exercised in relation to protected rights and liabilities. In the case of:

- (a) the exercise of a partial property transfer power, it must be the case that all rights and liabilities falling within a single title transfer collateral arrangement, set-off arrangement or netting arrangement are kept together so that either:
  - (i) all such rights and liabilities (the “protected set”) are transferred as a whole, for example, to a bridge institution or private sector transferee; or
  - (ii) the protected set is left with the residual institution in resolution.

In the case of (i), it is appropriate that following such transfer, the counterparty to the firm in resolution should not have a right of early termination against the transferee solely as a result of such transfer. This is ensured by Article 68 of the BRRD and is, of course, consistent with Key Attribute 4.2 of the FSB Key Attributes.<sup>4</sup>

In the case of (ii), the counterparty should be able to exercise any early termination rights it has against the institution in resolution once any period of suspension under Article 69 of the BRRD has ended and assuming, of course, that the relevant early termination right is not nullified by Article 68 of the BRRD. This, too, is consistent with Key Attribute 4.3 and Annex IV of the FSB Key Attributes.

- (b) the exercise of a contractual modification power, a resolution authority must not be permitted to use that power to disrupt the protection conferred by the relevant title transfer collateral arrangement, set-off arrangement or netting arrangement in any way, including (without limitation) by modifying the contract in such a way as to remove the right to set off or net the protected rights and liabilities or to otherwise alter the substantive effect of such an arrangement.

Secondly, and crucially, it is important that the remedy for any breach of this safeguard by a resolution authority is clear, certain and immediate. The appropriate remedy will, in our view, differ according to whether the breach resulted from the exercise of the partial property transfer power or the contractual modification power.

In relation to the partial property transfer power, one possible approach would be to provide that any transfer of a right or liability included within a protected set is void

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<sup>3</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [2013] OJ L176/338.

<sup>4</sup> Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011).

unless the whole of the protected set is transferred. Where, however, the transfer is part of a larger transfer of rights and liabilities by the resolution authority, this approach might cast doubt on the whole of the transfer, even though most of the rights and liabilities being transferred are not protected by a title transfer collateral, set-off or netting arrangement.

A better approach would therefore be not to provide that the transfer is void but instead that any right or liability so transferred is transferred subject to the operation of the set-off or netting under the relevant title transfer collateral,<sup>5</sup> set-off or netting arrangement. In other words, the operation of the relevant set-off or netting would take priority over the rights of the transferee so that the transferee would receive only what remains of the relevant right or liability transferred after operation of the set-off or netting.<sup>6</sup>

An example of a remedy that would not confer sufficient legal certainty would be an administrative remedy where a counterparty affected by a partial property transfer in breach of the safeguard would be required to apply to the resolution authority or some other public body or a court or tribunal for relief from the effect of the transfer. Any such administrative remedy would take time to obtain, with an outcome that would, by its nature, be uncertain. While the correct result might ultimately be obtained, an administrative remedy of this type would almost certainly fail to satisfy the high standard of legal certainty of enforceability required, for example, under the regulatory capital requirements for netting arrangements referred to above.

In relation to the contractual modification power, the only remedy that will, in our view, be sufficiently clear, certain and immediate would be to provide that the exercise of the contractual modification power in breach of the safeguard would be void.

Although the focus of this briefing paper has been on Article 77(1), ISDA believes that the above principles, appropriately adapted, can and should be taken into account in formulating the other safeguards required to be implemented under Chapter VII of the BRRD, particularly in relation to security arrangements and structured finance arrangements.

We urge each Member State, as part of its public consultation on the implementation of the BRRD, to consult on the implementation of the safeguards in Chapter VII of the BRRD and, in particular, the safeguard to be implemented under Article 77(1). In addition, we would be happy to discuss these issues or any other issues arising under the BRRD with relevant public officials and other interested stakeholders, if that would be of assistance.

For more information, please contact Peter Werner ([pwerner@isda.org](mailto:pwerner@isda.org)), Senior Director.

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<sup>5</sup> A title transfer collateral arrangement relies for its effect on the operation of a set-off or close-out netting provision.

<sup>6</sup> An example of this approach, in the current bank resolution regime of the UK, may be found in article 11 of the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009.

## **INFORMATION ABOUT ISDA**

Since its founding in 1987, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

ISDA has over 840 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

The address of our European office appears on the first page of this briefing note. Our registration number in the relevant EU register is **46643241096-93**.

The addresses of our other offices, including our head office in New York, may be found on our website at <http://www.isda.org> through the "Contact us" link at the top of the home page.

More than half of ISDA members are based in the European Union and neighbouring countries and most of the other members are active participants in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985.

Further details of ISDA's membership structure, including a list of the names of its primary, associate and subscriber members, is available from our website at <http://www.isda.org> through the "Membership" link on the left side of the home page.