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Proposed Moratoria Under the BRRD: A Step Backwards in Efforts to End 'Too Big To Fail'

The ISDA 2015 Universal Resolution Stay Protocol (Universal Stay Protocol), developed by ISDA in close coordination with the Financial Stability Board (FSB) and a number of national resolution authorities, addresses a major impediment to the resolvability of global financial institutions. By ensuring counterparties to an entity in resolution are on equal footing with respect to the exercise of default rights, regardless of the governing law of their agreements with that entity, the Universal Stay Protocol is a critical part of efforts to end 'too big to fail'.

New moratoria powers under the Bank Recovery and Resolution Directive (BRRD) proposed by the European Commission (EC) could trigger opt-out rights for entities that have adhered to the Universal Stay Protocol, therefore jeopardizing its effectiveness for European Union (EU) financial institutions. This would contravene efforts of the FSB to develop effective cross-border resolution frameworks, and would be a step backwards in the implementation of resolution strategies for EU financial institutions with global operations. It would also likely result in an unlevel playing field, with counterparties to non-EU-law-governed agreements standing to benefit at the expense of counterparties to EU-law-governed agreements.

This paper elaborates on the issues that could arise if the proposed moratoria powers are enacted and opt-out rights are triggered under the Universal Stay Protocol.

INTRODUCTION

Proposed moratoria under the BRRD may trigger opt-out clauses under the ISDA Universal Stay Protocol

ISDA and its members have worked closely with the FSB and a number of national resolution authorities to develop the ISDA 2014 Resolution Stay Protocol (2014 Stay Protocol) and the Universal Stay Protocol[1].

The Universal Stay Protocol[2], which ISDA published on November 12, 2015, effectuates amendments to covered master agreements, including ISDA Master Agreements, to contractually recognize stays and other limitations on termination rights and certain other remedies under special resolution regimes applicable to their counterparties in a number of jurisdictions[3]. The recognition ensures that counterparties to foreign-law-governed agreements are on equal footing with counterparties to local-law-governed agreements, and addresses one of the key impediments to an effective cross-border resolution identified after the financial crisis. To date, 26 global systemically important banks (G-SIBs) and their affiliates have adhered to the Universal Stay Protocol[4].

The new moratoria proposed by the EC on November 23, 2016, as part of amendments to the EU Bank Recovery and Resolution Directive (BRRD II), may amount to an adverse change to applicable legislation that would trigger adhering parties' rights to opt out of the Universal Stay Protocol with respect to counterparties that could be subject to the proposed moratoria. Exercise of opt-out rights would be problematic for several reasons:

- Such exercise could negatively impact the efficacy of the arrangements agreed by the FSB, global regulators and market participants in order to ensure effective recognition of stays in a cross-border resolution.
- It could result in an uneven playing field with respect to the exercise of default rights against an EU G-SIB in resolution under the BRRD, with counterparties to non-EU-law agreements standing to benefit at the expense of counterparties to agreements governed by the law of an EU jurisdiction.
- Due to the one-way nature of the opt-out rights, their exercise would negatively impact the resolvability of G-SIBs in EU jurisdictions without having any effect on the resolvability of G-SIBs in the US, Japan and Switzerland (ie, the other jurisdictions covered by the Universal Stay Protocol).
- As the opt-out rights are exercisable on a counterparty-by-counterparty basis, adherents would be able to selectively opt out with respect to some but not all EU G-SIBs, which could disproportionally affect EU G-SIBs viewed as 'weaker' and/or G-SIBs in certain EU jurisdictions.

[1] The Universal Stay Protocol is available at http://www2.isda.org/functional-areas/protocol-management/protocol/22

[2] Unless specifically stated, the analysis applicable to the Universal Stay Protocol would also apply to the 2014 Stay Protocol

[3] The Universal Stay Protocol also provides for amendments to covered master agreements to support orderly resolution under the US Bankruptcy Code. However, the opt-out provisions discussed here do not apply to those provisions, and therefore the provisions are not covered by this note

[4] A list of adherents to the Universal Stay Protocol is available at http://www2.isda.org/functional-areas/protocol-management/protocol-adherence/22. The Universal Stay Protocol is open for adherence by all market participants. However, the expectation has always been that only G-SIBs and certain other large global dealers would adhere to it. ISDA has also developed the ISDA Resolution Stay Jurisdictional Modular Protocol to enable all market participants (including buy-side institutions) to comply with regulations or legislation in various jurisdictions. This requires them to transact under terms that provide for cross-border recognition of stays and other limitations on termination rights and other remedies in financial contracts, regardless of the governing law of the applicable agreements. The ISDA Resolution Stay Jurisdictional Modular Protocol does not contain opt-out provisions and is therefore not covered by this note

- Enactment of the proposed moratoria would result in uncertainty for resolution planning efforts in the EU because adherents would be free to opt out with respect to EU G-SIBs at any time after enactment of the proposed moratoria (subject to any limitations under applicable law).

In this paper, we provide background on the Universal Stay Protocol and global efforts to address impediments to cross-border resolution. We then analyze the opt-out provisions in the Universal Stay Protocol and explain how they would interact with the proposed moratoria. Finally, we elaborate on the potential effects of adherents opting out of the Universal Stay Protocol. We conclude that the only way to avoid these results is to ensure that the BRRD remains consistent with global standards.

ISDA STAY PROTOCOLS

Adherents to the ISDA Universal Stay Protocol contractually recognize stays on termination rights that apply in certain jurisdictions if a bank enters into resolution

The Universal Stay Protocol replaces the ISDA 2014 Stay Protocol in its entirety with respect to entities that adhered to both. The operative provisions of the 2014 Stay Protocol and the Universal Stay Protocol are nearly identical, except that the 2014 Stay Protocol covers only transactions entered into under ISDA Master Agreements, whereas the Universal Stay Protocol also covers securities financing transactions entered into under certain master agreements published by the International Capital Market Association, the International Securities Lending Association and the Securities Industry and Financial Markets Association.

In addition, the Universal Stay Protocol contains mechanisms to expand the scope of: (a) covered transactions to include transactions other than those entered into under the master agreements referenced above, in order to match the scope of transactions subject to stays and other limitations on termination rights and certain other remedies under applicable special resolution regimes; and (b) covered jurisdictions.

ENDING 'TOO BIG TO FAIL'

The ISDA Universal Stay Protocol was developed in coordination with the FSB in response to concerns about the cross-border resolution of a systemically important bank

ISDA developed the 2014 Stay Protocol, and later the Universal Stay Protocol, in coordination with the FSB as a response to findings in the 2013 FSB report to the Group of 20 on *Progress and Next Steps towards Ending "Too-Big-To-Fail" (TBTF)*[5], which identified legal uncertainties regarding the cross-border effectiveness of resolution measures (eg, stays and other limitations on termination rights and other remedies) as one of the main obstacles to the resolution of G-SIBs that operate in multiple jurisdictions. After subsequent work on these issues, the 2015 FSB report *Principles for Cross-border Effectiveness of Resolution Actions*[6] concluded that:

> Effective temporary stays on early termination rights that arise only by reason of or in connection with a firm's entry into resolution are important to prevent the close-out of financial contracts in significant volumes. Such close-out action upon entry into resolution could disrupt the provision of critical functions, lead to the firm in resolution having an unbalanced book and undermine the objective of a resolution action that seeks to maintain the continuity of critical functions. The FSB *Key Attributes [of Effective Resolution Regimes for Financial Institutions]* therefore require jurisdictions to include in their resolution regimes powers for authorities to impose such temporary stays, accompanied by appropriate safeguards for counterparties…

[5] http://www.fsb.org/wp-content/uploads/r_130902.pdf?page_moved=1

[6] http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf

> In the absence of an appropriate statutory framework or contractual recognition provisions, there is a risk that domestic courts enforcing a contract governed by their domestic law may not give effect to a restriction or temporary stay on the exercise of early termination rights (including as a result of [cross-defaults and indirect defaults, including resolution of an affiliate]) imposed under a foreign resolution regime, or would be unlikely to do so sufficiently promptly to meet the needs of effective resolution in the foreign jurisdiction.

As noted above, the Universal Stay Protocol provides a means for adhering counterparties to contractually recognize stays and other limitations on termination rights and certain other remedies under special resolution regimes applicable to their counterparties in a number of jurisdictions, and therefore addresses a major obstacle to effective cross-border resolution.

Specifically, adhering parties to the Universal Stay protocol agree to 'opt in' to such stays and other limitations under the resolution regimes applicable to their counterparties and related entities of their counterparties (ie, credit support providers, specified entities and certain other parent entities) that have also adhered to the Universal Stay Protocol. As a result, adhering parties essentially agree they have the same rights with respect to a counterparty in resolution and its affiliates as parties transacting with these entities under agreements governed by the laws of the jurisdiction of the applicable resolution regime.

The Universal Stay Protocol initially applied to special resolution regimes in France, Germany, Japan, Switzerland, the UK and the US (referred to in the Universal Stay Protocol as 'identified regimes'). It contains mechanisms to expand its coverage to special resolution regimes in other FSB jurisdictions, as well as the jurisdictions of organization of the ultimate parent entity of G-SIBs, provided those special resolution regimes satisfy the requirements set out in the Universal Stay Protocol (the Universal Stay Protocol refers to these regimes as 'protocol-eligible regimes'). To satisfy these requirements, the regimes generally must be consistent with the FSB *Key Attributes of Effective Resolution Regimes for Financial Institutions*[7] (Key Attributes).

Section 4.3 of the Key Attributes states that stays on contractual acceleration or early termination rights should: "(i) be strictly limited in time (for example, for a period not exceeding two business days); (ii) be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty to counterparties…; and (iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of the stay (for example, failure to make a payment, deliver or return collateral on a due date)."

To date, ISDA has published country annexes to the Universal Protocol for Italy, the Netherlands, Spain and Sweden. Parties adhering to such country annexes agree these regimes are protocol-eligible regimes[8].

[7] http://www.fsb.org/wp-content/uploads/r_141015.pdf

[8] Adhering parties must separately adhere to country annexes. Therefore, not all adhering parties to the Universal Stay Protocol have adhered to the country annexes for these jurisdictions. However, if a party adheres to one country annex, it must adhere to all published country annexes (ie, it cannot pick and choose)

OPT-OUT PROVISIONS

Adherents can opt out with respect to other adhering parties if the resolution regimes of those adhering parties no longer meet FSB standards

A key aspect of the Universal Stay Protocol is that adhering parties only opt in to special resolution regimes that are consistent with the FSB Key Attributes and provide adequate safeguards to counterparties of the entities in resolution. Prior to publishing the Universal Stay Protocol, ISDA and its members reviewed the identified regimes to confirm they satisfied these criteria. Any subsequently added regimes must go through a similar vetting process.

To address adherents' concerns that an identified regime or subsequently added protocol-eligible regime could be amended so it is no longer consistent with the Key Attributes and/or no longer provides adequate safeguards to counterparties, the Universal Stay Protocol contains a mechanism whereby adherents can 'opt out' with respect to another adherent upon any such amendments to the special resolution regime that could apply to the other adherent. Specifically, Section 4(b)(i)(B) of the attachment to the Universal Stay Protocol states:

> (B) *Amendments to Identified Regimes*. If an Adhering Party ("X") *determines in good faith* that an amendment to an Identified Regime (other than an amendment specified in the Annex for such regime) subsequent to the First Adherence Date relating to *the length of any applicable stay (or the imposition of a stay), the obligations of parties during the pendency of a stay, the treatment of netting or setoff arrangements* or the priority of claims (other than any amendment relating to a bank that gives priority to the depositors of such bank over general unsecured creditors of such bank) *materially and adversely affects the ability to exercise Default Rights in respect of Eligible Agreements or related Credit Enhancements*, X shall be entitled, by written notice (an "Identified Regime Notice") to another Adhering Party ("Y") eligible for resolution under such Identified Regime, and Y's Primary Regulators, to elect that such Identified Regime will not, as between them, constitute an Identified Regime with respect to Y or its Related Entities for those Eligible Agreements with respect to which X's ability to exercise Default Rights has been materially and adversely affected. In the case of an Identified Regime Notice with respect to U.S. Special Resolution Regime – FDIA, Section 2(d) will be inapplicable as between X and Y. Any such election will remain effective until withdrawn by written notice from X. (*Emphasis added*.)

Section 4(b)(i)(C) of the attachment to the Universal Stay Protocol contains a similar opt out for protocol-eligible regimes.

PROPOSED MORATORIA

Proposed moratoria under the BRRD could significantly increase the length of stays on both performance obligations and termination rights

As described in more detail in the ISDA position paper, *Challenges with Expanding BRRD Moratoria Powers*[9], the proposed moratoria would suspend payment and delivery obligations of the institution in resolution and its counterparties (including with respect to derivatives and other financial contracts), both prior to resolution (the proposed pre-resolution moratorium) and in resolution (the proposed in-resolution moratorium).

As currently drafted, the proposed pre-resolution moratorium would apply for a maximum of five working days. It would be an 'early intervention measure' and a 'crisis prevention measure' for the purposes of the BRRD, and would therefore trigger the suspension of termination and other rights under the general resolution stay that currently exists under Article 68(3) of the BRRD.

[9] Available at http://assets.isda.org/media/f253b540-163/5e9412e8-pdf/ (see pages 6-9 in particular)

The general resolution stay overrides any termination, suspension, modification, netting or set-off rights and cross-default provisions that would otherwise arise under contracts entered into by the institution in resolution (and certain other group entities of that institution) upon the occurrence of certain trigger events *provided that substantive obligations under the contracts, including payment and delivery obligations and the provision of collateral, continue to be performed*. However, if applied alongside the proposed moratoria, payment and delivery obligations (including the provision of collateral) would be suspended and therefore would not arise. Accordingly, counterparties would lose the benefit of this safeguard under the general resolution stay.

The proposed in-resolution moratorium would apply for five working days but arguably with: (a) flexibility over when it could be exercised during the in-resolution phase; and (b) the potential to be utilized on multiple consecutive occasions (making the maximum period of suspension uncertain). It would be a 'resolution power', the application of which would in turn be a 'resolution action', and thereby a 'crisis management measure' under the BRRD, which would trigger the general resolution stay described above.

Moreover, in resolution, a resolution authority could impose the existing temporary stays under Articles 69-71 of the BRRD in addition to the proposed in-resolution moratorium and the general resolution stay. The existing temporary stays provide for two-business-day stays on payment and delivery obligations, enforcement of security interests and termination rights. Unlike the general resolution stay, which is automatic, these stays apply at the discretion of the resolution authority.

As a result, if the proposed moratoria are enacted, counterparties of an institution in resolution under the BRRD II would not be able to enforce that institution's payment and delivery obligations (including obligations with respect to collateral) *and* at the same time would have no rights to terminate, close out or net agreements with the institution.

If it is assumed that the proposed pre-resolution moratorium is imposed for five days, followed by the proposed in-resolution stay for five days and the existing temporary stays for two days in immediate succession, counterparties would be exposed to non-performance by the institution in resolution without the ability to terminate, close out and net agreements for 12 consecutive days. This would be a significantly longer period of time than the existing two-business-day temporary stay under the BRRD, and a significant departure from the existing application of the general resolution stay pursuant to which payment and delivery must continue.

APPLICATION OF OPT-OUT PROVISIONS

The proposed moratoria would likely trigger opt-out clauses under the Universal Stay Protocol

If the proposed moratoria are enacted, then pursuant to Section 4(b)(i)(B) or (C) (as applicable) of the attachment to the Universal Stay Protocol (opt-out clauses), adherents would have to each individually determine in good faith whether the proposed moratoria constitutes an amendment related to the "length of any applicable stay (or the imposition of a stay), the obligations of parties during the pendency of a stay [or the] the treatment of netting or setoff arrangements" that materially and adversely affects the ability to exercise 'default rights' in respect of 'eligible agreements' or related 'credit enhancements' (as each term is defined in the Universal Stay Protocol).

While interpretation of these provisions would be up to individual adherents in consultation with their own advisors[10], we believe it would be reasonable for adherents to conclude that enactment of the proposed moratoria would trigger the rights under the opt-out clauses. The proposed moratoria would affect both the length of the stay period during which counterparties could not terminate, net or set off, and would affect the performance obligations of the parties during the pendency of the stay.

While 'materially and adversely' is not defined, the proposed moratoria would be a significant departure from the existing stays under the BRRD, and from the principles for stays and moratoria set out in the Key Attributes, so we believe it would be reasonable for adherents to conclude that the proposed moratoria would materially and adversely affect the ability of adherents to exercise default rights.

Assuming the proposed moratoria are enacted and an adhering party determines it therefore has the right to opt out of the Universal Stay Protocol with respect to counterparties eligible for resolution under the BRRD II, the adhering party would send a written notice to the counterparty or counterparties with which it decides to opt out and to the primary regulator for each counterparty or counterparties. The written notice would need to indicate that the BRRD II, as implemented in the relevant jurisdiction, is no longer an 'identified regime' or 'protocol-eligible regime' (as applicable) between the adhering parties.

IMPLICATIONS OF OPT OUTS

Opt outs due to the proposed moratoria would create an unlevel playing field and put EU institutions at a disadvantage

Cross-border recognition generally: If the proposed moratoria are enacted and an adhering party exercises its opt-out rights with respect to another adherent or adherents that could be subject to resolution under the BRRD II, then the opting-out adherent would cease to contractually agree to recognize the stays and other limitations on termination rights and certain other remedies under the BRRD II with respect to the adherent(s) with which it opted out.

This would include both the existing stays under the BRRD II, in addition to the proposed moratoria and stays triggered by it. As a result, the risk identified by the FSB in 2015 that non-EU courts enforcing a contract governed by non-EU law between an adhering party and its relevant counterparty or counterparties may not give effect to stays and other limitations on termination rights and certain other remedies under the BRRD II (or would be unlikely to do so sufficiently promptly to meet the needs of effective resolution in the foreign jurisdiction) would exist once again[11].

[10] We note that pursuant to Section 3(e) of the Universal Stay Protocol, the Universal Stay Protocol and adherence letters thereto are governed by the laws of England and Wales, without reference to choice of law doctrine. However, the amendments made by the Universal Stay Protocol to covered agreements are governed by the law specified to govern each such covered agreement and otherwise in accordance with the applicable choice of law doctrine. In interpreting their rights under the opt-out clauses, adherents may need to consider the laws of England and Wales, the laws of the jurisdiction specified to govern each applicable covered agreement, and possibly the laws of other jurisdictions that could apply under relevant choice of law principles. Specific legal analysis of how the opt-out clauses would be interpreted under any such laws is beyond the scope of this note

[11] Note that the BRRD provides for automatic statutory recognition within the EU. Resolution measures taken by an EU resolution authority in respect of an EU institution within its jurisdiction, and resolution measures agreed in resolution colleges in the case of groups, are automatically recognized and must be enforced by resolution authorities of other EU member states

Without contractual recognition (and assuming no applicable statutory recognition procedures), the court's decision would likely be based on principles of comity as developed in the relevant jurisdiction and any other relevant precedent. As a result, entities in resolution under the BRRD II and their resolution authorities would have much less certainty over whether counterparties of these entities could exercise termination rights or other remedies.

Any exercise of such rights and remedies could disrupt the provision of critical functions, lead to the firm in resolution having an unbalanced book, and undermine the objective of a resolution action that seeks to maintain the continuity of critical functions. The possibility of this result would be a step backwards for efforts to end too big to fail and would threaten financial stability.

Unlevel playing field: Lack of contractual recognition by counterparties to non-EU-law agreements would also result in less certainty over whether such counterparties have the same rights with respect to the entity in resolution under the BRRD II and its affiliates as parties transacting with these entities under agreements governed by the laws of an EU jurisdiction. This in turn could result in an uneven playing field with respect to the exercise of default rights against an entity in resolution under the BRRD II, with counterparties to non-EU-law agreements standing to benefit at the expense of counterparties to agreements governed by the law of an EU jurisdiction.

As the BRRD II is a directive, the proposed moratoria would also have to be transcribed by each EU member state. Assuming the proposed moratoria would trigger the opt-out clauses, the trigger would occur on the date the proposed moratoria take effect in the relevant member state. Timing differences in transcription across member states could therefore result in an uneven playing field within the EU.

One-way nature of opt outs: A key feature of the Universal Stay Protocol is that all adhering parties adhere with respect to all other adherents. That is, adherents may not select on a counterparty-by-counterparty basis whether they will contractually recognize stays that could apply to other adherents. As a result, all adherents receive the benefits and assume the obligations of the Universal Stay Protocol. That is, adherents increase their resolvability because other adherents contractually agree to recognize stays that could apply to them and, at the same time, they contractually agree to recognize stays that could apply to all other adherents.

The opt-out clauses, however, are one way, which means that adherents that exercise the opt outs would retain the benefits of the Universal Stay Protocol with respect to the counterparty or counterparties with which they opt out (ie, the counterparty or counterparties would continue to be bound by the contractual recognition effectuated by the Universal Stay Protocol upon the resolution of the adherents that opt out), but would no longer be bound by the obligations (ie, the adherents that opt out would no longer be bound by the contractual recognition effectuated by the Universal Stay Protocol upon the resolution of the counterparty or counterparties with which they opt out).

This would negatively impact the resolvability of G-SIBs in EU jurisdictions without having any effect on the resolvability of G-SIBs in the US, Japan and Switzerland (ie, the other jurisdictions covered by the Universal Stay Protocol).

Selective nature of opt outs: As noted above, adherents to the Universal Stay Protocol are bound by terms of the Universal Stay Protocol with respect to all other adherents. The opt-out clauses, however, are exercisable on a counterparty-by-counterparty basis. Therefore, subject to their own discretion, adherents would be able to selectively opt out with respect to some but not all EU G-SIBs, which could disproportionally affect EU G-SIBs viewed as 'weaker' and/or G-SIBs in certain EU jurisdictions. As a result, the contractual recognition effectuated by the Universal Stay Protocol may cease to apply to the very EU G-SIBs for which resolution is more likely. This result would seriously undermine the global efforts to ensure orderly resolution of G-SIBs and end too big to fail, and could therefore negatively impact financial stability.

Timing for exercise of opt-out rights: Assuming that enactment of the proposed moratoria would trigger the opt-out clauses, adherents would be free to opt out with respect to EU G-SIBs at any time after such enactment, subject to any limitations under applicable law. This means that adherents could wait to opt out until an EU G-SIB shows signs of distress – a result that would also seriously undermine the global efforts to ensure orderly resolution of G-SIBs and end too big to fail, which could therefore negatively impact financial stability. Moreover, upon enactment of the proposed moratoria, all EU G-SIBs and their resolution authorities would have to assume for purposes of resolution planning that the contractual recognition effectuated by the Universal Resolution Stay Protocol would not apply. This result would seriously impede resolution planning efforts for EU G-SIBs.

HOW TO AVOID TRIGGERING OPT-OUT PROVISIONS

The only way to avoid opt outs is to ensure changes to the BRRD are consistent with FSB standards

In developing the Universal Stay Protocol, ISDA and its members very intentionally included the opt-out clauses to ensure adherents would never contractually agree to recognize stays in a cross-border resolution other than stays that are consistent with the globally agreed upon Key Attributes. Given that the proposed moratoria are not consistent with the Key Attributes, it would be important for adherents to the Universal Stay Protocol to be able to exercise their opt-out rights if the proposed moratoria are enacted, notwithstanding the very negative implications. The only way to avoid this result would be to ensure that the BRRD and any amendments remain consistent with the Key Attributes.

ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient.

Today, ISDA has over 875 member institutions from 68 countries. These members comprise a broad range of 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, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org.