DRS
DERIVATIVES RISK SOLUTIONS LLP

Via electronic submission:

European Banking Authority

Dear Sirs

Consultation Paper regarding a "Draft Regulatory Technical Standard on a minimum set of the information on financial contracts that should be contained in the detailed records and the circumstances in which the requirement should be imposed (Article 71(8) BRRD)"

Please find attached our response to the above Consultation Paper, published on 6 March 2015.

We set out our full responses to the questions raised in the Consultation Paper in the Schedule to this letter. We would be very happy to discuss any of the matters raised in greater detail if this would be of assistance.

Yours faithfully

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Schedule – Responses to Specific Consultation Paper Questions

Background

Most firms which are subject to the Bank Recovery and Resolution Directive[1] (BRRD) already mine data out of their financial contracts. This exercise is performed for regulatory compliance purposes, but also because it is in the interests of the bank to do so i.e. for risk management and competitive advantage purposes. Practices and degrees of investment in the process vary. However, given the current state of market practice in this area and the value of the underlying data requested by the EBA, it is appropriate to require firms to apply a minimum standard of technology (i.e. a relational database) and that firms maintain the information in that database in advance of the onset of any recovery or resolution scenario rather than after the event.

1. Do you agree with the circumstances in which the requirement to maintain detailed records shall be imposed?

The draft RTS makes clear that any relevant entity that is likely to be placed into insolvency, rather than resolution, would not automatically be subject to the requirement to maintain detailed records of financial contracts. This can certainly be viewed as consistent with the 'proportionality principle' which pervades much of the BRRD, particularly those parts addressing 'simplified obligations for certain institutions' which are deemed to be of lesser systemic importance[2]. However, this approach suffers from the problem that it may be difficult to know in advance that a particular institution will definitely go into insolvency rather than be resolved. This may also constitute an unwelcome signal to the market as it will effectively confirm, before the event, which firms are likely to be subject to resolution (and liable to bail-in) and which are not – a fact which could potentially impact the attractiveness of the debt that firm might issue.

Some of the assumptions made in the Draft Cost-Benefit Analysis / Impact Assessment (CBA/IA) accompanying the consultation paper also appear to be questionable. In part, the CBA/IA dismisses the option that the requirement to keep detailed records should apply to all institutions within the scope of the BRRD on the grounds that the collection of information relating to financial contracts would not be "of practical use to the authorities" in relation to those firms that would enter into insolvency, rather than resolution. However, in reality, this kind of information may very well be of use more generally in an insolvency situation – both to insolvency practitioners and to creditors. The damage that can be done, and the value that can be destroyed, by virtue of a disorderly wind-down via traditional insolvency should not be dismissed or underestimated. It should also not be forgotten that, fundamentally, the mining of data from financial contracts is a basic risk management exercise for firms. It is necessary, at the most basic of levels, to enable firms to understand the individual and aggregate risks they have accepted in signing the underlying contracts. In these circumstances, it seems difficult to conclude that this would be either an unreasonable request on the part of the EBA or that performing the exercise would be of no "practical use".

[1] Directive 2014/59/EU

[2] See Article 4

In addition, in supporting option 3, the CBA/IA assumes that the cost of mining data out of financial contracts for firms that would likely go into insolvency rather than resolution would be disproportionate to the benefits that would accrue by including such firms. This assumption should also be questioned. It is clear that there are material benefits to regulators from having access to this information. However, as previously noted, there are also potentially very significant benefits which accrue to firms themselves, not just in terms of regulatory compliance but also in terms of risk management and competitive advantage. Examples include collateral management, collateral optimisation and XVA calculations. These benefits far outweigh the costs associated with the data mining process. Indeed, the recognition of this fact is the reason why many firms already routinely mine data of this type from their contractual portfolios.

One possible solution may be to set two 'minimum sets of information', one for those firms which are entitled to take advantage of the application of 'simplified obligations' pursuant to Article 4 of the BRRD and another set for those which cannot. If this approach were adopted the following wording from Article 2 of the draft RTS would not be required: "…where the resolution plan or the group resolution plan foresee the taking of resolution actions in relation to the institution or entity concerned in the event the conditions for resolution are met…" Admittedly, however, this approach suffers from an increased level of complexity in terms of implementation.

In looking at alternative approaches, it should be remembered that a degree of proportionality exists naturally within the market, in that firms which would go into insolvency (or benefit from Article 4 simplified obligations) rather than stand to be resolved, would tend to be smaller and less complicated in nature. It is likely that such firms will have fewer financial contracts from which to mine data. As such, the obligation in relation to such firms is likely to be much less in any event.

2. <u>If the answer is no. What alternative trigger could be used?</u>

Please see the response to question 1.

3. <u>Do you agree with the list of information set out in the Annex to the draft RTS which it is proposed shall be required to be maintained in the detailed records?</u>

The consultation paper makes clear that the information to be maintained in the detailed records is a minimum only and that resolution authorities are free to require additional information. Nonetheless, the ultimate purpose of maintaining "detailed records" relating to "financial contracts" is to facilitate the more effective application of resolution powers and resolution tools, with the power to suspend temporarily the termination rights of any party to a contract with an institution under resolution[3] being specifically mentioned. The specific fields referred to in the Annex to the draft RTS were introduced after assessing which information about financial contracts would be important in terms of achieving this goal. In other words, the required information purports to go to the heart of what it is to be resolvable as a financial institution – as the impact assessment says, the focus is to identify information which is 'important for BRRD purposes'.

[3] Under Article 71(1) of the BRRD

In reality, much of the information that could adversely impact the ability of a resolution authority to exercise resolution powers or resolution tools will be contained within master agreements, rather than transaction confirmations. With this in mind and with a particular focus on the ISDA Master Agreement, we would suggest that the EBA consider requiring firms to mine the following additional information from financial contracts:

Clause	Explanation
Events of Default	Can adversely impact the effective application of resolution powers and resolution tools.
Cross-default/Cross-acceleration	Can adversely impact the effective application of resolution powers and resolution tools.
Termination rights generally	Should be regarded in the same light as Events of Default and so can adversely impact the effective application of resolution powers and resolution tools.
Credit downgrade triggers	Often take the form of Events of Default / Termination Events and so can adversely impact the effective application of resolution powers and resolution tools.
Material adverse change clauses	Often take the form of Events of Default / Termination Events and so can adversely impact the effective application of resolution powers and resolution tools.
Agency arrangements	Undisclosed agency arrangements may make application of resolution powers and resolution tools more difficult as the identity of the true counterparty may be difficult to ascertain.
Indemnities	Should not of itself prevent exercise of a resolution power or tool but may still constitute a barrier to resolution if indemnities are enforced.
Illiquid CSA collateral	Should not of itself prevent exercise of a resolution power or a resolution tool but may still constitute a barrier to resolution in terms of transferring or terminating transactions.
ISDA 'First Method'	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution if a counterparty has a right to 'walk away' without making payment.
Specified Entities	An unusually wide definition of "Specified Entities" will widen the application of ISDA Events of Default and/or Termination Events.
Automatic Early Termination (AET)	In normal circumstances, resolution powers and tools should have been implemented before insolvency (and therefore AET) applies. Nonetheless, it would be helpful to understand where the risk of AET arises.
Title Transfer/Security Interest Collateral	Secured liabilities are not subject to the bail-in tool under the BRRD.

Client Money Rules	Indicating whether the liability created by a transaction was subject to client money rules would be of direct relevant to the exercise of resolution powers and tools and such liabilities would not be 'eligible liabilities' and there not subject to bail-in under the BRRD.
Limited recourse provisions	Limited recourse provisions are often found in master agreements executed with SPV clients. Broadly, clauses of this type state that, irrespective of the amount owed to the firm on a close-out, the amount payable to the firm will be limited to the assets of the SPV. As such, these provisions could potentially have an adverse impact on the application of resolution powers and resolution tools.
'Adequate assurance' provisions	'Adequate assurance' provisions can operate against a firm, against a firm's client, or on a mutual basis. Broadly, a clause of this type states that a party can, in certain circumstances, request additional 'assurance' from its counterparty – often in the form of a guarantee, letter of credit or additional collateral. Consequently, if the clause operates against the firm – requiring it to provide a guarantee, letter of credit or additional collateral to its counterparty – this could have an adverse impact on the application of resolution powers and resolution tools.

The draft RTS does not require information to be maintained in a specific template. On balance, this is probably the correct approach, although both the industry and particularly regulators would benefit from standardisation of data in terms of being able to monitor and quantify systemic risk. Either way, the requirement in the Consultation paper that "information should be kept in a central location on a relational database e.g. capable of being interrogated by the authorities or from which information can be provided easily to the authorities" and that data should be capable of being "extracted readily and transmitted to the relevant authority" is undoubtedly appropriate and correct. However, it must be recognised this requirement implies a degree of granularity in terms of the way in which the data is extracted. Unfortunately, this requisite level of granularity is absent from the RTS. As such, in the absence of a specific template, the EBA should consider providing guidance to firms which are subject to the draft RTS regarding the exact way in which more specific and detailed information from master agreement portfolios can be presented. At the very least, it would be useful to state that free-text fields are not appropriate (given that free-text fields would not be 'capable of being interrogated easily').

Specific clarification in relation to some of the data required by the RTS would be helpful, as set out below:

Field	Comment
Field 10: Contractual recognition – Write-down and conversion (third country-governed contracts only)	Is it contemplated that this would be a "yes/no" answer or would more granular information be required? Field 11 requires reporting counterparties to potentially provide more than a simple "yes/no" answer as it requires reporting counterparties to specify which resolution powers are recognised (in circumstances where not all are recognised). If analogies can be drawn with Field 11, it would seem that Field 10 would require more than just a simple "yes/no" answer. However, the position would benefit from clarification.
Field 34: Termination conditions	A more granular explanation of the way in which this clause should be presented is required. Potentially, this field includes all Events of Default and Termination Rights and so could comprise a large amount of information.
Field 35: Termination right	A more granular explanation of the way in which this clause should be presented is required. Potentially, this field includes many Events of Default and Termination Rights and so could comprise a large amount of information.
Field 36: Master Agreement type	Rather than just refer to a master agreement type, it would be better to identify the actual master agreement used i.e. to refer to its type and its "dated as of date". This would help to avoid possible confusion in the exercise of resolution powers and tools.
Field 38: Netting arrangement	It is not clear what information this field is seeking. What response does the EBA expect firms to provide in relation to this field? Normally, it would be possible to conclude whether a netting arrangement exists simply by virtue of understanding whether a master agreement is in place (and the type). A different question is whether or not a party can calculate exposure on a net basis in any given situation. Broadly, this depends not only on the existence of a netting agreement, but also the existence of a 'clean' netting legal opinion for the relevant jurisdiction. Is Field 38 looking to address either of these questions or something different? Either way, additional information would be helpful.

Field 41: Type of liability/claim	Can you explain what this field means and also, why is comes under the heading "Clearing"? Presumably, it seeks to assess the extent to which a particular reporting counterparty is maintaining sufficient 'own funds and eligible liabilities' (MREL) for the purposes of Article 45 of the BRRD and the extent to which a particular liability is subject to the bail-in tool. This requires an assessment of whether a 'liability' is an 'eligible liability' – a process which will require the firm to map trades to the legal requirements of the BRRD (particularly Article 44(2)). Although derivative liabilities cannot count towards MREL[4], it is possible for individual Member States to exclude derivatives transactions from the ambit of the bail-in tool (see Article 49(2) and Article 44(3)). The net result is that, if we are trying to identify whether a derivative is subject to bail-in we would have to look at (a) the rules in the relevant member state; (b) the actual transaction; and (c) the rules of the BRRD. How is it proposed to capture this information with Field 41?
General	How quickly should information within a financial contracts database be updated? The RTS is unclear. The stated use to which such information would be put (i.e. the more effective application of resolution powers and tools) suggests that information should be refreshed frequently. Requiring data to be mined from financial contracts and included within a database within 24 hours of execution may be considered appropriate if the FSB's "Key Attributes"[5] document can be considered to be a template. However, this would represent a significantly shorter timeframe than currently exists, on average, within the market today. Either way, guidance on this point would be very beneficial to the industry.

[4] Article 45(4)(e)

[5] http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

It would also be advisable to require firms to retain a copy of the actual contract executed with each counterparty (at least as far as this relates to information extracted from a master agreement rather than a transaction confirmation) together with the data to be included within the database. Particularly in light of the fact that (a) the draft RTS is not very granular in terms of specifying data to be provided and (b) it does not require information to be maintained in a specific template, metadata (i.e. the information extracted from financial contracts) will inevitably capture only a partial representation of underlying risks. As such, metadata cannot be regarded as a substitute for actual data. In reality, when assessing fundamental resolvability, there is no substitute for being able to readily access the actual underlying contract. A requirement to maintain an actual copy of the contract would also enable resolution authorities to readily relate the metadata extracted from financial contracts to the financial contracts themselves, enabling an assessment of the accuracy of the metadata extracted by firms to be conducted. Given that data accuracy is of fundamental importance in any resolution situation (but is a factor which is not addressed at all within the consultation paper) a check and balance of this type would appear to be appropriate.

4. If the answer is no. What alternative approach could be used to define the circumstances in which the requirement should be imposed in order to ensure proportionality relative to the aim pursued?

Please see response to question 3.

5. Do you agree that in the Annex to the draft RTS the same structure as in the Commission's delegated regulation (EU) no 148/2013 should be kept?

Yes, this would seem to be a sensible approach.

6. Considering the question above do you think it would be possible and helpful to define expressly in the RTS which data points should be collected at a "per trade" level, and which should be collected at a "per counterparty" level?

In reality, all information is being collected at a "per trade" level. The only difference is that some of that information resides within transaction confirmations (which are executed on a "per trade" basis) whereas other information is contained within master agreements (which are executed on a "per counterparty" basis). Nonetheless, this does not change the fact that the provisions of master agreements take effect at a "per trade" level – it is simply the case that these provisions apply to multiple trades at one time. The fact that a master agreement applicable to multiple trades can be amended at any point in time creates obvious challenges in making sure that data is accurate and up-to-date at all times. However, irrespective of this, in terms of the reporting required by the RTS, it would not seem necessary to specify which data points should be collected at a "per trade" level and which should be collected at a "per counterparty" level.