

KEY POINTS

- The Bank Recovery and Resolution Directive 2014/59/EU (BRRD) overrides the FCAD so that, on an exercise of resolution powers under the BRRD, protection for financial collateral arrangements, set-off arrangements and netting arrangements now resides in the BRRD rather than under the FCAD.
- The BRRD's safeguards for financial collateral arrangements, set-off arrangements and netting arrangements are narrower in scope than that under the FCAD. Such protection should not apply: (i) to financial collateral arrangements, set-off arrangements and netting arrangements, where necessary, in order to ensure the availability of covered deposits; and (ii) if the EBA's recommendations are adopted by the European Commission, to general unrestricted sweep-up set-off and netting arrangements. The EBA recommends that the BRRD's safeguard should only apply to sweep-up set-off and netting arrangements where they refer to specific financial contracts.
- Although the scope of the BRRD safeguard appears more restricted than that under the FCAD, does this have a detrimental consequence to the financial market? This is arguable. The restricted approach adopted by the BRRD attempts to maintain the legal certainty of such arrangements by strictly defining those arrangements that will not benefit from the safeguard. But we are yet to see the exact further restrictions to the safeguard, as recommended by the EBA.

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Financial collateral and the BRRD: change without consequence?

This article considers the interplay between financial collateral arrangements, set-off and netting arrangements, and the "appropriate protection" requirements for such arrangements under the Bank Recovery and Resolution Directive (BRRD).

INTRODUCTION

The Bank Recovery and Resolution Directive 2014/59/EU (BRRD) establishes a recovery and resolution framework to deal with the failure (or likely failure) of certain EU incorporated banks and certain investment firms (together referred to as "institutions"), and certain of their group companies. The BRRD is part of an initiative to end the so-called "too big to fail" problem and is largely informed by the global Financial Stability Board (FSB)'s Key Attributes of Effective Resolution Regimes for Financial Institutions.

This recovery and resolution framework outlines inter alia share and property transfer powers, bail-in and write-down powers and certain ancillary powers (including powers to modify contractual arrangements). It also mandatorily overrides certain contractual default rights which would otherwise accrue to a counterparty on the occurrence of such resolution powers.

In order to ensure the effectiveness of such resolution powers, the Financial Collateral Arrangements Directive

2002/47/EC (the FCAD) has been amended such that certain specific protections under the FCAD are made subject to the resolution powers in the BRRD and, more generally, the introduction of new Art 9a which provides that the FCAD shall be without prejudice to the BRRD.

The BRRD provides for a number of safeguards – such as the 'no creditor worse off' safeguard, which compares the resolution outcome to the affected creditor's position under a hypothetical insolvency process and allows for compensation if the latter would have produced a better outcome – and other protections for counterparties to financial arrangements, including collateral arrangements. A detailed analysis of all of these protections is beyond this article, which focuses on the scope of the arrangements that are protected by the safeguards that specifically speak to collateral arrangements. For avoidance of doubt, we do not consider here the nature of the protection provided under the BRRD as this would, in any event, fall

primarily to member states to determine and the manner in which the BRRD addresses counterparty enforcement rights will be the subject of a separate, future article.

THE FCAD PROTECTIONS

The FCAD was introduced to strengthen the legal certainty of financial collateral arrangements – defined to include security financial collateral arrangements and title transfer financial collateral arrangements – and to create a protective regime to ensure the enforceability of such arrangements, regardless of the insolvency of a collateral provider. It also provides protections for the enforcement of bilateral close-out netting provisions. In particular, Art 4 of FCAD protects certain rights of collateral takers to enforce their arrangements and Arts 6 and 7 of the FCAD protect title transfer financial collateral arrangements and close-out netting provisions by requiring that they take effect in accordance with their terms.

For the purposes of the FCAD, financial collateral is limited to cash, financial instruments and credit claims, and the collateral taker must be a public authority, central bank, financial institution or (in certain circumstances and subject to member state discretion) other non-natural persons.

Feature

The BRRD has amended the FCAD so that Arts 4 to 7 of the FCAD will not restrict the enforcement of a financial collateral arrangement (or restrict the effect of a security financial collateral arrangement, any close-out netting or set-off provision) that is imposed by virtue of write-down of capital instruments or resolution powers under the BRRD. Moreover, new Art 9a states that the FCAD will be without prejudice to the BRRD. In effect, therefore, on the exercise of BRRD resolution powers only those safeguards and protections set out under the BRRD will be available for financial collateral arrangements – and not those under the FCAD.

range of security arrangements. The term “set-off arrangements” is defined broadly as any ‘arrangement under which two or more claims or obligations owed between the institution under resolution and a counterparty can be set off against each other’.¹ Subject to our comments below, together these terms should ensure that financial collateral arrangements and close-out netting provisions within the scope of the FCAD are covered by the BRRD safeguards – as well as, more broadly, any other set-off arrangements.

The BRRD leaves its definition of “appropriate protection” vague. Article 77(1) BRRD simply requires member states to prevent:

... on the exercise of BRRD resolution powers only those safeguards and protections set out under the BRRD will be available for financial collateral arrangements ...

THE BRRD’S “APPROPRIATE PROTECTION”

Recital 95 of the BRRD notes the importance of financial collateral arrangements:

‘... in the event of a transfer of some, but not all, of the assets, rights and liabilities of a failing institution, it is appropriate to include safeguards to prevent the splitting of linked liabilities, rights and contracts, as appropriate.’

The BRRD thus introduces various safeguards, including “appropriate protection” for financial collateral arrangements, set-off arrangements and netting arrangements.

The BRRD cross-refers to the FCAD for the purposes of defining “title transfer financial collateral arrangements” and “netting arrangements”. Curiously, it uses the term “security arrangement” but does not offer a precise definition of that term; by not limiting the scope of protected security arrangements to those arrangements over financial collateral, the BRRD would seem to protect a broader

- the transfer of some, but not all, rights and liabilities that are “protected” under title transfer financial collateral arrangements, set-off arrangements and netting arrangements between the entity under resolution and another person; and
- the modification or termination of rights and liabilities that are “protected” under such title transfer financial collateral arrangements, set-off arrangements and netting arrangements by use of ancillary powers.

In relation to security arrangements, similar ‘keep together’ protection and protection from modification and termination is set out under Art 78 of the BRRD.

In this article we refer to such “appropriate” protections as the “Appropriate Protection Safeguards”.

Article 76(1)(a) and (b) of the BRRD require member states to ensure that such appropriate protection applies where a resolution authority:

- makes a partial transfer of property using property transfer powers;² or
- modifies a contract using the ancillary contractual modification powers.³

IS THE SCOPE OF THIS “APPROPRIATE PROTECTION” EQUIVALENT TO THE PROTECTION PROVIDED UNDER THE FCAD?

Quite simply, no.

The protection under the BRRD deviates from that provided under the FCAD in two key respects.⁴ First, the Appropriate Protection Safeguards are not available in respect of certain covered deposits. Second, although it remains to be seen, we expect the European Commission – following the European Banking Authority (EBA) recommendations – to adopt a delegated act⁵ further restricting the application of the Appropriate Protection Safeguards in relation to sweep-up set-off and netting provisions.

Covered deposits

The BRRD explicitly overrides the Appropriate Protection Safeguard “where necessary” in order to ensure the availability of deposits covered by the European Deposit Guarantee Schemes Directive 2014/49/EU (DGSD).

The DGSD – in broad terms – requires the guarantee (or “cover”) by member states of deposits of individuals and companies (recently extended to include large companies, but broadly excluding financial institutions and public authorities) up to €100,000, and higher amounts in respect of certain temporary high balances.

Article 77(2) of the BRRD allows both the:

- transfer of DGSD covered deposits, if they are part of a title transfer financial collateral arrangement, set-off arrangement or netting arrangement, without transferring other assets, rights or liabilities that are part of the same arrangement; and
- transfer, modification or termination of assets, rights or liabilities that are part of the same title transfer financial collateral arrangement, set-off arrangement or netting arrangement without transferring DGSD covered deposits.

Article 78 contains a similar carve-out in the context of security arrangements.

Noting that the protection under the FCAD is not available where one party to the arrangement is a natural person, and is only available for arrangements with micro, small and medium enterprises if the relevant member state has chosen to exercise the necessary discretion, the BRRD carve-out is broader only in respect of covered deposits of large companies. Although this is a divergence from the protection provided under the FCAD, this difference is no surprise as it follows one of the principal policy drivers of the BRRD: minimisation of the cost for taxpayers⁶ and reflects European policy makers' now familiar preference to protect covered deposits over other arrangements.

Sweep-up set-off provisions

The technical advice provided by the EBA on 14 August 2015 to the European Commission⁷ (Technical Advice) outlines a further potential divergence from the protection provided under the FCAD, based on a concern that the efficiency and feasibility of the partial property transfer powers would be jeopardised if set-off arrangements or netting arrangements are protected in accordance with their terms in every circumstance.⁸

The EBA identifies so-called sweep-up set-off arrangements – which provide for the set-off of any and all rights between the parties – as posing this risk. The Technical Advice notes that if such sweep-up set-off arrangements (which may also manifest under netting arrangements) were protected under the Appropriate Protection Safeguards, any liabilities between the parties would be protected against being separated from each other. This represents a problem in the context of the partial property transfer resolution powers as, in the words of the EBA:

‘This would make the partial transfer with regard to this counterparty unmanageable, and in general would jeopardise the feasibility of the tool altogether, as the resolution authorities might even not be able to discern which liabilities are or are not covered by these arrangements.’⁹

The EBA further notes that such an approach could privilege certain counterparties so that counterparties with higher bargaining power (who had been able to negotiate the inclusion of a sweep-up set-off arrangement in their favour) could benefit disproportionately, and regardless of whether there was a link between all their claims and the types of transactions.¹⁰

... the EBA's recommendation that sweep-up set-off provisions should not benefit from the Appropriate Protection Safeguard ... would also represent a change ...

Such concerns drive the EBA's recommendation that the European Commission, by way of its delegated act mandated under Art 76(4) of the BRRD, limit the Appropriate Protection Safeguards to apply only to certain “qualifying” arrangements (or categories of arrangements) – for example, those within the BRRD definition of “financial contracts” – and liabilities which are of a homogenous class and which are clearly identified in the set-off arrangement or netting arrangement.

The Technical Advice further recommends that member states be allowed the option, where appropriate, to extend the Appropriate Protection Safeguard to those arrangements which are recognised for risk mitigation purposes under prudential rules – including under the Capital Requirements Directive 2013/36/EU (CRDIV) framework.¹¹

A CHANGE WITHOUT CONSEQUENCE?

The FCAD was introduced to strengthen the legal certainty of collateral arrangements and to create a protective regime to ensure the enforceability of such arrangements, regardless of the insolvency of a collateral provider. As has been noted by the International Swaps and Derivatives Association (ISDA),¹² it is of paramount importance that any protections for financial collateral arrangements, set-off

arrangements and netting arrangements be clear, certain, immediate and robust.

Another serious concern is that, where the Appropriate Protection Safeguard differs in its protection from the protection under the FCAD, the Appropriate Protection Safeguard may not be sufficient to protect credit risk mitigation techniques that operate to reduce systemic risk within the financial market.

The first divergence from the FCAD, in respect of covered deposits discussed above, does alter what was the status quo under the FCAD. The application of this carve-out from the Appropriate Protection Safeguard is only applicable “where necessary” – which inherently introduces an element of uncertainty to its application. However, as it is possible to identify DGSD covered deposits with sufficient certainty (the DGSD provides a comprehensive definition), it follows that this divergence from the FCAD should not completely undermine the Appropriate Protection Safeguard's clarity, certainty, immediacy or robustness – and this should go some way to reduce concerns with the narrowing of the protections under the FCAD.

The second divergence from the FCAD considered above – the EBA's recommendation that sweep-up set-off provisions should not benefit from the Appropriate Protection Safeguard, if implemented – would also represent a change to what was the *status quo* under the FCAD.

The proposal in the Technical Advice that set-off and netting arrangements should identify particular “financial contracts” in order to benefit from the Appropriate Protection Safeguard should not undermine legal certainty of scope of the Appropriate Protection Safeguard – in fact it requires arrangements to be more exact in their terms.

Feature

Biog box

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Both the BRRD and the EBA's recommendations reflect concerns about the loss of protection for arrangements that achieve credit risk mitigation. The EBA further notes that such protection should not be limited purely to risk mitigation, but references other fields of prudential regulation and notes that member states should have some flexibility in this regard.¹³ If this approach is adopted, this should go some way to reflect market concerns on the loss of integrity to arrangements that mitigate credit, and other, risks.

CONCLUSION

The BRRD Appropriate Protection Safeguard narrows the protection that was available under the FCAD. Such restrictions are driven by concerns to ensure the integrity of resolution powers, and partial property transfer powers in particular, without undermining DGSD covered deposit protection.

Concerns that such restrictions may undermine the legal certainty of financial collateral arrangements are, to a certain extent, met by the use of defined terms which allow the quantification of arrangements that do not benefit from the Appropriate Protection Safeguard.

The recommendations of the EBA in its Technical Advice remain recommendations

for now and it remains to be seen what further restrictions (if any) the European Commission may adopt.

Finally, as with any provision of a European directive, the Appropriate Protection Safeguards may be implemented with national nuances. Thus their application may differ from member state to member state. ■

- 1 See Art 2(1)(99) of the BRRD.
- 2 Such property transfer powers are set out under Art 63(1)(d) of the BRRD.
- 3 Such ancillary contractual modification powers are set out under Art 64(1)(f) of the BRRD. The ancillary contractual modification powers allow a resolution authority to modify or terminate a contract to which the entity under resolution is party to, or to substitute parties to, such contracts.
- 4 The EBA proffers a third respect in which the scope of the BRRD protection may deviate from that under the FCAD as it suggests that Art 78(1) of the BRRD is not intended to encompass floating charges prior to crystallisation. The authors consider that this analysis cannot be free from doubt, as Art 76 expressly contemplates protection for floating charges. Noting that institutions which may be subject to resolution under the BRRD do not commonly grant floating charges, this point is not considered further.

- 5 The European Commission is required to adopt delegate acts that further specify the classes of arrangements that fall within the scope of, amongst others, title transfer financial collateral arrangements, set-off arrangements and netting arrangements.
- 6 See recital 5 of the BRRD.
- 7 On the scope of a delegated act to further specify the classes of arrangements.
- 8 See para 10 of the Technical Advice.
- 9 See para 10(a) of the Technical Advice.
- 10 See para 32 of the Technical Advice.
- 11 See paras 41–43 of the Technical Advice.
- 12 See ISDA's 13 August 2014 Briefing Note for member states of the European Union on implantation of Art 77(1).
- 13 See para 44 of the Technical Advice.

Further Reading:

- The EU Bank Recovery and Resolution Directive: moving towards full implementation [2015] 3 JIBFL 162.
- The EU Bank Recovery and Resolution Directive: preventing another financial crisis [2013] 10 JIBFL 641.
- LexisNexis Loan Ranger blog: Implementation of the Bank Resolution and Recovery Directive.

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