February 5, 2015

European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ

RE: Contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive (BRRD); EBA/CP/2014/33

Ladies and Gentlemen:

The Bankers Association for Finance and Trade (“BAFT”) is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide.

BAFT is grateful for the opportunity to submit comments concerning the European Banking Authority (“EBA”) consultation (the “Consultation”)1 on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive (“BRRD” or the “Directive”).2 Our comments follow our previous correspondence on this matter regarding the potential impact of Articles 44 and 55 of the BRRD on transaction banking services.3 In those comments, we noted that Article 55(1) would appear to require the inclusion of contractual recognition clauses in a wide range of liabilities, including contingent liabilities supporting international trade transactions, along with agency payment arrangements (such as bond, transfer and escrow agency liabilities).

Article 55(3) of the BRRD requires the EBA to develop draft regulatory technical standards (“RTS”) in order to further determine the list of liabilities to which the exclusion in Article 55(1) of the BRRD applies and the contents of the term required in that paragraph, taking into account banks’ different business models. In this regard, the RTS is a welcome opportunity to clarify the scope of liabilities subject to contractual recognition of bail-in. In particular, we welcome the EBA initiative to provide exception from Article 55 to liabilities to foreign settlement systems. Unfortunately, BAFT believes the consultation proposals do not provide the necessary clarity to ensure international markets will not be disrupted by the inclusion of contingent obligations as liabilities for the purposes of contractual recognition under the BRRD. We encourage the EBA to consider clarifying this view of liabilities in order to exclude the noted contingent obligations through the finalization of the RTS process. This would more closely align the BRRD with international processes on recovery and resolution and would help to avoid disruption in critical real-economy financing services. We also take the opportunity here to address some concerns related specifically to the treatment of liabilities under the Consultation which may become unsecured, along with issues for liabilities under agreements amended after the implementation date of the BRRD.

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1. Treatment of contingent liabilities

Under Article 55, financial institutions will be required to include a contractual term by which the creditor or party to the agreement creating the liability recognizes that the liability is subject to write-down and conversion powers of a resolution authority, except for certain exclusions and exemptions. However, “liabilities” is not a term clearly defined in the BRRD and, consequently, the application of liabilities subject to bail-in may not be limited to liabilities as commonly understood from a balance sheet perspective. It therefore has very wide application which, we believe, could capture many contractual liabilities that realistically are unlikely to be the subject of bail-in in most resolution scenarios.

Liabilities under the BRRD and in the context of the proposed RTS would likely extend to contingent liabilities, including those liabilities which are connected to the financing of international trade, along with those supporting the payment of moneys from one party to another in investment markets and the marketplace for sale and purchase of other assets. In particular, liabilities could capture contingent trade finance instruments such as letters of credit, bank guarantees, and performance bonds essential to supporting importers and exporters in the European Union (“EU”) and globally. Because contingent products are dependent upon the outcome of a future event (i.e., performance and payment under the terms of the documentary instrument), their inclusion as a bail-in liability in the event of a bank resolution scenario would not contribute to loss absorption or aid in ensuring the continuity of a failing institution’s critical financial and economic functions. From an accounting perspective, contingent liabilities are not included on the balance sheet but instead represent off-balance sheet obligations of the company and thus, effectively, do not have a value before the guarantor is obliged to pay. As such, it would be impractical to value such liabilities in a resolution scenario and, therefore, no financial benefit could be derived from their write-down. Lastly, they do not arise from a banker/depositor or creditor/debtor relationship and thus do not realistically form part of the BRRD Minimum Requirements for Own Funds and Eligible Liabilities (“MREL”) nor would they be included in scenarios envisaged under the Financial Stability Board (“FSB”) proposal on Total Loss Absorbing Capacity (“TLAC”) for globally systemically important banks.

By considering contingent obligations as liabilities, difficulties would arise when including Article 55 compliant language where industry practice does not recognize such language. Contractual language in the area of trade finance in particular is highly standardized and the inclusion of BRRD compliant language in such agreements would raise doubts in counterparties’ minds as to the commitments being made. In addition, inclusion of BRRD contractual terms for these types of obligations is likely to require the implementation or amendment of other contractual terms and the updating of legal opinions specific to contingent liabilities. Taken in total, this could cause significant disruption in the financing of cross-border trade transactions and payment mechanisms relating to investments, as delays or terminations of deals could arise with downstream impact on EU clients of financial institutions subject to the Directive.  

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4 “Member States shall require institutions and entities referred to in points (b), (c) and (d) of Article 1(1) to include a contractual term by which the creditor or party to the agreement creating the liability recognizes that liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority, provided that such liability is: (a) not excluded under Article 44(2); (b) not a deposit referred to in point (a) of Article 108; (c) governed by the law of a third country; and (d) issued or entered into after the date on which a Member State applies the provisions adopted in order to transpose this Section.” Article 55(1)(a)-(d), BRRD

5 For further information on the types of contingent trade finance instruments which could be captured as liabilities under BRRD, please see the BAFT Traditional Trade Finance Definitions, February 2012, available at www.baft.org/policy/library-of-documents/traditional-trade-finance-definitions

6 In addition, and in reference specifically to Question 3 of the Consultation on components of the contractual term required pursuant to Article 55(1), BAFT believes that Article 4 of the Consultation broadly requires institutions to achieve contractual recognition and agreement by methods it believes reasonably satisfies the requirements of Article 4, provided that the institution believes that the requirements of Article 4 and Article 55(1) are satisfied. In particular and for example, in relation to trade financing obligations, the
We do not believe the issues around the scope of liabilities in the context referenced have been clarified through the RTS consultation process and, indeed, the proposed RTS appears to reduce the flexibility for a balanced interpretation of some requirements. To avoid unintended disruptions to the critical services delivered by contingent obligations, we respectfully request a practical approach to liabilities which can be realistically bailed-in with clarification on the scope of these obligations and, in particular, how this is applied relative to contractual recognition under Article 55.

In this regard, we note that the FSB’s work in relation to cross-border recognition and loss absorbing capacity indicates that contractual clauses are most relevant for instruments issued to meet loss absorbency requirements. It should be made clear that such agreements which fall within the scope of operational agreements, including contingent liabilities such as trade finance agreements and agency payment obligations, should not be within the scope of bail-in or be subject to contractual recognition under Article 55.

We note that Article 55 includes provision for Member State resolution authorities to grant recognition to third country jurisdictions with sufficiently equivalent regimes. BAFT believes that EU regulators should seek to take all practical steps to maximize the scope of this mutual global recognition system, not only to reduce the burden and complexity of compliance with Article 55, but also because we believe that a broad mutual global recognition regime will likely provide a much more robust framework for resolution and recovery. As such, and as an alternative step to outright clarification, we suggest that the EBA takes the opportunity presented by the development of FSB guidelines to make a recommendation to the European Commission that the Level 1 text be amended to ensure EU alignment with the international standards.

2. Liabilities that may become unsecured

The BRRD states that Resolution authorities shall not exercise the write down or conversion powers in relation to secured liabilities. Article 3 of the Consultation specifies that liabilities which may become unsecured in part or in full can be subject to bail-in. We note that the term “may become unsecured” is unclear, as any security, if challenged in court, may become invalid. As such, any secured liability has potential to become unsecured.

We emphasize that there is no suggestion in the BRRD that certain secured liabilities may be exempt on this basis and it is not clear why liabilities that may become unsecured should be distinguished against other secured liabilities if they are secured at the time the bail-in is taking place. We believe the suggested wording goes beyond mere clarification by the EBA, as it changes the scope of liabilities subject to bail-in established by the BRRD and should be adjusted accordingly.

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7 “The first subparagraph shall not apply where the resolution authority of a Member State determines that the liabilities or instruments referred to in the first subparagraph can be subject to write down and conversion powers by the resolution authority of a Member State pursuant to the law of the third country or to a binding agreement concluded with that third country.” Article 55(1), BRRD

8 Article 44 (2)(b), BRRD
3. Liabilities under agreements amended after implementation

Article 3 of the Consultation specifies that liabilities under agreements amended after the implementation date of BRRD (regardless of whether or not the liability is created after that date) are in scope to include contractual terms for recognition of bail-in. Such liabilities will ultimately include obligations created before the date of implementation and, in our view, this goes beyond clarification by the EBA by expanding the list of liabilities to include those created before implementation of the BRRD.

We believe there is no common definition of what represents an “amended agreement”, as agreements can be changed in a variety of ways which do not alter the fundamental state of the contract. For example, should certain provisions of governing law in an agreement change, in that part where the agreement contradicts the new law it would become invalidate and would therefore be legally amended without action on the part of either counterparty. Similarly, should the contact details or authorized signatories provided in the agreement change (which is normally done unilaterally and is followed by notification sent to the counterparty); the agreement would be technically amended.

Such a broad view of “amendment” will, we believe, lead to critical disruption of client servicing by amending a large number of contracts to include BRRD compliant language when the fundamental terms remain the same as those agreed pre-implementation of BRRD. We believe the suggested wording in the Consultation by the EBA goes beyond mere clarification, as it changes the scope of liabilities subject to bail-in established by the BRRD and should be adjusted accordingly.

Conclusion:

BAFT appreciates the opportunity to highlight these issues for clarification. We look forward to further dialogue going forward on finalizing the most efficient and effective EU resolution regime. For further information, please contact Matthew L. Ekberg at mekberg@baft.org or +1-202-663-5537.

Very truly yours,

Tod R. Burwell
President and Chief Executive Officer