The EU Bank Recovery and Resolution Directive (BRRD)\(^1\) and Derivatives

The below is intended to be a resource that sets out key impacts on derivatives under the BRRD for informational purposes only. This is summary in nature and is not legal advice and should not be relied upon as a basis for providing advice.

### KEY IMPACTS ON DERIVATIVES

- **The BRRD is the EU’s response to global initiatives to end so-called “too big to fail” problem.**
- **The BRRD will not just affect entities directly within its scope, it will also impact any entity that transacts with those entities.**
- If an entity meets the criteria for resolution, **resolution authorities may use various “resolution tools”**. Derivatives contracts may (i) be transferred to a new counterparty, (ii) be “bailed-in” – ie written down (but only to the extent unsecured) or converted into equity (but only the unsecured portion), or (iii) remain with the entity under resolution.
- **A new resolution tool - “bail-in” - applies to derivatives liabilities** but only to the net close-out amount. Derivatives would be terminated and valued by resolution authorities for the purposes of bail-in in accordance with the procedure set out in the BRRD.
- **Resolution authorities have wide ranging powers in respect of the liabilities of an entity-in-resolution.** Contractual termination and other rights may be temporarily suspended and/or permanently overridden. Payment and delivery obligations may be temporarily suspended and contractual terms may be modified or cancelled. These powers may be used in respect of derivatives liabilities.
- However, **the BRRD provides for safeguards** to ensure the protection of netting, set-off, security and collateral (including title transfer collateral) arrangements in resolution.
- **Cross-border recognition of resolution action is a major concern** and as a result:
  - Contractual recognition of bail-in for certain derivatives liabilities governed by non-EU law is required by the BRRD. ISDA has produced a protocol solution.
  - Regulators have requested **ISDA Resolution Stay Protocols** be produced as a contractual solution to ensure that stays and overrides on termination and other rights in resolution will be respected in third country jurisdictions. Statutory stay rules are also being developed in certain jurisdictions.
  - Thus, **counterparties may be required to contractually agree** to bail-in and the imposition of resolution stays in their contracts with in-scope entities to the extent they wish to continue to trade with those entities.

1. **THE BRRD**

The BRRD is the EU’s response to global initiatives (primarily the Financial Stability Board (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions\(^2\) (the **FSB Key Attributes**)). The

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\(^1\) Directive 2014/59/EU.
BRRD provides for the establishment of a harmonised EU-wide framework for the recovery and resolution of credit institutions and certain systemically-important investment firms.3

The BRRD can be broadly divided into three sections: (i) preparation and planning; (ii) early intervention; and (iii) resolution. The focus of this summary is on the “resolution” stage. From a derivatives perspective, to date, much of the interest has focussed on the new resolution tool – “bail-in” - as well as the impact on termination rights.

2. THE EU FRAMEWORK

As an EU directive, the BRRD was required to be implemented into the national law of each EU member state by 1 January 2015 other than the “bail-in” tool which was required to be implemented by 1 January 2016. The BRRD text itself is the framework (or “level 1”) legislation and is supplemented in certain areas by secondary (or “level 2”) legislation (ie regulatory technical standards (RTS) and implementing technical standards (ITS) produced by the European Commission in consultation with the European Supervisory Authorities (eg the European Banking Authority (EBA)).

It is important to note that, as the BRRD is required to be implemented into the national law of each EU member state, the resolution regime in each EU member state may not be the same. For further information relating to implementation in EU, European Economic Area (EEA) and European Free Trade Association (EFTA) states4, please refer to the ISDA BRRD Implementation Monitor.5

On 23 November 2016, the EC published proposals to amend certain aspects of the BRRD (the “BRRD2 Proposals”).6 Given the proposals have only just been published, it is currently difficult to quantify the precise impact but the proposals (once finalised) mean that certain provisions of the BRRD will be amended in due course. A discussion of those changes is outside the scope of this summary.

3. IF AN IN-SCOPE ENTITY MEETS THE CRITERIA, RESOLUTION TOOLS AND POWERS MAY BE APPLIED

If an entity meets the criteria for resolution7, the BRRD seeks to provide the relevant authorities in each member state with a minimum set of resolution powers to ensure that certain resolution tools can be used effectively across the EU.

3.1 Resolution tools

The resolution tools, some of which were already part of the law of certain member states, are: (i) the sale of business tool8; (ii) the bridge institution tool9; (iii) the asset separation tool10; and (iv) the bail-in tool (in respect of which see further below).11 The use of resolution tools may mean that derivatives liabilities are transferred to another entity or “bailed-in”.

3.2 General and ancillary resolution powers

Resolution powers are broad and include:

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4 Recital (1) of the BRRD states the BRRD aims to “prevent insolvency or, when insolvency occurs, to minimise negative repercussions by preserving systemically important functions of the institution concerned” and to minimise the costs for tax payers.

5 Note that Switzerland is not required to implement BRRD but has introduced a regime with similar characteristics to BRRD.

6 http://www2.isda.org/isda-brrd-implementation-monitor/.


8 See Articles 32 and 33 of the BRRD.


10 Article 42 of the BRRD.

11 Article 43 and Article 63(1)(e)-(i) and Article 59 of the BRRD.
• the **general powers**\(^{12}\) - which include the power to transfer rights, assets or liabilities of an institution in resolution to another entity, the power to write-down, convert or cancel certain liabilities and to extend the maturity of certain liabilities and the power to close out and terminate financial contracts or derivatives contracts for the purposes of bail-in; and

• the **ancillary powers**\(^{13}\) - which include the power to cancel or modify the terms of a contract to which the institution under resolution is a party.

### 3.3 Specific resolution powers

Resolution authorities are also given some specific powers to help them effect an efficient resolution including the:

(a) **Mandatory default override power**\(^{14}\)

(b) **Power for temporary suspension of payment and delivery obligations**\(^{15}\)

(c) **Power for temporary suspension of enforcement of security**\(^{16}\)

(d) **Power for temporary stay of termination rights**\(^{17}\)

Resolution powers may mean that the rights of counterparties to derivatives transactions with the entity under resolution or a related entity are affected.

### 4. Resolution tools and powers must be exercised in compliance with ‘Safeguards’

As the powers of resolution authorities to override other legal and contractual rights are very broad, the need for appropriate and robust safeguards is very important.\(^{18}\)

Crucially, in a derivatives context, safeguards relating to the protection of security, title transfer financial collateral, structured finance, set-off and netting arrangements have been introduced with the aim of ensuring that these arrangements cannot be disrupted in the event of a resolution. Covered bond arrangements are also covered by the protections.

Safeguards include the prevention of a transfer of some but not all of the rights and liabilities under a protected arrangement (to avoid “cherry-picking” by resolution authorities) – known as a partial property transfer - and protection in the context of cancellation or modification of contract terms.

There is also protection for the operation of trading, clearing and settlement systems – ie the default rules of these systems take precedence over partial transfers and contractual modifications.\(^{19}\)

A safeguard is also included so that creditors are not worse off in the event of a bail-in or partial property transfer than they would be should normal insolvency proceedings be commenced.\(^{20}\)

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\(^{12}\) Set out in Article 63 of the BRRD.

\(^{13}\) Set out in Article 64 of the BRRD.

\(^{14}\) Article 68 of the BRRD.

\(^{15}\) Article 69 of the BRRD.

\(^{16}\) Article 70 of the BRRD.

\(^{17}\) Article 71 of the BRRD.

\(^{18}\) Set out in Articles 73-80 of the BRRD.

\(^{19}\) Article 80 of the BRRD.

\(^{20}\) Article 73 of the BRRD.
5. **BAIL-IN**

5.1 **What is bail-in?**

Under the BRRD, resolution authorities have the power to write down a failing institution’s liabilities (ie certain claims of unsecured creditors of a failing institution) to the extent required in proportion to losses (or to zero) in order to recapitalise the institution as a going concern or to convert liabilities into equity. These ‘write-down and conversion powers’ are also known as “bail-in”. A “bail-in” of creditors and shareholders is intended to avoid a “bail-out” by the relevant government and, thus, to address the moral hazard concern.

5.2 **What are the general rules for derivatives and bail-in?**

(a) Derivatives liabilities are, in principle, bail-in-able

(b) But only the net close-out amount can be bailed in

(c) Derivatives liabilities will be terminated and valued by resolution authorities for the purposes of resolution.

(d) Derivatives liabilities will not be bailed-in first - the creditor hierarchy must be respected

5.3 **Are there any exclusions to the general rule?**

(a) **Exclusions from bail-in**

There are also a number of exclusions from bail-in. Of particular interest in a derivatives context is the exclusion relating to “secured liabilities” — although note that this exclusion does not include any “excess” over the value of the security. “Secured liabilities” include a liability secured by a charge, pledge or lien or collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements.

(b) **Discretionary exclusions at the point in time of a bail-in**

In exceptional circumstances, resolution authorities may also apply discretionary exclusions to bail-in (subject to certain conditions) at the point in time of resolution. The Commission Delegated Regulation (EU) 2016/860 of 4 February 2016 published in the OJ on 1 June 2016 further specifies circumstances where exclusion is necessary. It is possible, that resolution authorities may exclude derivative liabilities on a case-by-case basis at the point in time of a bail-in. However, limited comfort can be taken from this prior to a bail-in as there is no certainty as to whether these exclusions would be used in practice and exclusions may be applied differently by different resolution authorities.

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21 Articles 43-55 and 63(1)(e)-(i) of the BRRD.
22 See Article 44(2) of the BRRD.
23 See Article 44(2)(b) of the BRRD.
24 As explained towards the end of Article 44(2) of the BRRD.
25 Article 44(3) of the BRRD.
26 Article 44(3) of the BRRD.
5.4 What is the impact on liabilities governed by a non-EU law? Article 55 of the BRRD - Contractual recognition of bail-in requirement

The BRRD amends the EU Credit Institutions Winding Up Directive (CIWUD)\textsuperscript{28} so that, if the BRRD has been properly implemented in the relevant member states, the application of bail-in powers should be recognised and enforced across the EU. There is, however, less clarity as to whether a court in a non-EU jurisdiction would recognise and enforce EU bail-in powers (to the extent these powers had not been expressly recognised in the relevant non-EU jurisdiction) meaning that counterparties entering into contracts governed by a non-EU law may end up being treated differently in a resolution scenario to those entering into contracts governed by an EU law.

In order to address this and ensure that liabilities governed by a non-EU law may also be bailed in in EU member states, Article 55 of the BRRD requires that, if a liability is issued or entered into by an in-scope entity after the relevant implementation date, is governed by a “third country” (ie non-EU) law and is not an “excluded liability” or an excluded deposit, a contractual recognition clause is included in each relevant liability. Pursuant to a contractual recognition clause, the creditor or party to the agreement creating the liability recognises that the liability may be subject to bail-in and agrees to be bound by any bail-in. Further detail as to the list of liabilities excluded and the contents of the term required under Article 55 are set out in the Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 published in the OJ on 8 July 2016 (the Article 55 RTS).\textsuperscript{29}

The BRRD requires that provisions are adopted by member states in order to comply with the Article 55 requirement by 1 January 2016 at the latest. From a derivatives perspective, it is worth emphasising that:

(a) The term “liability” is very broad.
(b) The requirement only applies to liabilities governed by a third country (non-EU) law
(c) The requirement can apply to existing as well as new agreements.
(d) There is uncertainty relating to use of the “secured liabilities” exclusion”.
(e) The contents of a contractual recognition clause must comply with the Article 55 RTS and all elements listed in the Article 55 RTS must be addressed

5.5 ISDA has produced a protocol solution to assist with Article 55 compliance

ISDA has produced the ISDA 2016 Bail-in Article 55 BRRD Protocol (the Article 55 Protocol)\textsuperscript{30} which offers market participants an efficient way to amend the terms of certain agreements to reflect the requirements of Article 55 of the BRRD as implemented in the relevant jurisdiction. It is worth noting that the scope of the Article 55 Protocol is limited to certain entity and transaction types only.

The Protocol aims to assist in-scope Dutch, French, German, Irish, Italian, Luxembourg, Spanish and UK entities to comply with the requirement. Additionally, the Article 55 Protocol only amends existing ISDA Master Agreements and certain other master agreements, framework agreements and give-up and execution agreements which are governed by a non-EU law. It does not purport to amend all in-scope liabilities. Further detail on the Article 55 Protocol can be found in the FAQs: http://www2.isda.org/functional-areas/protocol-management/faq/28/.

\textsuperscript{28} Directive 2001/24/EC.
\textsuperscript{29} http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32016R1075
\textsuperscript{30} http://www2.isda.org/functional-areas/protocol-management/protocol/28
6. DERIVATIVES COUNTERPARTIES MAY BE UNABLE TO CLOSE-OUT AND/OR EXERCISE OTHER RIGHTS IN RESPECT OF THEIR DERIVATIVES CONTRACTS IF THEIR COUNTERPARTY IS FAILING

6.1 Will resolution trigger contractual termination rights under my ISDA Master Agreement?

Regulators had expressed concern that the simultaneous close-out of derivatives transactions during the resolution of a large, cross-border bank could hamper resolution efforts and destabilise markets. As a result, to allow the resolution to happen, special resolution regimes usually permit termination and other rights (which may include rights under Section 2(a)(iii) of the ISDA Master Agreement and rights to enforce security) to be permanently overridden (to the extent that rights relate to early intervention or resolution) and/or to be stayed for a short period of time, provided that the contractual payment and delivery obligations and the provision of collateral continue to be performed.

Any event of default that may otherwise have been triggered under the ISDA Master Agreement may, therefore, be permanently overridden (to the extent it relates to early intervention or resolution) or may be temporarily suspended as a result of the BRRD (equally parties may be unable to rely on Section 2(a)(iii) of the ISDA Master Agreement to withhold performance).

As noted above, the BRRD includes certain resolution powers to achieve this including: a mandatory default override power\(^{31}\); and a power for temporary stay of termination rights\(^{32}\).

Whether the taking of resolution action will trigger an event of default under an ISDA Master Agreement (or, indeed, any other agreement) and whether a party can rely on Section 2(a)(iii) of the ISDA Master Agreement is, therefore, somewhat academic given the override.

However, it may be possible to terminate the contract in certain circumstances, for example, if the contractual payment and delivery obligations and the provision of collateral are no longer being performed or if an event of default arises under the contract which is not connected to the resolution.

6.2 Will the mandatory default override and temporary stay provisions of the BRRD be recognised in non-EU jurisdictions?

Possibly not. The problem is that (outside the EU and, consequently, the immediate reach of the BRRD) it is very difficult to achieve political agreement on a cross border recognition regime of statutory resolution frameworks (and discretionary recognition does not provide enough legal certainty). One of the key issues has been that politicians do not want to relinquish powers to a foreign resolution authority in the context of the resolution of a bank. There is a risk, amongst other things, that the relevant resolution authority may prefer local creditors over foreign creditors.

In September 2013, the FSB published a progress report on efforts to end “too-big-to-fail” which provided that, by the end of 2014, the FSB would develop proposals for contractual and/or statutory approaches to prevent large scale early termination of financial contracts in resolution.

In November 2013, a number of regulators (UK, US, France, Germany, Japan and Switzerland) requested that ISDA amend the ISDA Master Agreement to eliminate termination rights in the event of resolution of a counterparty. This contractual solution is intended to work alongside longer-term efforts to put in place cross border recognition of statutory resolution frameworks.\(^{33}\)

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\(^{31}\) Article 68 of the BRRD.

\(^{32}\) Article 71 of the BRRD.

Consequently ISDA has published three ISDA Resolution Stay Protocols.

6.3 What are the ISDA 2014 Resolution Stay Protocol and the ISDA 2015 Universal Resolution Stay Protocol and what do they do?

ISDA has published:

(a) the ISDA 2014 Resolution Stay Protocol (the 2014 Protocol)

(b) the ISDA 2015 Universal Resolution Stay Protocol (the 2015 Protocol)

Under the 2014 Protocol, adherents agreed to amend certain ISDA Master Agreements and related credit enhancement/credit support arrangements to:

(a) Contractually “opt-in” to the resolution regime of their counterparty (provided their counterparty had also adhered). The protocol only opts adhering parties in to provisions in “Identified Regimes” –the resolution regimes in France, Germany, Japan, Switzerland, UK and US – as well as any resolution regime in another FSB jurisdiction that satisfies certain safeguards and conditions set out in the protocol – “Protocol-eligible Regimes”.

(b) Contractually “opt-in” to certain US insolvency proceedings (provided their counterparty had also adhered) – Certain US insolvency regimes do not provide for statutory stays on the exercise of cross default rights (and, in some cases, direct default rights) to the extent that an affiliate of a counterparty becomes subject to insolvency proceedings. However, as regulations are expected to be introduced in the future, US regulators asked ISDA to incorporate contractual stays on cross-default rights (and certain direct default rights).

The 2015 Protocol supersedes and will replace the amendments in the 2014 Protocol in their entirety (to the extent that both counterparties have adhered). The operative provisions of both protocols are nearly identical. However, it is worth noting the following key differences:

(a) Scope of Transactions: The 2015 Protocol broadens the scope of transactions covered to include securities financing transactions (SFTs) by including a new SFT Annex. This annex has been developed in conjunction with the trade associations responsible for SFT market standard documentation: ICMA, ISLA and SIFMA.

(b) Option to include additional Country Annexes: this will require (voluntary) re-adherence.

(c) Option to include an Other Agreements Annex: this will require (voluntary) re-adherence.

6.4 What is the ISDA Resolution Stay Jurisdictional Modular Protocol (ISDA JMP) and what does it do? What is the link with specific jurisdictional rules relating to the cross-border recognition of contractual stays (for example, the recent UK PRA Stay Rules)?

The ISDA JMP is an ongoing project and the third ISDA resolution stay protocol. This protocol was published on 3 May 2016 with the ISDA UK (PRA Rule) Jurisdictional Module opened for adherence and the ISDA German Jurisdictional Module opening for adherence from 3 May 2016 and 28 June 2016 respectively.

34 For further information on the 2014 Protocol, please refer to this link: https://www2.isda.org/functional-areas/protocol-management/protocol/20.
35 For further information on the 2015 Protocol, please refer to this link: http://www2.isda.org/functional-areas/protocol-management/protocol/22.
The ISDA JMP has been drafted with a broader scope of adherent (e.g. buy-side market participants) in mind (although G-SIBs and the G-18 are also expected to adhere). FSB members committed to encourage broader adoption of amendment by introducing new stay rules in their jurisdictions. The policy aim is the same as that of the 2014 and 2015 Protocols, however, the ISDA JMP will be closely aligned with the requirements of the regulations relating to contractual stays in the relevant jurisdictions – many of which are yet to be finalised. Parties would adhere to the ISDA JMP in order to comply with mandatory, statutory regimes. Under the ISDA JMP, parties will sign up if there is a particular regulation that requires parties to obtain the consent of their counterparties to be subject to stays on and/or overrides of certain termination rights under special resolution regimes in order to allow trading on a cross border basis (for example, the UK PRA final rules on contractual stays in financial contracts governed by a non-EU law published in November 2015 (the UK PRA Stay Rules)\(^3\)).

Unlike the 2015 Protocol, the ISDA JMP will allow market participants to decide which jurisdictional modules they wish to adhere to depending on whether they have entered into relevant contracts with an entity subject to the relevant jurisdictional rules (the jurisdictional modules themselves will contain the operative provisions). The entities and transactions in scope of each module of the ISDA JMP will match the scope in the relevant jurisdictional rules (which may be different in different jurisdictions). Scope of application may vary between jurisdictions as may timing for compliance (for example, the UK PRA Stay Rules require compliance for third-country law financial arrangements with certain financial counterparties by 1 June 2016 and all other counterparties by 1 January 2017).