

Comments

of the Association of German Banks on the FSB Consultative Document:
“Cross-border recognition of resolution action”

1 December 2014

Lambert Koehling
Division Manager
Telephone: +49 30 1663-3150
Fax: +49 30 1663-
lambert.koehling@bdb.de

Ref. BdB: Re.05
Prepared by Kg

Association of German Banks
Burgstrasse 28
10178 Berlin | Germany
Telephone: +49 30 1663-0
Fax: +49 30 1663-1399
www.bankenverband.de
USt.-IdNr. DE201591882

I. General Remarks

The Association of German Banks has supported the general approach taken by the Financial Stability Board regarding the introduction of a comprehensive and consistent framework for the resolution of banks from the outset.

In view of the international nature of financial markets, the ability to implement resolution measures in relation to institutions or groups of institutions operating in more than one jurisdiction, is, of course, a necessary prerequisite for the effectiveness of such framework.

Accordingly, such framework necessarily has to address the competences of the resolution authority to take action as lead authority in another jurisdiction, the coordination between this resolution authority and the authorities from the other jurisdictions, and the recognition of the actual enforcement measures taken by the resolution authority in relation to a counterparty and assets outside its ordinary scope of the jurisdiction. The latter effectively requires, to a certain extent, the acceptance of an extraterritorial reach of actions and measures of a foreign public entity and thus the recognition of actions and effects ultimately governed by foreign public law.

A cross-jurisdictional exercise of resolution powers raises very complex practical and legal questions which can, ultimately, only be resolved by

- the adoption of internationally harmonised standards and rules regarding the recognition of measures in all relevant jurisdictions,
- the implementation of a legal (statutory) framework supported by or based on inter-governmental agreements setting out the rights, obligations and necessary protections for the parties which may be affected by the resolution measures, and
- close coordination between the relevant supervisory and resolution authorities of the affected jurisdictions in accordance with pre-determined rules and standards.

Against this background we welcome the opportunity to comment on the consultative document by the Financial Stability Board addressing this issue.

II. Key Observations

Our key observations can be summarized as follows:

- For the reasons set out in more detail in our response to question 4, we have serious concerns regarding the reliance on contractual clauses as a means of giving effect to resolution measures in another jurisdiction, which, in particular in the case of a bail-in or of the imposition of a stay regarding contractual termination rights, may severely impair the legal

and economic position of the counterparty vis-à-vis the institution under resolution. Effectively, such contractual clauses intend to give extraterritorial reach to regulatory measures. Contractual clauses are necessarily a very imperfect solution to address the challenges that come with such extraterritorial application and enforcement of regulatory powers. It should, in particular, not be expected that such contractual clauses will be easily enforceable in all jurisdictions or that they will remain legally unchallenged when resolution actions are taken; or that any such legal challenges will generally be unsuccessful. Resolution actions only relying on contractual clauses for their enforceability will always be subject to a considerable degree of legal uncertainty. This holds particularly true where such contractual clauses are to be relied upon without there being any statutory support under applicable local law or at least an inter-governmental agreement in place which can be taken as an indication that such type of contractual clause is not conflicting with public policy of the jurisdiction in question. It can also not be expected that legal opinions will be able to redress the legal risks effectively since they cannot do away with existing legal uncertainties or mandatory law. Therefore, we would view it as absolutely crucial that inter-governmental agreements on the mutual recognition of resolution action are entered into between the relevant jurisdictions, and that the concerted efforts of regulatory authorities to introduce internationally harmonised regulatory rules be continued.

- The precise scope of any recognition of resolution measures (that is, the extent to which the effectiveness of resolution measures is to be accepted as being enforceable and the limits these are subject to) must be clearly circumscribed, regardless of the means by which such recognition is to be achieved. Any recognition must also be contingent upon the existence of adequate safeguards, that is, safeguards which are consistent with standards set under the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB Key Attributes). Likewise, it must be ensured that the recognition of measures cannot invalidate essential risk mitigation instruments of institutions, in particular, the general effectiveness of close-out netting as means to reduce and manage default risks.
- As in the case of insolvency procedures in a cross-jurisdictional situation, it is of paramount importance to have clear and internationally harmonised and recognised rules for the determination of the lead/primary resolution authority. Ideally, the relevant resolution authority should already be determined in advance (e.g., the home authority of the group in question).
- Any regulatory rules requiring institutions to introduce contractual clauses giving effect to resolution measures also need to apply to all other relevant potential counterparties. Otherwise, the institutions subject to such a (unilateral) obligation face the very real risk that their counterparties will simply not accept such contractual clauses and will instead henceforth enter into transactions with other institutions which do not require submission to such resolution measures. This would of course largely defeat the purpose of the regulatory

initiative and result in severe competitive disadvantages for the institutions subject to the obligation.

III. Responses to individual questions

1. Are the elements of cross border recognition frameworks identified in the report appropriate? What additional elements, if any, should jurisdictions consider including in their legal frameworks?

We largely concur with the analysis. However, we see the need to address the issues set out below more clearly and also note the following:

- Existence of Appropriate Safeguards

In order to ensure an adequate protection of the interests of the counterparty of an institution under resolution, it should be set out more clearly that resolution measures need only be recognised to the extent these are combined with appropriate safeguards conforming to the requirements under the FSB Key Attributes. Specifically, the resolution regime in question should – as a minimum – provide for protective measures in relation to close-out netting provisions consistent with items 4.2 and 4.3 of the FSB Key Attributes and, in particular, observe the core principles set out in item 5 ("no creditor worse off"). At the same time, it should be ensured that the recognition of measures does not invalidate the effectiveness of essential risk mitigation instruments of institutions, in particular the general effectiveness and regulatory recognition of close-out netting as a means to reduce and manage default risks, since no counterparty will be able to accept a material impairment to a key risk mitigation technique.

Please see our response below to question 4 regarding the general concerns regarding the suitability of contractual clauses as a legal basis for granting resolution measures extraterritorial reach and the need for inter-governmental agreements and internationally harmonised regulatory rules as a necessary basis for ensuring the effectiveness of any such contractual provision. In this context, we note that it will, of course, not be possible to implement the element addressed under item 1.2 / No. 6 (legal protection of authorities and their officials) by way of contractual clauses.

- Determination of Lead Resolution Authority

As in the case of insolvency procedures in cross-jurisdictional situations, it is of paramount importance to have clear and internationally harmonised and recognised rules for the

determination of the lead/primary resolution authority. Ideally, the relevant resolution authority should already be determined in advance.

- Examples of Statutory Frameworks Giving Effect to Foreign Resolution Measures (Box 1)

As for the examples mentioned in Box 1, we would like to point out the following:

- The UNCITRAL Model Law on Cross-Border Insolvency is not a good example for an effective legal framework for the recognition of resolution measures, in particular resolution measures in relation to financial institutions, as it - *inter alia* - fails to address the need for appropriate safeguards.
- Likewise, the legal frameworks introduced in Switzerland and Singapore may not entirely conform to the requirements set out in the FSB Key Attributes, again, in particular with respect to the safeguards outlined therein.
- We note that no reference is made to the UNIDROIT Principles on the operation of Close-out netting Provisions adopted in May 2013, in particular Principle 8 thereof, which addresses the need to strike a balance between the legal protection of close-out netting provisions on the one hand and the powers of resolution authorities on the other hand.

2. Do you agree that foreign resolution actions can be given effect in different ways, either through recognition procedures or by way of supportive measures taken by domestic authority under its domestic resolution regime? Do you agree with the report's analysis of these approaches?

We refer to our response to question 3 as well as our response to question 4 regarding the need for inter-governmental agreements and statutory law as a legal basis for the recognition of foreign resolution actions.

3. Do you agree that achieving cross-border enforceability of (i) temporary restrictions or stays on early termination rights in financial contracts and (ii) 'bail-in' of debt instruments that are governed by the laws of a jurisdiction other than that of the issuing entity is a critical prerequisite for the effective implementation of resolution strategies for global systemically important financial institutions (G-SIFIs)? Is the effective cross-border implementation of any other resolution actions sufficiently relevant for the resolvability of firms that the FSB should specifically consider ways of achieving their cross-border enforceability?

We concur with the view that these two resolution actions (temporary stays and bail-in) will be the most challenging to give effect to in a cross-jurisdictional context. An asset transfer may presumably pose similar challenges.

We also assume that stays (temporary stays and even more so, indefinite stays) and the bail-in instruments will be the resolution measures causing the greatest concerns from the perspective of counterparties of institutions potentially subject to such a resolution measure, as all of these actions directly affect and impair the legal and economic position of such counterparty. These resolution measures may also have a significant adverse impact on counterparties' risk management since they can severely limit the effectiveness of contractual rights (such as close-out netting) they rely on in order to mitigate default risks connected to financial transactions.

Among these three, the bail-in will presumably be the one that will be the most difficult to accept by these counterparties – not only because a bail-in necessarily has a direct financial impact but also because counterparties will, in all likelihood, fear that a bail-in may be structured in such a way that it disproportionately affects foreign counterparties or that any discretion afforded to resolution authorities regarding both the decision to exercise bail-in powers as well as the eventual scope of the bail-in, may be exercised with a tendency to favour the home market of the resolution authority. These concerns can only be alleviated by ensuring that resolution measures can only be exercised

- within clearly circumscribed limits based on and defined by a statutory legal framework which includes appropriate safeguards, and
- in close coordination of both the home supervisory authorities of the counterparties and the resolution authority.

4. Do you agree that contractual approaches can both fill the gap where no statutory recognition framework is in place and reinforce the legal certainty and predictability of recognition under the statutory frameworks once adopted?

No. Contractual clauses cannot provide a sufficiently reliable legal basis for giving extraterritorial reach to regulatory powers of a regulatory authority in another jurisdiction. This holds even more true where such contractual clauses are not supported by statutory law permitting or requiring such clauses, or at least an inter-governmental agreement or internationally harmonised regulatory rules which can be taken as an indication that such clauses are consistent with public policy.

It is to be expected that local courts will view contractual rights effectively granting extraterritorial reach to regulatory rules with considerable reservations, even more so, where these may be perceived to be unilateral in nature or imposed upon the "local" counterparty. Such contractual provisions may, therefore, be considered to be incompatible with fundamental principles of local law (such as principles of equity or general fairness, or statutory requirements concerning the fairness of standard terms and conditions or general principles of public policy (*ordre public*) or even investor protection). This risk is significantly higher where such contractual provisions are not supported by statutory laws and inter-governmental agreements as well as internationally harmonised regulatory requirements which could serve as an indication that the clauses are consistent with public policy principles of that jurisdiction. In sum, it cannot be expected that such contractual clauses will be easily enforceable in all jurisdictions or that they will remain legally unchallenged when resolution actions are taken; or that any such legal challenges will generally be unsuccessful. Consequently, any resolution action solely relying on contractual clauses for their recognition and effectiveness will always be subject to a considerable degree of legal uncertainty.

Moreover, contractual solutions can only be implemented with the consent of the counterparty. In view of the considerable risks and disadvantages involved, counterparties have no motivation to consent unless they are themselves required to do so under applicable law.

We note and welcome that the consultation document recognises some of the above-mentioned concerns and deficiencies of a contractual approach in the introductory section of item 2. We do, however, have the following comments regarding the subsequent, more specific observations set out under items 2.1.1 et seq. of the consultation paper:

- ISDA Protocol:

A protocol system such as the one operated by ISDA is a helpful tool to facilitate the implementation of contractual provisions between a great number of contracting parties. However, it cannot resolve all problems arising in this context:

It still requires the willingness of each party to adhere to the protocol and cannot capture parties unwilling to accept the contractual clauses in question.

The protocol system can also not be used to amend or implement provisions in other types of standard agreements: The terms to be implemented via a protocol need to be aligned with the provisions of the agreement in question and are therefore agreement-specific. Because of the complexity of the issues involved, it will not be possible to rely on a generic / general clause for all types of agreements. Moreover, other types of agreements may well be subject to the laws of the same jurisdiction.

Finally, the protocol system is not necessarily accepted by, or appropriate for, all potential counterparties (e.g., non-financial institutions) and may not necessarily be accepted in all jurisdictions.

- Key Principles for Cross-Border Bail-In Clauses: Contractual Provisions

Under item 2.2.1 No. 1 of the consultation paper it is stated that "*courts will generally enforce contractual provisions properly entered into unless contrary to public policy*": We believe that this expectation may be too optimistic. In particular, we would argue that, because of the unusual nature of the rights granted by such clauses and the far-reaching consequences, it is likely that such contractual clauses, even if properly drafted with best efforts, are amenable to legal challenges not only on the basis of public policy principles but also other general legal principles (see our comments above). The lack of any inter-governmental agreements and/or statutory law making the recognition of resolution measures part of the public policy will only increase the likelihood of the success of such legal challenges.

The same applies correspondingly to the issue of waivers and consents addressed in No. 4 of item 2.2.1 of the consultation: Counterparties need to be able to clearly define and delineate in advance the extent and limits of such waivers (or the equivalent legal concept under applicable law). Moreover, to what extent counterparties are able to contractually waive rights or consent to such measures (or accept a limitation of their rights in an equivalent manner under applicable law) may differ considerably between jurisdictions.

In general, we believe that careful consideration should be given to the fact that any statement or recommendation on how to draft the terms of a contractual provision regarding the bail-in has to take into account that the contractual terms to be introduced will have to address the requirements of very different jurisdictions with very different legal traditions and concepts. Recommendations or expectations being too detailed or specific should be avoided. In addition, it is important that none of the recommendations

or requirements inadvertently presuppose specific legal concepts, as these may not be easily transposable into equivalent legal concepts of all other jurisdictions.

- Key Principles for Cross-Border Bail-In Clauses: Legal Opinions

It can also not be expected that legal opinions will be able to effectively redress the legal risks and uncertainties described above:

Legal opinions can only assess or describe legal risks and make recommendations on how to minimise or avoid these, where this is possible. Although they may help drafting the relevant clauses such that legal risks are minimised, this can, however, only be done to the extent this is actually possible under applicable law and always with residual risks (which – because of the unusual nature of the clauses and the reasons mentioned above – can be expected to be higher than in other situations). Depending on the jurisdiction, it may well impossible to enter into a legally effective contractual clause giving effect to all aspects of a bail-in measure or other resolution measures subject to the laws of another jurisdiction.

The necessary effectiveness and certainty can, consequently, only be achieved through clear statutory laws and inter-governmental agreements as well as internationally harmonised regulatory rules requiring such recognition. Lacking these, contractual provisions can only be an imperfect and interim solution to extend the reach of regulatory powers under a resolution regime. It should also be clear that this approach has considerable inherent risks and disadvantages.

Should legal opinions be required notwithstanding the above, too formal, detailed and specific requirements should be avoided as, depending of the type of agreement in question, institutions may find it useful to incorporate the relevant legal issues in opinions obtained for other purposes. In addition, the format of a legal opinion may also depend on the legal traditions and laws of a jurisdiction. The most flexible approach in this respect would seem to be to give a resolution authority the right to demand legal opinions on a case by case-basis in the course of the institutions' resolution planning.

5. Are the key principles for recognition clauses in debt instruments set out in the report appropriate? What other principles or provisions do you consider necessary to support the exercise of 'bail in' powers in a cross border context?

The key concerns voiced above regarding a contractual solution should apply to some extent correspondingly in the case of debt instruments: For example, terms and conditions in debt instruments are often subject to the same legal requirements applicable to contracts or similar requirements so that the legal risk described above should be the same. In addition investor protection requirements would need to be taken into account.