Comments

Association of German Banks

Consultation Paper EBA/CP/2015/10 - Draft Regulatory Technical Standards on the valuation of derivatives pursuant to Article 49(4) of the Bank Recovery and Resolution Directive (BRRD)

13 August 2015

Lambert Koehling
Director
Telephone: +49 30 1663-3150
Fax: +49 30 1663-1399
lambert.koehling@bdb.de

Ref. BdB: RE.05
Prepared by Kg

Association of German Banks
Burgstraße 28
10178 Berlin | Germany
Telephone: +49 30 1663-0
Fax: +49 30 1663-1399
www.bankenverband.de
USt.-IdNr. DE201591882

I. General remarks

We welcome the opportunity to comment on the draft proposal for regulatory technical standards (RTS) to the Bank Recovery and Resolution Directive (BRRD) concerning the valuation of derivatives pursuant to Art. 49 (4) of the Bank Recovery and Resolution Directive (BRRD). In our response, we have limited ourselves to commenting on key issues addressed under Questions 1 to 7 and 10.

Our key concern in this connection is the proposal to primarily rely on actual replacement transactions in order to determine the close-out amount as this is inconsistent with market practice and the contractual terms governing the valuation of derivatives in standard netting agreements used by market participants. These concerns are addressed in more detail in our response to Questions 3 and 4.

II. Responses to individual questions

Question 1: Do you agree with the definitions above? Do you consider it necessary to specify some of them further, and in particular the definitions of "commercially reasonable replacement trades" and "unpaid amounts"?

- No. 6: "Unpaid Amounts"

It could be considered to clarify that the term "unpaid amounts" also includes interest and other payments.

- No. 11: "Commercially Reasonable Replacement Trade"

"Commercially reasonable" is a common law legal concept which may not always be easily transferable into legal concepts of other jurisdictions. The references in the definition to "market practice" and "best efforts" are intended to address this to some extent. However, "best efforts" itself is again a common law legal concept. In view of the fact that the results of any valuations made in accordance with the RTS may be reviewed by local courts and against the background of locally applicable insolvency laws it will be necessary to find a more neutral definition.

According to the current definition of "Commercially reasonable replacement trade" the counterparty which is closed-out has to make "*best efforts* "to obtain the "*best value for money".* The definition thereby effectively sets an extremely and potentially unreasonably high standard (in any event a significantly higher standard than indicated by the term "commercially reasonable"). The more appropriate and realistic standard would be to require "*commercially reasonable efforts"* and a "*price that is commercially reasonable"*.

As to our general concerns regarding the reliance on actual replacement transactions in order to determine the close-out amount, see our response to Questions 3 and 4.

- Lack of a definition for "collateral"

We note that the term "collateral" remains undefined and suggest to add such a definition. Our understanding is that "collateral" also includes amounts equal to the value of the collateral transferred under a credit support annex (as calculated pursuant to Paragraph 6 of the ISDA Credit Support Annex (Bilateral Form – Transfer) subject to English Law and No. 9 of the Collateral Addendum to the German Master Agreement for Financial Derivatives Transactions ("Besicherungsanhang zum Rahmenvertrag für Finanztermingeschäfte")) and that such amounts will be considered in the early termination amount calculation pursuant to Article 4 (1) lit a. of the RTS.

Question 2: Should the deadline given by the resolution authority to the counterparty be further framed? If yes, explain why and how? Does this drafting allow the resolution authority to conclude resolution actions in a sufficiently swift manner?

Yes: For one, the notice should clearly specify the netting agreement/transactions which should be closed-out and the specific time and date of such close-out (close-out date) and/or the time by which counterparties have to produce information on the replacement trades (or other valuation data, see our responses to Questions 3 and 4).

Moreover, the period between the notification and the relevant close-out date needs to be pre-defined or at least subject to a pre-defined - and necessarily short - time limit. The resolution authority cannot have complete discretion in setting the close-out date because such complete discretion could effectively undermine the purpose of the strict limitation of the resolution stay and impair the rights of the counterparty.

Furthermore, to ensure that the close-out is accomplished as smoothly as possible and also to reduce the risk of legal challenges, i.e. based on breaches of the no creditor worse off-principle (NCWO-principle), it will be important that all necessary notifications are made in the contractually agreed form and addressed to contractually agreed addressees. This should be expressly clarified.

As to the general concerns regarding reliance on actual (commercially reasonable) replacement trades, see our response to Questions 3 and 4 below.

Question 3: This valuation principle is intended to be aligned with common market practice that recognises replacement costs in an early termination event, whilst giving certainty to the resolution authority on the methodology to be followed. Do you agree

that this valuation principle would result in a fair valuation for the closed-out netting set and as such avoid a breach, from the counterparty's perspective, of the no-creditor-worse-off principle?

In order to avoid uncertainty and potential legal challenges on the basis of the NCWO-principle, the close-out amount needs to be calculated and valued in accordance with the terms agreed in the relevant master agreement:

Article 49(3) BRRD states that, where bail-in applies to liabilities arising from derivatives contracts, the valuation of derivatives under a netting agreement must be carried out *in accordance with the terms of that agreement*. The approach proposed in the draft RTS contains a number of elements which are not consistent with the terms and concepts of standard netting agreements and thus deviates from market practice and the principle set out in Art. 49 (3) BRRD.

For one, as currently drafted, the RTS only allow closed-out counterparties to contribute to the valuation conducted by the resolution authority or the valuer if they have entered into actual replacement trades before the given deadline. However, pursuant to the terms of standard netting agreements for OTC-derivatives such as ISDA Master Agreements or the German Master Agreement for Financial Derivatives Transactions (Deutscher Rahmenvertrag für Finanztermingeschäfte), the party which determines the relevant close-out amount is not required to enter into actual replacement transactions and can rely on other data than the price of actual replacement trades to determine the close-out amount, such as quotations.

Moreover, under most standard agreements the non-defaulting party (that is the party other than the party in relation to which the termination event exists) calculates the close-out amount. This is also consistent with the concept applicable in many jurisdictions that the party which has suffered damages is the one which is entitled to determine the potential claim, if any. This of course does not preclude the defaulting-party to question the amount so determined and/or require a substantiation of the claim.

Question 4: Do you agree with the preferential status given to commercially reasonable replacement trades? Should there be also a prioritisation among other sources of data?

No. As already mentioned above in our response to Question 1 (regarding the definition of "Commercially Reasonable Replacement Trade") the concept of commercial reasonableness as it is currently defined raises some concerns and the reliance on actual replacement transactions is inconsistent with market practice.

In view of the concerns raised in our response to Question 3, we propose to amend the RTS so that the counterparties can calculate the close-out amount in accordance with the terms of the

relevant netting agreement which means that they can make use of other data than the price of actual replacement trades.

Question 5: Do you agree with the method described under paragraph 2 for the resolution authority to calculate the close-out amount? Is there a reason to believe that mid-market prices might not always be available or possible to derive from other data sources? And under which circumstances? In that case, what do you consider as an appropriate reference for calculating the close-out amount?

As already mentioned above in our response to Questions 3 and 4 above, we believe the calculations have to be made in accordance with the terms specified in the relevant agreement.

Question 6: Should adjustments to the bid-offer spread, other than those specified under Article 6(4)(c), be considered?

See our response to Question 5.

Question 7: Do you agree with the treatment of CCPs as laid down in this Article? Are the conditions laid down in this article compatible with a swift and efficient valuation of cleared derivatives within the context of a resolution process? Do you see any material risk that the treatment of CCPs as laid down in this Article could conflict with the requirements for a sound risk-management framework to deal with the default of a clearing member?

We believe that transactions cleared via a CCP (cleared transactions) should be excluded as such from any bail-in. Cleared transactions, in particular with EMIR-authorized or recognized CCPs, can and should generally be qualified as secured liabilities and as such be exempted from a bail-in. A CCP is required to collateralise any trades in accordance with the requirements under EMIR (or pursuant to equivalent third country rules) in order to qualify as an authorised (recognised) CCP. Therefore centrally cleared derivative contracts should fall within the secured liabilities definition of Article 44 (2) b) BRRD. In this context it should also be assumed (and clarified) that this not only applies to transactions between CCP and clearing member but also to the directly connected transaction between clearing member and client (client clearing).

Question 8: Article 7(1) is intended to be aligned with market practice in early termination events. Do you see a risk of increased market volatility on the first market day following the close-out notification, which could adversely affect the termination value? Do you consider the notion of "commercially reasonable" date sufficiently self-evident or should it be further specified?

Non-Applicable.

Question 9: As provided for under Article 7(2), the resolution authority will have the possibility to produce a valuation at a date or time earlier than the earliest commercially reasonable date as part of a provisional valuation carried out pursuant to Article 36(9) of the BRRD. This possibility is intended to allow for a swifter resolution process as resolution authorities will be able to apply the write down and conversion powers on the basis of the early determination. As in all cases where taking resolution action based on a provisional valuation, resolution authorities will update their determination either as part of a subsequent provisional valuation or the final valuation. At that point they will either adjust the write down and conversion of creditors, provided they have previously made the necessary arrangements such as holding sufficient equity, or provide alternative compensation, if necessary, on the basis of the final valuation of difference in treatment pursuant to Article 74 of Directive 2014/59/EU. Do you consider this optional early determination appropriate, or do you consider that this option would unreasonably increase the risk of litigation or ex post compensation according to Article 74 of the BRRD?

Non-Applicable.

Question 10: Alternatively, should resolution authorities always wait until there is pricing available in the market before producing their valuation, and therefore wait until that date before applying the bail-in tool?

No. In some cases it may take too long until pricing is available. Thus, it may be necessary to provide for alternatives in the event pricing does not become available within an adequate period of time.

Question 11: The possibility to produce an early determination is available also in relation to claims of a CCP. In this case the final valuation will reflect the CCP claim as determined pursuant to Article 6, on the basis of the CCP default procedures if provided under the conditions of that Article. Do you consider it appropriate to also allow an early determination in relation to CCP claims?

Non-Applicable.

Question 12: If so, do you consider that, with regard to CCP claims, resolution authorities should always be obliged to adjust the bail-in treatment of the CCP if and once the CCP provides its determination pursuant to Article 6? In that case, how do you assess the risk that the CCP determination process could hold back the finalisation of the bail-in process also for other claims? Alternatively, does the assessment of difference in treatment pursuant to Article 74 of the BRRD provide a sufficient safety net for CCPs?

Non-Applicable.

Question 13: Do you find the guidance provided in paragraph 2 of this Article sufficiently clear as to the terms of comparison?

Non-Applicable.

Question 14: Do you agree with the main drivers of the destruction in value as described in this Article?

Non-Applicable.

Question 15: Do you agree with the provision for a precautionary buffer? Do you consider the indicative elements supporting this precautionary buffer as sufficient? Do you see other considerations that should be taken into account when calculating a precautionary buffer?

Non-Applicable.

Question 16: In determining destruction in value, should resolution authorities incorporate into their analysis the impairment to the firm's franchise value that would result from the termination and closing-out of a firm's derivatives contracts and the cessation of its related business operations?

Non-Applicable.