



MANAGED FUNDS  
ASSOCIATION

EUROPEAN BANKING AUTHORITY  
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7 August 2015

Dear Sirs,

**AIMA and MFA Joint Response to EBA Consultation Paper on Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)**

AIMA<sup>1</sup> and MFA<sup>2</sup> (“we”) are grateful for the opportunity to respond to the Consultation Paper on Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD) (the “Consultation”)<sup>3</sup> published by the European Banking Authority (the “EBA”) on 13 May 2015.

We strongly support efforts to ensure the ongoing stability of the European financial system, notably via rules under the BRRD. Our members are active participants in the global over-the-counter (“OTC”) derivatives market and are the direct counterparties of EU credit institutions and large investment firms when transacting in non-centrally cleared derivatives contracts. At the same time, our members rely on various other services offered by these EU financial institutions (e.g., trade execution, prime brokerage, etc.), which fall within the scope of the BRRD. Thus, our members have a strong interest in ensuring that the BRRD’s recovery and resolution mechanisms function efficiently and robustly to avoid the disorderly failure of a distressed systemically important banking institution and to preserve broader financial stability.

We agree that the resolution authorities’ ability to “bail-in”<sup>4</sup> shareholders and unsecured creditors subject to the “no creditor worse off than under normal insolvency proceedings” principle<sup>5</sup> is important to minimise the moral hazard associated with government bail-outs of failed systemically-important banks and to ensure that losses are allocated to those persons/entities that stand to gain from the financial successes of the bank. However, as AIMA argued throughout the Level 1 development process of the BRRD, we are concerned that the application of the bail-in tool to derivative contracts during the resolution of a bank could threaten to destroy value far

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<sup>1</sup> Founded in 1990, the Alternative Investment Management Association (“AIMA”) is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry - including hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. Our membership is corporate and comprises over 1,500 firms (with over 9,000 individual contacts) in more than 50 countries. AIMA’s manager members collectively manage \$1.5 trillion in assets.

<sup>2</sup> Managed Funds Association (“MFA”) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent and fair capital markets. MFA, based in Washington, DC, is an advocacy, education and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry’s contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

<sup>3</sup> Available at: <https://www.eba.europa.eu/documents/10180/1073039/EBA-CP-201-10+CP+on+RTS+on+derivatives+valuation.pdf>.

<sup>4</sup> As used in the Consultation, this term refers to the resolution authorities’ power to write down and convert liabilities of an institution under resolution.

<sup>5</sup> See Recital 73 and Article 73 of BRRD

in excess of the losses actually absorbed by residual liabilities post close-out. The EBA itself recognised this potential destruction in value in the Consultation, where it noted, “[a]n early termination of derivative contracts may give rise to costs that would not have been incurred if the contracts had been maintained until maturity”.<sup>6</sup> Such costs would include the crystallisation of losses “not fully reflected in the fair value of the contracts before close-out”, which “...could stem for example, from additional replacement costs incurred by the counterparty, or costs incurred by the institution under resolution to replace hedges left upon by the close out.”<sup>7</sup>

It is our strong belief that a resolution authority should only apply a resolution tool if the benefits of its application outweigh the costs. In the context of bail-in, it would be detrimental to impose costs and losses upon either: (i) derivatives counterparties; or (ii) the institution under resolution that exceed the benefits to the institution under resolution. Otherwise, such application could exacerbate the systemic consequences of the institution’s failure, which is contrary to the BRRD’s resolution objectives.<sup>8</sup>

In this regard, we believe that, rather than applying the bail-in tool to derivative contract liabilities, it could become necessary for resolution authorities to apply the “exceptional circumstances” exclusion from bail-in under Article 44(3) of BRRD, in particular sub-paragraph (d) of this Article. As you know, this exclusion allows a resolution authority in exceptional circumstances to exclude certain liabilities from the application of the bail-in tool where “the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in”. In the Consultation, the EBA mentioned the need for resolution authorities to consider whether they may need to “activate” this exclusion, rather than close out derivatives contracts.<sup>9</sup> We appreciate this recognition and would suggest that it is important for there to be a broad application of the Article 44(3)(d) exceptional circumstances exclusion to derivatives contract liabilities to prevent unnecessary destruction in value that could lead to broader systemic consequences from the resolution of a systemically important banking entity.

The European Commission has also recognised the significant difficulties that result from the bailing-in of derivatives in its work on adopting delegated acts under Article 44(11) of BRRD to “...specify further the circumstances when exclusion is necessary to achieve the objectives specified in [Article 44(3)]”.<sup>10</sup> For the purposes of the exceptional circumstances exclusion under sub-paragraph (a) of Article 44(3) - which applies to liabilities that are impossible to bail-in within a reasonable timeframe - the European Commission has developed a draft indicative list of liabilities that are more likely to meet the conditions for this exclusion and that a resolution authority should assess at the moment of applying the bail-in tool. This list includes liabilities arising from derivatives. We support this approach but would stress that a resolution authority should undertake this assessment and make a decision at the earliest opportunity possible upon entry into resolution, if not before, to avoid counterparty uncertainty and negative impacts on the underlying OTC contract market.

We recognise the importance of, and support, the EBA’s role in developing a robust, objective and consistent methodology with which to compare the destruction in value that would arise from the close-out and bail-in of derivative contracts with the loss absorbing capacity actually generated

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<sup>6</sup> Consultation at 5.

<sup>7</sup> See *id.* at 13

<sup>8</sup> In particular, the resolution objective contained under Article 31(2)(b) of BRRD is “to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline”.

<sup>9</sup> Consultation at 5-6.

<sup>10</sup> Article 44(11) of BRRD

by application of such bail-in tool.<sup>11</sup> We also appreciate the significant difficulties facing: (i) the EBA in creating such a methodology; (ii) resolution authorities in their application of such methodology; and (iii) derivatives counterparties seeking to predict how such a methodology would affect their derivatives contracts.

We think it is particularly problematic that there is a lack of market data on the likely consequences of applying bail-in to derivatives liabilities, as bail-in is an entirely new concept for OTC derivatives. For this reason, we would suggest that the EBA also consider undertaking further work - perhaps alongside the European Commission - to analyse the likely practical consequences of bailing-in derivative liabilities and the EBA's Article 49(4)(c) methodology to compare the destruction in value with loss absorbing capacity. This analysis could take the form of a quantitative study looking at what the likely results would have been of applying the EBA's proposed methodology to previous institutional failures, as well as to hypothetical future institutional failures.

We believe that the results of such quantitative work could lead resolution authorities to determine that it is necessary to apply the "exceptional circumstances" exclusion under Article 44(3)(d) to derivative liabilities in the substantial majority of resolution scenarios. Therefore, the results of an EU study could lead to greater predictability in a future resolution scenario. Such predictability would help promote consistent future action by resolution authorities when making resolution decisions (*i.e.*, resolution authorities would not need to wait until an institution's entry into resolution before considering the likely outcome of the application of the valuation methodology). In addition, it would help to bolster confidence among the failing institution's counterparties and the broader market.

If you have any further questions or comments, please contact Adam Jacobs ([ajacobs@aima.org](mailto:ajacobs@aima.org)) or Jiri Król ([jkrol@aima.org](mailto:jkrol@aima.org)) of AIMA, or Carlotta King ([cking@managedfunds.org](mailto:cking@managedfunds.org)) or Stuart J. Kaswell of MFA.

Yours faithfully,

/s/

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/s/

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<sup>11</sup> Consultation at 5-6.