German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on EBA-Consultation Paper Draft Regulatory Technical Standards on the contractual recognition of stay powers under Article 71a(5) of Directive 2014/59/EU

Register of Interest Representatives
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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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Comments on EBA Consultation Paper on Draft Regulatory Technical Standards on the contractual recognition of stay powers under Article 71a(5) of Directive 2014/59/EU

Question for consultation

1. Do you agree with the approach the EBA has proposed for the purposes of further determining the first paragraph of Article 71a of the BRRD?

The approach raises several concerns, most of which we address in more detail in the responses to questions 2 to 4.

Our concerns and comments take into account our experiences over the past four years with the practical implementation of the parallel contractual recognition requirements under Art. 55 BRRD (as transposed into German law with § 55 of the German Recovery and Resolutions Act (SAG)) and the contractual recognition requirements regarding the regulatory stays under the SAG in place since 2016 in the form of § 60a SAG (including the development of a supplemental agreement with a standard contractual recognition clause for the German master agreement documentation), as well as the experiences we have had in connection with the development of standard contractual recognition clauses for the German master agreement documentation for derivatives and securities finance transactions addressing parallel requirements under the recovery and resolution regimes of a number of third country jurisdictions (Switzerland, USA, Japan and UK).[1]

These concerns can be summarised as follows:

Failure to address the issue of retroactivity:
In order to avoid clearly disproportionate burdens for institutions and their counterparties and also in order to avoid considerable disruptions, it is essential that the RTS address the issue of contractual recognition clauses concerning the resolution stays already implemented in existing contractual relationships (legacy agreements) by confirming that the new requirements under Art. 71a BRRD do not have any retroactive effect and that consequently master agreements or other financial contracts which already contain similar contractual recognition clauses regarding resolutions stays do not need to be renegotiated (grandfathering).

Many institutions have already implemented contractual recognition clauses concerning the suspension rights under the previous version of the BRRD and national law implementing the BRRD either because national law already mandated the inclusion of such clauses (as it is the case in Germany in accordance with § 60a SAG, which has been in place since 2016) or in accordance with the international regulatory initiative requesting institutions to implement such clauses, or both.

The recognition clauses were in many cases included into the relevant financial contracts with the help of ISDA protocols, which represents a very efficient way of complying with this requirement and which has also been favoured by the regulatory authorities, or by bilateral agreements, often in the form of standard documentation developed for the relevant standard market documentation.

[1] The templates for these supplemental agreements (German language originals and in all cases, except the supplemental agreement on Swiss resolution measures, also as English translations) are publicly available under the following link: https://bankenverband.de/service/rahmenvertraege-fuer-finanzgeschaefte/sag-zusatzvereinbarung/

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Without grandfathering for these legacy financial contracts (including master agreements), all the efforts made by the institutions over the past years to reach out to their counterparties and to negotiate the inclusion of such clauses would be invalidated and the relevant institutions would be forced to repeat the negotiation and re-papering exercise in relation of the entire population of legacy agreements. In the case of the ISDA protocols, new protocols would have to be created which would have take into account that parties have already included parts of the required language into their agreements by means of an earlier protocol.

It will be extremely difficult for European institutions to convince their counterparties to accept the amendment or replacement of these already negotiated/included clauses - not least, because this would require the relevant counterparty to review the new clauses (or protocol element) once again and, in many cases, once again seek legal counsel to assess the legal and regulatory implications of the changes as well as the legal risks from their specific perspective. Particularly in light of the current crisis, the counterparties will legitimately have little interest in revisiting this issue and expending time and effort (including incurring further legal costs).

In this context, as regards the protocol solutions and notwithstanding their usefulness, it has to be recognized that such protocols can help only to a limited extent, since protocols will never reach all relevant counterparties (in particular, smaller and medium-sized counterparties) and are also not available for all relevant types of contractual agreements.

We therefore urge the EBA to provide clarification to the effect that legacy financial contracts which are master agreements which already include contractual recognition clauses in respect of regulatory stays based on the aforementioned regulatory requirements or member state laws requiring such clauses preceding the adoption of Art. 71a BRRD are grandfathered.

In addition, it will be necessary to establish a phase-in period for the implementation of the contractual recognition requirements under Art. 71a BRRD in view of the fact that institutions will need reasonable time to include these clauses in the contracts (with regard to the further issue that it will not be possible to include the clauses in every single agreement and in respect of each counterparty: see also below).

Both the grandfathering of legacy master agreements and other agreements already containing contractual recognition clauses and a phase-in period would greatly help institutions to prioritise their implementation efforts in a risk-based manner.

As to the fundamental concerns regarding the proposed requirement to subject recognition clauses to the laws of a member state, which would dramatically increase the difficulties for EU institutions to implement such contractual recognition clauses and also significantly reduce the effectiveness of the clauses, see our response to Question 3.

Unnecessarily detailed, rigid and impractical requirements regarding the specific content and format of the contractual recognition clauses:

We note that the proposal does not specify an actual clause (prescribed contractual recognition clause) which - as stated in the background and rationale – would have been the preferred approach. This approach was not chosen because it was determined that such a prescribed contractual recognition clause might not be effective in all jurisdictions. Instead it was decided to prescribe key mandatory elements.

This decision to refrain from prescribing a specific contractual recognition clause is, of course, to be supported and we fully agree that prescribed contractual recognition clauses would undermine the effectiveness of such a clause. Thus, in principle, we support the alternative approach based on key mandatory elements.

However, we believe that the key mandatory elements as proposed are too detailed and rigid and are also formulated in such a way that they effectively amount to prescribed clauses or at least can be interpreted as setting out a very narrow and rigid framework for the drafting of the contractual clauses leaving very little room for adjustments. The description of the mandatory components of the contractual term in the draft RTS should only set out the intended effect of such contractual term and avoid prescribing specific legal concepts or terms. For example, the draft RTS may state as a mandatory component of the term that the respective powers of the relevant resolution authority must be applicable to the rights of the counterparty under the particular financial contract. Whether this is achieved by the acknowledgement and/or acceptance by the parties of such powers or by a declaration that they are bound by such powers or by submission to such powers or by other legal means should be left to be determined by the drafters of the clauses and in accordance with the law applicable to the contract. In this connection we also note that some elements of the proposed key elements appear to be influenced by common law contractual customs and concepts which cannot always be easily transposed into other legal customs and concepts and can thus could make the clauses to be drafted on the basis of the key elements unnecessarily cumbersome and complex (see also our comments on question 2 below).

In view of the very detailed nature of the proposed key elements and especially if the requirements were to be interpreted narrowly, they are likely to cause largely the same problems that a prescribed contractual recognition clause would.

We believe that it is of paramount importance to take into account the legitimate interests and perspective of the counterparties which are expected to accept these clauses and the very significant impact the clauses can have on their contractual rights. In view of the understandable concerns of the counterparties, the clauses to be developed need to be adjusted to the contractual agreement, the applicable contract law and/or relevant contractual customs and standards existing for these agreements under the applicable law in which they are supposed to take effect. This in turn means that institutions (or in the case of standard market documentation, the industry associations developing the standard documentation) must be afforded considerable flexibility regarding the exact wording and structure of the clauses as long as the clauses set out the core contractual obligations and rights and achieve their intended legal/contractual effect for the purpose of the resolution of an institution.

The key elements should therefore be either set out as recommendations or limited to these core contractual obligations and rights and avoid any unnecessary further aspects, especially purely declaratory, informational or duplicative elements.

This is also the approach taken by the aforementioned supplemental agreements concerning the contractual recognition of resolution measures of third country resolution regimes developed for the German master agreement documentation for derivatives, securities repurchase and securities lending transactions. This ensured that the clauses are acceptable to the counterparties, which significantly increased the acceptance of these clauses by the counterparties.

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We believe that the core obligations and rights to be addressed in a contractual recognition clause should consist of the following:

- Recognition (in the appropriate form, be it in the form of an acknowledgment, acceptance or otherwise) that the financial contracts can be subject to certain resolution measures and the effects and obligations resulting from these measures.

- Clear specification of the resolution measures and powers to be recognised.

- Clear definition of the scope of the recognition, i.e. the agreements / types of financial contracts covered by the clause and which may thus be affected be the measures.

In contrast hereto, we believe that the contractual clauses should refrain from mixing the actual contractual provisions regarding the recognition of the effects of the measures with purely informational content, not least in order to avoid legal uncertainties and misunderstandings. The clauses should also avoid duplicative and purely declaratory provisions.

Some of the key elements proposed go beyond what we believe to be the core contractual obligations and rights and/or can at least be interpreted to require clauses which are to some extent duplicative, informational or declaratory in nature (addressed in more detail in our comments on question 2). We therefore see the clear risk that the key elements - as currently proposed - may unnecessarily restrict the ability to develop clauses which are adjusted to the area where they are to be used. This approach can accentuate the one-sided nature of the clauses - which in turn makes it even more difficult for counterparties to accept them and may also introduce unnecessary legal uncertainties (regarding the additional concerns and impediments to be expected in connection with the proposed requirement to subject the contractual recognition clauses to a member state law, see our response to Question 3).

We therefore see the need for a review of the proposed key elements. At the very least, it should be ensured and clarified that these requirements do not restrict the ability to make adjustments as long as the clauses have the intended effect and address the core elements set out above.

In this connection it should be noted that these clauses are intended to support the resolution measures by providing for a contractual right to enact these measures independently from, and in addition to, the regulatory rights established under the BRRD and the member state laws implementing the relevant BRRD provisions. The regulatory right to enact these measures exists regardless of the contractual recognition clauses: that is, these clauses are not a condition precedent for the legality and enforceability of the regulatory measures.

Failure to address the issue that institutions will in some cases not be able to impose the contractual recognition clauses on counterparties:

The experience with Art. 55 BRRD and other contractual recognition requirements such as the aforementioned § 60a SAG has demonstrated that it will never be possible to impose the required clauses on all contractual agreements/financial contracts falling within the scope of the requirement, regardless of the efforts undertaken by the institutions.

Especially with regard to already existing financial contracts, counterparties may simply reject the inclusion of such clauses, and the institution will have no means to implement them without cooperation from the counterparty. That counterparties will have reservations against the inclusion of such clauses is to be expected since these clauses effectively require a submission to the powers of a foreign regulator and have a significant impact on their contractual rights. The restriction of the contractual rights may also have regulatory consequences. Each counterparty therefore needs to assess the consequences of such restrictions of its contractual rights from its perspective and under the applicable contract law as well as its regulatory laws and rules. There may also be legal impediments: For example, public entities may not be permitted to subject themselves contractually to any measures of a foreign regulatory authority. Some types of financial contracts are also concluded on the basis of international practices, customs and terms which do not foresee the inclusion of such clauses (especially, where these clauses have to conform to specific formats) as they may not be compatible with the accepted standards and contractual customs for these transactions and in the relevant market.

It thus has to be expected that institutions will not be able to implement the clauses with respect to every single financial contract or in each case with the exact content as required pursuant to Art. 1 of the draft RTS. However, this cannot be a concern where and as long as this does not affect the resolvability of the institutions and where the institutions make this transparent to the relevant regulatory authorities. This should be clarified in the draft RTS.

2. Do you agree with the approach the EBA has proposed with regard to the components of the contractual term required pursuant to Article 71a of the BRRD?

As already indicated in our response to question No. 1, we have concerns regarding certain elements of the approach:

Art. 1 (1) - Acknowledgement and acceptance

As the requirements may have to be implemented in contractual agreements in other languages and may also be subject to a contract law and contractual practices which do not have a direct equivalent to a formal "acknowledgment", we assume that this requirement is not intended to require a provision setting out a formal acknowledgment in a narrow/literal sense. Instead we believe that any clause with the same effect, setting out that the counterparty is aware, recognises or accepts the relevant regulatory measure, is sufficient for the purposes of Art. 71a BRRD.

In order to avoid any misunderstandings, this understanding should be confirmed, for example by replacing the words

> "the acknowledgment and acceptance"

by the words

> "the acknowledgment, acceptance, recognition or any other provision or declaration with the same effect".

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Art. 1 (2): Description of powers

The requirement to provide a description of the resolution powers raises serious concerns since this can be understood as an obligation to not only specify the powers and measures but also to provide a general explanation in the form of general/background information. This cannot be intended because this would mix contractual elements with purely informational elements, which in turn could seriously affect the effectiveness of the clause: Contractual clauses need to be limited to setting out the contractual rights and obligations and should not serve as source of general information. In particular, it is necessary to distinguish clearly between the contractual rights and obligations on the one hand and additional information on the context and background of these rights and obligations on the other hand in order to avoid any confusion and misunderstandings over the interpretation of the clause, its scope and legal nature.

A contractual agreement is not and should not be an instrument to provide information to the other counterparty, especially not on such a complex matter as regulatory powers granted by a European directive and implemented by the laws of a member states: The information conveyed by contractual clauses can never be complete and comprehensive as it is impossible to condense all information on the regulatory measures, the relevant laws granting the powers and their interpretation into a contractual clause. Contractual clauses as a means of information will always be insufficient and potentially misleading. In any event, the information provided by a party to a contractual agreement cannot and should never replace the independent assessment and analysis by the counterparties, especially not with regard to such a complex issue as resolution measures. The same applies to a replication of the statutory text of the BRRD provisions and the national implementing laws as these, by themselves, are also incomplete without an understanding of the interpretation of the provisions and the resolution regime as a whole. In addition, a description or replication of statutory provisions in a contract could be considered in some jurisdictions as constituting legal advice provided by the party upon whose request the clause has been included. This could raise issues of liability and adversely affect the validity and enforceability of the contractual recognition clause in general.

We therefore assume that - pursuant to this requirement - the contractual clause needs to specify as precisely as possible the resolution powers the counterparty is recognising. This will in practice best be achieved by naming the specific measures including a reference to the relevant provisions, e.g. as in Art. 1(3)(a) of the draft RTS.

In order to clarify this and to avoid any misunderstanding, we therefore propose to replace the word

> "description"

by the word

> "specification".

Art. 1 (3): Requirement for a declaration to be bound by the effects and requirements

The requirement under Art. 1 (3) to include a provision under which the counterparty recognises to be bound by the effects of the measures or requirements is, to some extent, duplicative or at least significantly overlaps with the requirements under Art. 1 (1) and (2): Where a counterparty has already contractually recognised the effects of the measures and the consequences resulting therefrom, there is no

need for a further additional/separate declaration that the counterparty will be bound by them (the recognition is already contractually binding and does not need to be reinforced). It should be entirely sufficient and would also make the contractual clauses simpler and shorter, if these elements were to be combined in one clause recognising the measures and powers listed in Art. 1 (3) (a) and (b). Please see also our comments relating to the disadvantages of the prescribed use of legal terms in the required clause.

This should be clarified.

Further, it is not quite clear what, in addition to the acknowledgement, acceptance and recognition of being bound by the effect of the application of the powers, should be achieved by the agreement that the parties "shall endeavour to ensure the effective application of these powers". The decision on the most effective application of the powers must remain with the resolution authorities. The counterparty can only be bound by the decision of the resolution authority to exercise its powers in a certain manner. It would be clearly unreasonable to expect the counterparties to a financial contract to contractually agree to endeavour to go beyond the decision of the authorities.

Art. 1 (4): requirement to acknowledge and accept that no other contractual term impairs the effectiveness and enforceability of the contractual term and that the contractual term is exhaustive

As to the understanding of the term "acknowledgment and acceptance", the comments on Art. 1 (1) apply correspondingly. Furthermore, we would like to point out that the provision required is primarily of a declaratory nature and thus necessarily of limited practical relevance: The clause would not prevent any subsequent further agreement negating or contradicting this declaration (which, of course, would be a breach of regulatory requirements on the part of the institution subject to the BRRD).

The requirement in Art. 1(4) has therefore no added value. As such, the requirement is largely redundant and would not justify a change in the market standard clauses already in use to which the market participants are already accustomed.

At the very least it should be clarified that this requirement is not intended to be understood as demanding a more or less complete replication of the wording and that a clause to the same effect would fulfil this requirement, for example a clause stating/documenting that the parties have not entered into an agreement overriding this clause and/or that this agreement takes precedence over any other agreement.

3. Do you believe that having the Art.71a BRRD clause governed by the laws of an EU jurisdiction would improve the likelihood that it would be effective and enforceable before the courts of the relevant third country jurisdiction? Please provide your reasons for this view. Further, what do you consider to be the advantages or the disadvantages of using the provision proposed under art 1(5) of the draft RTS?

No: On the contrary, this requirement will significantly increase risk of unenforceability of the clause and, in addition, significantly make it more difficult for counterparties to accept these clauses:

As already pointed out in our responses to the previous questions, it is essential that the contractual recognition clauses are adjusted to the contractual agreements and the applicable law. This necessarily

means that the contractual recognition clause will, in general, be subject to the same contract law as the rest of the agreement. This not only ensures that the clause operates correctly together with the contractual rights under the relevant agreement it is intended to suspend or amend but also avoids discrepancies and/or inconsistencies in the interpretation and application of the contractual agreement and the clause.

In addition, a split choice of law resulting in the application of a different law for the contractual agreement on the one hand and another for the contractual recognition clause on the other significantly increases the complexity for the counterparties, which will further reduce their willingness to accept such clauses.

It is also extremely difficult to see how the application of a law on these contractual recognition clauses different from the law of the relevant contractual agreement is intended to improve the legal effectiveness in the jurisdiction where the measures are to take effect: On the contrary, it has to be expected that such a split choice of law will actually invite and facilitate legal challenges or at least prolong the process.

Furthermore, such a split choice of law regarding the contractual recognition of regulatory stays may have unintended regulatory consequences: Under the new ECB guidance on the notification of netting agreements, any change affecting the governing law of a netting agreement used for regulatory purposes can deemed to be a change leading to a "new type of netting agreement" resulting in a de-recognition of the agreement for regulatory netting unless and until re-notified as a new agreement.

Lastly, it is unclear whether such a split choice of law has an effect on the choice of jurisdiction/venue (where such choice has been made in the agreement or is otherwise possible): Commonly, in a financial contract, parties would submit all disputes arising out of such a contract to the jurisdiction of the courts located in the jurisdiction of the law applicable to a such financial contract. One aim of this practice is to avoid a situation where courts of one jurisdiction would have to decide upon a matter governed by the laws of another jurisdiction. However, in case of a split choice of law applicable to a financial contract as requested in the draft RTS, a judge in the third country would be ruling on the validity and enforceability of the recognition clause governed by the laws of a member state. A choice of jurisdiction/venue in favour of the courts of the relevant member state in parallel with the choice of law for the clause would not be an option, as the disputes over the contractual right governed by the laws of a third country and contractual recognition of the stay of the exercise of such rights governed by the laws of a member state are connected and should be decided in one single litigation proceeding.

The clearly most appropriate and safest approach is therefore to submit the contractual recognition clause to the same governing law that also applies to the financial contract it relates to.

In addition, in accordance with the standard contractual recognition clause regarding regulatory stays already in use, the counterparty accepts/recognises limitations resulting from the regulatory stays on its contractual rights in the same manner and/or to the same extent as if the agreement/s were governed by the laws of a member state. Such a requirement should provide sufficient comfort.

4. What are the standard clauses you are likely to use for your financial contracts pursuant to this requirement? Will the clause differ for various types of financial contracts (please detail if yes)?

Preference for the use of standard clauses developed for standard market documentation where available

With regard to financial contracts entered into under standard market documentation, institutions will generally rely on standard clauses/agreements developed for the relevant standard market documentation (which, in many cases, have been discussed with regulators).

As already mentioned above, in the case of derivatives and securities finance transactions under German master agreements, specifically where such agreements are governed by the laws of a third country, there is already a template for a supplemental agreement regarding the contractual recognition requirements under Art. 55 BRRD/§ 55 SAG (bail-in) and § 60a SAG (suspension rights). The supplemental agreement will now need to be reviewed in view of the new Art. 71a BRRD and the new requirements to be established by the draft RTS, which are the subject of this consultation.

Institutions may, in some cases, also develop individual solutions for other types of financial contracts, especially for financial contracts not based on standard market documentation.

Contract type-specific rather than one single clause for all types of financial contracts

In general, institutions will use clauses developed for a certain type of financial contract and/or contractual documentation or certain sub-groups of financial contract types (for example derivatives and securities finance transactions under certain types of master agreements) wherever possible in the form of the above mentioned standard clauses developed for the standard market documentation.

Institutions are not likely to use one single contractual recognition clause for all types of financial contracts. Experience has shown that such all-encompassing clauses are difficult to apply from the perspective of the counterparty and also may be difficult to apply to the potentially broad range of types of contractual agreements and transactions they would have to cover.

5. Do you agree with the draft Impact Assessment?

We disagree with certain aspects of the impact assessment:

Item 6

While we believe that contractual recognition clauses can support the implementation of resolution measures, it needs to be recognised that they – as any contractual instrument – can never ensure that resolutions measures will be recognised in every jurisdiction under all circumstances: A residual risk of legal challenges will always remain. The only instrument which would provide the desired legal certainty are international agreements on the reciprocal recognition of resolution measures. We therefore reiterate our urgent call to intensify the efforts to conclude such intergovernmental agreements.

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Items 8 to 16

We believe that on the one hand the impact assessment significantly overstates the risks associated with less uniform approaches to the contractual clauses and the advantages of uniformity/convergence and on the other hand does not sufficiently take into account the clear disadvantages of too rigid/formalistic requirements:

The experience over the past four years with such clauses, from the perspective both of the party having to impose them on the other party and of the counterparty on which it is being imposed, has clearly demonstrated that institutions and industry associations need to focus on developing clauses tailored to the contractual agreements and counterparties involved by addressing the core elements we described in our response to question 1 and by taking into account the need to make the clauses easily understandable, operable and acceptable to the counterparties. The specification of the content of the required clause should not include any legal concepts, as these will always derive from one legal system, but should state the intended result that the clause is supposed to accomplish.

The last point cannot be stressed enough: In order to ensure greater acceptance and effectiveness, the contractual recognition clauses need to be designed to take into account the perspective and legitimate interests of the counterparties.

The clauses which have been developed by the banking industry so far may differ to some extent in length, structure and format, but this does not have any impact on the level-playing field among the institutions, as the core content already follows from the regulatory provisions setting out the obligation to impose these clauses on counterparties. In addition, the wide-spread use of standard market documentations for financial contracts and the contractual recognition clauses developed for these documentations already ensure a very high degree of convergence.

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