ISDA® Safe, Efficient Markets

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European Banking Authority
Floor 46
One Canada Square,
London
E14 5AA

By email to mrelreport@eba.europa.eu

ISDA response to EBA Interim Report on MREL – Report on implementation and design of the MREL framework – EBA-Op-2016-12 - 19 July 2016

The International Swaps and Derivatives Association, Inc. (**ISDA**)[1] is grateful for the opportunity to provide feedback on the European Banking Authority (the **EBA**) interim report on MREL published in July 2016 (the **Consultation**). Given ISDA's focus on over-the-counter (**OTC**) derivatives markets, ISDA's response is primarily focussed on the impact on derivatives markets.

We note that derivatives which are financial instruments as set out in points (4) to (10) of Section C of Annex I to the Markets in Financial Instruments Directive (**MiFID**) are *eligible liabilities* pursuant to the EU Bank Recovery and Resolution Directive (**BRRD**). However, derivatives liabilities are excluded from MREL (pursuant to Article 45(4)(e) of the BRRD as implemented in the relevant member state). Consequently, ISDA wishes to focus its response on section 6.2 of the Consultation which relates to third country recognition of resolution powers and does not wish to focus on wider MREL considerations. Notwithstanding that ISDA's comments focus on derivatives liabilities, our view is that it is important for the EBA to consider any amendments to Article 55 in the context of the operations of in-scope BRRD entities as a whole.

ISDA broadly supports global and EU efforts for cross-border recognition of resolution action and, in a contractual recognition of bail-in context, has published the ISDA 2016 Bail-in Article 55 BRRD Protocol (Dutch/French/German/Irish/Italian/Luxembourg/Spanish/UK entity-in-resolution version) to enable certain in-scope derivatives counterparties to comply with Article 55 of the BRRD relating to the contractual recognition of bail-in.

Notwithstanding this support, ISDA strongly agrees with the EBA that a reduction of the burden of compliance with third country recognition requirements is necessary. Significant concerns remain in respect of how Article 55 and, in particular, the provisions of the related Article 55 RTS published in the Official Journal of the EU on 8 July 2016 (the **Article 55 RTS**) impact derivatives markets. In a derivatives context, the burden is significant and disproportionate, not least because derivatives appear unlikely to be bailed-in in practice due to a number of practical difficulties, particularly as regards valuation.

In addition, whereas the majority of derivatives liabilities are likely to be collateralised leaving little or no liability to bail in, it is not currently clear that collateralised derivatives liabilities may benefit from the secured liabilities exclusion as set out in the Article 55 RTS meaning that the market view is that Article 55 wording may currently be required in all collateralised derivatives liabilities.

More generally, we note that there does not appear to be consistent application (and, thus, a level playing field) across the EU in respect of how Article 55 of the BRRD is being interpreted by the relevant authorities

[1] Information regarding ISDA is set out in Annex 1 to this response.

in different EU jurisdictions in terms of which liabilities are within scope. Thus, there appears to be a risk that some entities could be at a competitive disadvantage to the extent that they are required to push for inclusion of Article 55 language in certain liabilities whereas their EU competitors located in other member states (as well as their non-EU competitors) are not so required. Consequently, harmonisation of the contractual recognition of bail-in rules on a pan-EU basis is extremely desirable.

Based on the policy approaches put forward by the EBA, ISDA's view is that, whilst policy approaches (i) and (ii) could undoubtedly be helpful (as discussed further below), the best way to reduce the compliance burden would be to limit the scope of Article 55 so that it only applies to instruments eligible for MREL – ie policy approach (iii) as set out in the Consultation.

ISDA sets out below its comments on the practical difficulties faced in a derivatives context below as well as suggested approaches to improve the regime.

PRACTICAL DIFFICULTIES FACED IN IMPLEMENTING CONTRACTUAL RECOGNITION OF BAIL-IN CLAUSES IN A DERIVATIVES CONTEXT

Key practical difficulties in a derivatives context include:

- **Lack of consistency of application of the contractual recognition of bail-in requirement across member states** – Currently, the scope of the contractual recognition of bail-in requirement has been interpreted differently in different member states. Members believe that some of the regulatory inconsistency has arisen due to the extremely broad scope of the contractual recognition rule, as well as the uncertain interpretation of some provisions (for example, what constitutes a "liability"). The breadth and ambiguity of the rule have opened the door to varying interpretations in different jurisdictions, as well as made it necessary for regulators to devise solutions on a member state-by-member state basis in situations where it is clear that compliance is impossible. Some of these situations are discussed further below (for example, in respect of liabilities to non-EU central counterparties (**CCPs**)). Lack of consistency across member states risks putting certain EU in-scope entities at a competitive disadvantage vis-à-vis their competitors (both in and outside of the EU) as well as greatly increasing the compliance burden for firms operating on a cross-border basis. Harmonisation of the contractual recognition of bail-in rules on a pan-EU basis is, therefore, extremely desirable. Consequently, ISDA's view is that the most effective way to reduce the compliance burden is to limit the scope of Article 55 to apply to a clearly defined set of liabilities in a manner that can be applied consistently across all member states reducing the need for discretion by each resolution authority – this translates into a preference for policy approach (iii).

- **Uncertainty relating to use of the secured liabilities exclusion in a derivatives context and lack of alignment with market conventions –** A significant problem in respect of the application of contractual recognition of bail-in to derivatives is the lack of clarity over the "secured liabilities" exclusion. In summary, based on the Article 55 RTS, it is not clear which derivatives liabilities (if any) may benefit from an exclusion from the contractual recognition of bail-in requirement by virtue of the "secured liabilities" exemption.

  The main problem with the formulation is the requirement that any collateralisation be "on a continuous basis in compliance with regulatory requirements of EU law or of the law of a third country achieving effects that can be deemed equivalent to EU law". The result is that derivatives liabilities that would typically be regarded by the relevant counterparties as "fully collateralised" may be within scope of the contractual recognition of bail-in requirement if there are no applicable regulatory requirements to which the collateralisation relates (for example, liabilities under a non-WGMR[2]

[2] In 2009, the G20 initiated a regulatory reform programme adding the development of margin requirements for non-centrally cleared derivatives to the programme in 2011 and mandating the International Organization of Securities Commissions (**IOSCO**) and the Basel Committee on Banking

compliant New York law-governed ISDA Master Agreement incorporating a New York law-governed CSA). It is difficult to negotiate the insertion of a bail-in clause when the counterparty may regard the liability as collateralised. This disconnect from the standard market understanding of collateralisation may lead to counterparties refusing to accept an amendment to include Article 55 wording, putting EU-regulated firms at a competitive disadvantage vis-à-vis their non-EU counterparts.

Another issue is that the timing of contractual recognition of bail-in requirements and WGMR requirements are not aligned. Rather than being phased in from September 2016 depending on counterparty type in line with global agreement, the EU WGMR requirements have now been delayed and it is currently not clear when they will enter into effect. Certain in-scope liabilities will be compliant with WGMR requirements in other jurisdictions from September 2016 (for example, the US WGMR requirements). However, as there are currently no EU WGMR requirements in effect, it will not be possible for a US WGMR compliant liability to be "equivalent" to EU law (ie as there are no existing EU requirements). This means that counterparties must include contractual recognition of bail-in language even if the relevant transaction is subject to WGMR requirements in a non-EU jurisdiction and/or will be subject to WGMR requirements when the EU rules enter into effect. In this context, the effort required to include wording for a short period of time is disproportionate to the benefits.

- **Impracticability of including Article 55 language in liabilities to non-EU CCPs -** As the contractual recognition of bail-in requirement only applies to non-EEA law governed liabilities (thereby excluding most (if not all) contracts between EEA clearing members and EEA CCPs), it is more likely that the requirement will be of relevance to non-EEA CCPs (for example, CCPs established in the US or in Asian jurisdictions). It is not possible for in-scope counterparties to amend the terms without consent of the relevant non-EU CCP which has not been forthcoming. To address this issue in a UK context, the UK PRA has provided welcome clarity that liabilities to non-EU FMIs (for example, non-EU CCPs) may fall in the category of liabilities which it would be impracticable to amend. To provide greater certainty, the impracticability of including Article 55 wording in such liabilities should be also recognised in any amendments to Article 55 (note: this could be achieved indirectly via policy approach (iii). We note in any event that the EBA does not anticipate that liabilities to CCPs will be bailed in in practice either because they will be excluded liabilities or because there is unlikely to be an unsecured liability to bail in.[3] Consequently, the compliance burden and cost associated with a requirement to include Article 55 wording in liabilities to CCPs does not seem justified.

- **Uncertainty relating to treatment of client cleared derivatives liabilities** - Whilst, at least in a UK context, the PRA has indicated that liabilities to non-EU FMIs (for example, non-EU CCPs) may fall in the category of liabilities which it would be impracticable to amend, the position in respect of client cleared derivatives liabilities is unclear even though, typically, the collateral arrangements between a client and clearing member match the collateral arrangements between the clearing member and the CCP. In a client cleared context, the parties would need to seek to rely on the secured liabilities exclusion. However, it is unclear whether the secured liabilities exemption could be relied upon in the client cleared context (or indeed in a clearing member/CCP context) because it is less obvious that the collateralisation is "in compliance with regulatory requirements".

Supervision (**BCBS**) to develop consistent global standards in respect of such margin requirements. IOSCO and BCBS subsequently formed the Working Group on Margining Requirements (**WGMR**) to develop a proposal on margin requirements for non-centrally cleared derivatives. In September 2013, BCBS and IOSCO published a framework for margin requirements for non-centrally cleared derivatives (the **BCBS-IOSCO Framework**) which was subsequently amended in March 2015 to reflect a revised timetable for implementation. The BCBS-IOSCO Framework sets out the key objectives, elements and principles of the final margining framework for non-centrally cleared derivatives globally. Margin rules are being developed in the EU as well as in other jurisdictions. Each of these jurisdictional rule sets is informed by the BCBS-IOSCO Framework and are referred to colloquially as the "WGMR requirements".

[3] https://www.eba.europa.eu/documents/10180/1312572/EBA-RTS-2015-11+RTS+on+the+valuation+of+derivatives.pdf. Note that page 3 of the executive summary provides "Liabilities of a bank under resolution to a central counterparty (CCP) are likely to fall under the exemptions from bail-in provided for under the BRRD (eg Article 44(2)(b))". The final report provides that "If risk mitigation policies are adequately followed, it is unlikely that a defaulting clearing member would face a liability to the CCP exceeding the collateral posted. Thus, bailing in such liabilities seems unlikely under normal risk-management conditions" (see page 10).

- **Broad definition of "liability" has led to a lack of clarity in respect of scope and the requirement to include the wording in liabilities not suitable for bail-in –** The term "liability" is not defined in the BRRD (although some regulators, such as the UK PRA, have sought to define this term). In a UK context, the broad definition of "liability" in the UK PRA rules may extend to non-monetary/contingent obligations leading to scope for mismatch of application vis-à-vis other member states who may have taken a narrower approach to interpretation. Uncertainty in respect of liabilities included has led to market practice of inclusion of Article 55 wording in a wide range of liabilities as a matter of caution where such liabilities would not affect resolvability. This has dramatically increased both direct costs of compliance with the rule through additional time spent negotiating and amending agreements on a broad scale, and indirect costs of compliance through loss of business by impacted firms, without a corresponding benefit to the resolvability of impacted firms.

  In addition, certain low value contracts (or *de minimis* contracts) will have little or no impact on resolvability and, thus, it seems costly and disproportionate to include Article 55 wording in these liabilities. It is difficult to see how the inclusion of Article 55 wording in these contracts would have any meaningful impact in the context of a resolution.

- **Conflict with applicable third country law and regulation –** Firms have found it impossible to agree the inclusion of Article 55 wording in liabilities governed by certain third country laws where inclusion is not permitted by the law or regulation of that third country, as well as for certain liabilities to central banks and government entities regardless of the governing law. Certain members have been informed by local regulators in non-EEA FSB countries that they do not expect contractual recognition of bail-in language to be incorporated in agreements with domestic counterparties.

DISCUSSION OF SUGGESTED EBA APPROACHES TO IMPROVE THE REGIME

ISDA's preferred approach is policy approach (iii) as it addresses existing concerns relating to the application of Article 55 to derivatives liabilities and also would ensure a more consistent application of the requirements throughout member states than policy approaches (i) and (ii). Below we explain the rationale for this preference and discuss the respective advantages and disadvantages of each suggested approach from a derivatives perspective.

- **Policy approach (i) – Introduce additional exemptions** – Additional exemptions (for example, in respect of liabilities to CCPs) could undoubtedly be useful. The problem with this approach is that exemptions necessarily take the form of an exhaustive list and this approach (at least if used alone) would consequently run the risk of not including all relevant liabilities (for example, client cleared derivatives liabilities may not be excluded even though liabilities to CCPs may be excluded). Additionally, unless existing issues with current exemptions are also addressed in a satisfactory manner (for example, the above issues with the secured liabilities exemption), many of the existing compliance issues in a derivatives context will remain.

- **Policy approach (ii) – Introduce a power for resolution authorities to grant waivers from Article 55 –** Waivers could also be useful to firms. However, as waivers are agreed at a national level, they can lead to inconsistent application of the rules as between member states. Thus, this is not ISDA's preferred approach. As outlined above, inconsistent application and over-reliance on waivers could put firms in certain jurisdictions at a competitive disadvantage and create an unlevel playing field. Firms would also be required to apply for waivers and assess the position in each different member state in order to comply which could be burdensome. Also, as with policy approach (i), unless existing issues with current exemptions are also addressed in a satisfactory manner (for example, the above issues with the secured liabilities exemption), many of the existing compliance issues in a derivatives context will remain.

However, if waivers were limited (as suggested by the EBA) to liabilities not eligible for MREL, it is possible that most (if not all) derivatives liabilities could be excluded (depending on final determination of the liabilities that constitute MREL).

If waivers were limited (as also suggested by the EBA) to liabilities not eligible for bail-in, this would not address the concerns above relating to derivatives liabilities as derivatives liabilities are eligible for bail-in (thus, for example, concerns relating to the secured liabilities exemption would remain).

As suggested by the EBA in the alternative, if penalties are only applied by resolution authorities when failure to implement Article 55 constitutes an impediment to resolvability, this could be problematic as it would require determination on whether there would be an impediment to resolvability. There would be less clarity as to whether a particular liability was in or out of scope at the outset when drafting transaction documentation. Whilst alone this would not provide a satisfactory solution, firms may feel reassured if resolution authorities made it clear that a common sense enforcement of the requirement is the approach they would take as a matter of course.

- **Policy approach (iii) – Limit the scope of Article 55** – The EBA suggests limiting the scope of Article 55 so that it only applies to instruments which are eligible for MREL. From a derivatives perspective, this approach would address a number of the concerns highlighted above as derivatives liabilities (at least those defined in MiFID) are excluded from MREL (see Article 45 of the BRRD). The Bank of England has also stated that, "In particular, where the value of a liability depends significantly on derivatives or embedded derivative components, it is likely to be difficult to value rapidly in resolution. This presents a practical barrier to bailing in these liabilities. The Bank therefore considers that liabilities with significant derivative components…are unlikely to be suitable MREL resources. Liabilities subject to set off or netting arrangements are also not appropriate MREL resources."[4]

  Thus, it would no longer be necessary (if policy approach (iii) is taken) to rely on the secured liabilities exclusion and the above issues with the exclusion would consequently be no longer relevant. We note that this approach is in line with the approach agreed at a global level (for example, see the FSB Principles for Cross-Border Effectiveness of Resolution Actions – 3 November 2015).

  This is ISDA's preferred approach as it addresses concerns relating to derivatives liabilities and also would ensure a more consistent application throughout member states than a waiver or exemption approach.

ISDA notes that a statutory – as opposed to contractual - framework is the optimum solution to cross-border recognition issues (as per the FSB Principles of Cross-Border Effectiveness of Resolution Actions– 3 November 2015). Additionally, the development of determinations by resolution authorities in member states to the effect that the liabilities can be subject to bail-in pursuant to the law of the third country and/or binding agreements with third countries to that effect (as contemplated by Article 55 of the BRRD) would also provide a greater degree of legal certainty to market participants than contractual recognition of bail-in clauses and would reduce the risk of legal challenge.

We hope that you find our comments useful in your continuing deliberations. Please do not hesitate to contact the undersigned if we can provide further information about the derivatives market or other information that would assist the EBA in its work in relation to the effective implementation of the contractual recognition of bail-in requirements. Please contact Samantha Riley (sriley@isda.org) if you have any queries.

Yours sincerely

[4] http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf

ISDA

Katherine T. Darras
ISDA General Counsel

Annex 1

ABOUT ISDA

Since its founding in 1985, 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.

Today, the Association has over 850 members from 67 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 addresses of our European offices are as follows:

International Swaps and Derivatives Association, Inc.
c/o NCI Park Leopold Business Centre, 4th floor
38/40 Square de Meeûs
Brussels 1000
Belgium
Telephone: +32 (0) 2 401 8758
Fax : +32 (0) 2 401 8762
isdaeurope@isda.org

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD
United Kingdom
Telephone: +44 (0) 20 3088 3550
Fax: +44 (0) 20 3088 3555
isdaeurope@isda.org

Our registration number in the relevant EU register is 46643241096-93.

More information about ISDA is available from our website at http://www.isda.org, including a list of our members, the address of our head office in New York and other offices throughout the world and details of our various Committees and activities, in particular, our work in relation to financial law and regulatory reform.