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The BRRD, the Stay Protocol and the impact on derivatives

- Overview of the EU Bank Recovery and Resolution Directive (the "BRRD")
- The BRRD's impact on derivatives
- Cross-border issues relating to bank resolution
- The ISDA Resolution Stay Protocol (the "Stay Protocol")

New year's resolutions

The start of 2015 has a two-fold significance for bank resolution regimes since it marks the advent of the BRRD and the initial phase of the Stay Protocol. Both of these initiatives form part of the on-going regulatory response to the global financial crisis precipitated by the demise of Lehman Brothers in 2008. In particular, they seek to address the issue of institutions which are seen as "too big to fail". This is the perception that during the financial crisis certain financial institutions were too big and too important to the global financial system to be allowed to fail because of the risk that essential banking services would have been disrupted and widespread financial contagion would have ensued.

Part of this issue was the concern that traditional insolvency proceedings would not have been effective to resolve an institution with an extensive derivatives book, since such proceedings would have triggered an immediate liquidation of a large volume of such contracts under the close-out netting provisions that are standard in the relevant industry agreements. As a result, a number of institutions were supported by public funds.

In order to mitigate these risks, the approach of the BRRD is that large financial institutions should not in the first instance go through normal insolvency proceedings but should instead be resolved under specific resolution measures in order to minimise the impact of their failure on the financial system and the wider economy.

BRRD

The BRRD covers, among other things, pre-emptive recovery planning by financial institutions, regulators' powers to intervene in the running of financial institutions and regulators' tools for the resolution of failing financial institutions. Various provisions of the BRRD affect collateral, security, termination and close-out arrangements, which are critical components of derivative transactions.

By the start of the new year member states should have transposed the BRRD into their national laws. Member states were required to adopt the required implementing measures by 31 December 2014 and should apply them from 1 January 2015, except that the bail-in tool may be applied from 1 January 2016 at the latest.

Stay Protocol

1 January 2015 is also the date on which the special resolution regime ("SRR") provisions of the Stay Protocol became effective between the globally significant financial institutions (known as "SIFIs" or "G-SIFIS") that adhered to the Stay Protocol in November last year.

The Stay Protocol is a multi-lateral contractual mechanism to facilitate cross-border recognition of the "stay" of termination rights under SRRs such as the BRRD. Such stay or suspension aims to give regulators time to deal with a distressed financial institution in an orderly fashion, without the market instability that would be wrought by the institution's counterparties closing out their transactions at the same time. The Stay Protocol is the product of a coordinated effort by regulators and the derivatives industry.

Scope of this briefing

This briefing will give an overview of the BRRD then focus on the BRRD's possible effects on derivative transactions and netting arrangements in particular. It will look at the implementation of bank resolution rules in the UK and the impact on derivatives transactions with UK financial institutions. It will also consider certain issues relating to the cross-border implementation of resolution regimes and give an overview of the Stay Protocol.

Summary: key points for derivatives

- Stay: termination rights can be temporarily suspended when an institution goes into resolution.
- Override: default triggers linked to crisis prevention or crisis management measures are automatically overridden.
- Modification: regulators have the power to modify or cancel contracts as part of resolution action.
- Netting, set-off and collateral: the adequacy of safeguards against regulators' powers to make partial property transfers and modify contracts will need to be considered under each member state's regime.
- Bail-in: close-out payments under derivatives agreements can be subject to bail-in. Regulators can compel close out and carry out the close-out valuation.
- Post-stay outcome: after a temporary suspension, derivatives contracts should either be transferred to a new entity or remain with the original entity, in which case they may be subject to bail-in on a net basis. If not bailed in, the counterparty can exercise applicable termination and close-out netting rights under its contract.

» Together these points amount to a major change in the way derivatives are enforced on insolvency and will impact counterparty risk assessment.

BRRD

Aim

The BRRD aims to give national regulators credible powers and tools for dealing with unsound or failing financial institutions and to establish a framework for cooperation in cross-border resolution action. It seeks to implement principles recommended by the Financial Stability Board (the "FSB") in "Key Attributes of Effective Resolution Regimes for Financial Institutions" (November 2011).

"The objective of an effective resolution regime is to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss, while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in a manner that respects the hierarchy of claims in liquidation."

The BRRD substantially overhauls current / previous European law regarding resolution of failing financial institutions. In addition, under their national laws various member states had previously enacted their own resolution regimes (such as the Banking Act 2009 in the UK), which will now be superseded or amended in order to comply with the BRRD.

Status

The BRRD was published in the Official Journal of the EU on 12 June 2014 and entered into force on 2 July 2014. It will be supplemented by numerous regulatory and implementing technical standards which are typically due to be finalised in around 6 or 12 months from now. It is a minimum harmonisation directive, therefore at national level member states are able to introduce new tools and impose other requirements not set out in the BRRD, provided that such measures are not inconsistent with the BRRD. Consequently, although the BRRD has an immediate impact now, it is likely to be some years before its full consequences can be properly assessed.

UK implementation

The UK is applying all the provisions of the BRRD from January 2015, including the bail-in requirements, subject to certain exceptions (explained below). Some requirements of the BRRD are already in place in the UK under existing law, however changes are needed in order to implement the BRRD fully. The BRRD is being implemented through six statutory instruments and changes to the PRA Rulebook, the FCA Handbook and the Special Resolution Regime Code of Practice, as well as an updated PRA supervisory statement.

Key components

The BRRD applies to credit institutions, particular investment firms and certain related entities.
It covers three possible phases in their lifecycles.

- <u>Preparation</u>: Both recovery planning and resolution planning are required at group and subsidiary levels.

  Institutions are required to draw up recovery plans providing for measures to be taken by the relevant institution to remedy any significant deterioration in its financial position and to submit those plans to their competent authorities for assessment. If the relevant competent authority identifies material deficiencies in the plan, they can require changes to the plan and ultimately can direct the institution to take any measures they consider necessary and proportionate, including changes to strategy and/or structure.

  Resolution authorities will draw up a resolution plan for each institution for which they are responsible, after consulting the relevant competent authority and after consulting the resolution authorities of the jurisdictions in which any significant branches are located insofar as is relevant to the significant branch. When drawing up the resolution plan, the resolution authority shall identify any material impediments to resolution and, where necessary and proportionate, set out actions for how those impediments could be addressed.

- The BRRD also sets out intra-group financial support arrangements that can be agreed as part of the planning process and activated if necessary if the relevant entities meet the conditions for early intervention (explained below).
- Early intervention: Competent authorities are accorded an expanded set of powers to enable them to intervene if an institution is in a rapidly deteriorating financial condition but has not yet reached the point of failure. Possible remedial action includes removing or replacing the management, appointing a temporary administrator, requiring implementation or updating of the recovery plan, convening a meeting of shareholders to adopt urgent reforms and requiring the institution to draw up a plan for the restructuring of debt with its creditors.
- Resolution: National authorities are given resolution tools and powers to take rapid and effective action when bank failure cannot be avoided. The primary objective of resolution is to minimise the extent to which the cost of a bank failure is borne by the relevant member state and its taxpayers.

  In addition, a framework is provided to improve cooperation and coordination between national authorities so that, should a cross-border banking group fail, national authorities will be able to coordinate resolution measures to protect financial stability in all affected member states and achieve the most effective outcome for the group as a whole.

The far-reaching effects of provisions under these three phases raise the general question of whether they alter the way market participants analyse counterparty risk. When considering a transaction with an in-scope institution, market participants may now want to assess not only the counterparty's creditworthiness but also the recovery planning, intervention measures and resolution framework that support that counterparty.

In relation to derivatives in particular, resolution is the most likely of these three phases to affect transactions in existence at the time, therefore this briefing focuses on resolution below.

Resolution

The BRRD provides for new resolution tools and powers to be given to national resolution authorities. Resolution authorities do not have to have taken early intervention measures before resolution action can be considered, however all of the following conditions must be met:

(a) either the competent authority or the resolution authority, in each case after consulting the other, has determined that the institution is failing or is likely to fail;

(b) having regard to timing and other relevant factors, the competent authority considers there is no reasonable prospect that any alternative private sector measures would prevent the failure of the institution within a reasonable timeframe; and

(c) a resolution action is necessary in the public interest.

Resolution authorities should base the determination as to whether these conditions are satisfied on a fair, prudent and realistic valuation of the institution's assets and liabilities which has been carried out by a person independent of any public authority.

Objectives of resolution

Resolution authorities are required to use the tools and powers that best achieve the objectives of resolution. The objectives, which have equal weighting, are the following:

(a) to ensure the continuity of critical functions;

(b) to avoid significant adverse effects on the financial system, in particular by preventing contagion spreading from the institution in resolution;

(c) to protect public funds by minimising reliance on state support;

(d) to protect depositors benefitting from deposit guarantee schemes and investors benefitting from financial services compensation schemes; and

(e) to protect client funds and client assets.

In addition, resolution authorities are required to seek to minimise the cost of resolution and avoid destruction of value unless necessary to achieve resolution objectives.

Toolbox

The BRRD provides for resolution authorities to have the following four main resolution tools at their disposal:

(a) the sale of business tool;

(b) the bridge institutions tool;

(c) the asset separation tool; and

(d) the bail-in tool.

Use of resolution tools

These main tools may be used individually or in any combination (except that the asset separation tool must be used in conjunction with another resolution tool). The bail-in tool is the subject of extensive provisions, therefore this is covered in its own section below.

In addition to the above tools, resolution authorities have the ability to appoint a special manager to replace the management of an institution in resolution.

Furthermore, the BRRD also permits member states' governments, in coordination with the resolution authorities, to use financial stabilisation tools, but only as a last resort. These tools allow member states to participate in the recapitalisation of the institution in resolution and to take it into temporary public ownership.

Whilst many of these tools are already present in several national laws regarding bank resolution, the BRRD represents a significant development in that there will be a minimum level of harmonisation of these powers, which will also benefit from cross-border recognition and enforceability within the EU.

Resolution powers – issues relating to derivatives

Under the BRRD resolution authorities are to have a broad range of powers. The powers that are most significant in relation to derivatives are as follows.

- **Power to suspend termination rights.** Resolution authorities will have the power to suspend the termination rights of any party to a contract with either (a) an institution in resolution or (b) a subsidiary of the institution in resolution, where such subsidiary's obligations are guaranteed or otherwise supported by such institution and the relevant termination right is based solely on the insolvency or financial condition of the institution in resolution. The intention behind the suspension is to allow the resolution authority time to act without having to contend with counterparties closing out transactions, thereby undermining the institution's financial position and destabilising the market in general.

  The suspension would initially be temporary, lasting from publication of the notice of the suspension until midnight at the end of the following business day, and would be subject to the condition that payment, delivery and collateralisation obligations continue to be performed under the relevant contract. If at the end of the suspension period (a) the obligations under the relevant contract have been transferred to another entity or (b) the obligations under the relevant contract remain with the original counterparty but are subject to bail-in, then the original termination right is permanently overridden. If, however, at the end of the suspension period neither a transfer nor a bail-in have been effected, then the relevant party may be able to exercise an insolvency-related termination right under the terms of the relevant contract.

  The UK implementation of the BRRD includes the removal of an exemption under the Safeguards Order which previously allowed termination rights under netting arrangements and financial collateral arrangements to be exercised in the event of a partial property transfer. The issue of partial transfers is discussed further under "Protection for financial collateral, set-off and netting arrangements" below.

  The move away from the immediate exercise of termination rights as the primary remedy for a market participant facing an institution in distress may be regarded as a fundamental change in the way market participants, certainly in Europe, are protected against credit risk of their counterparties. The cross-border recognition of suspensions of termination rights will be bolstered by the Stay Protocol, which is discussed below.

- **Impact on netting.** Effective netting is central to derivatives markets, both for credit risk mitigation and regulatory capital purposes. The question arises as to whether the power to suspend termination rights could affect the enforceability of close-out netting. There are two aspects to this question.

  The first relates to the duration of the suspension. For example, under the Capital Requirements Regulation, in order for a master netting agreement to qualify as an eligible form of credit risk mitigation, it must give the non-defaulting party the right to terminate in a timely manner, and it may be necessary to consider whether this is affected by the possibility of a suspension. Accordingly, where netting opinions are used for regulatory capital purposes, they may need to be revisited (notwithstanding that recital 95 to the BRRD indicates that the intention behind the text is that netting and the regulatory capital treatment of exposures covered by a netting agreement should not be affected by the BRRD).

The second relates to resolution measures implemented while the suspension is in effect, such as (a) transfer of the relevant derivatives master agreement to another institution or a bridge bank or (b) bail-in of the liabilities under the agreement. These points are discussed under "Protection for financial collateral, set-off and netting arrangements" below.

- **Automatic override of default triggers**. A corollary of the suspension of termination rights is that neither a crisis prevention or crisis management measure, nor any event directly linked to the application of such a measure, is allowed to constitute a trigger for contractual termination, netting or set-off rights or enforcement of security in relation to the institution in resolution or a member of its group on a cross-default basis. Furthermore, any such measure will not be treated as an "enforcement event" for purposes of the Financial Collateral Directive or as "insolvency proceedings" for purposes of the Settlement Finality Directive. In each case this is subject to the condition that payment, delivery and collateralisation obligations continue to be performed.
- **Power to suspend certain obligations.** Resolution authorities have the power to suspend any payment or delivery obligations under a contract with an institution in resolution. If the obligations of the institution in resolution are suspended by an exercise of this power, its counterparty's obligations will also be suspended for the same period of time. As with the suspension of termination rights mentioned above, this suspension would be temporary, lasting from publication of the notice of the suspension until midnight at the end of the following business day. The concept of such a suspension will generally be familiar to derivatives market participants since it has, broadly speaking, a similar effect to that of the condition precedent in Section 2(a)(iii) of the ISDA Master Agreement.
- **Power to restrict enforcement of security interests**. Resolution authorities have the power to impose a temporary restriction on secured creditors of an institution in resolution from enforcing security interests over any assets of that institution, except that this does not affect rights of CCPs and clearing systems in relation to margin.
- **Amendments to the Financial Collateral Directive**. Where a resolution authority uses the power to restrict enforcement of security interests or any of the other resolution powers to impose a restriction on the enforcement of financial collateral arrangements or on the effect of any close-out netting, then such restriction prevails over the provisions of the Financial Collateral Directive that would otherwise protect such enforcement or close-out.
- **Power to modify contracts**. Resolution authorities have the ancillary power to cancel or modify the terms of a contract to which the institution in resolution is a party.

The specific powers above are supplemented by various general powers and ancillary powers. Although relatively long, the list of general powers is non-exhaustive and specifies that resolution authorities should have "all the powers necessary to apply the resolution tools" pursuant to the BRRD, therefore it remains possible that resolution authorities will come to wield further powers.

Given that the above powers are potentially extremely far-reaching, it is critical that they are used appropriately and do not give rise to unintended adverse effects. Accordingly the BRRD provides for certain safeguards, which are discussed below.

Resolution principles and safeguards

Any resolution action should be taken in accordance with prescribed principles, in particular the "no creditor worse off" principle, which provides that no creditor of the institution in resolution will incur greater losses than it would have incurred if the institution had been subject to "normal insolvency proceedings". Further parameters are that, in exercising the powers to suspend termination rights or contractual obligations or to restrict enforcement of security, resolution authorities must have regard to the possible impact on the orderly functioning of the markets.

These broad guiding principles are reinforced by certain specific safeguards. Those most relevant to derivatives are discussed below.

- **Protection for financial collateral, set-off and netting arrangements**. This protection is critical, given the importance of effective netting to derivatives markets. Member states are required to ensure that there is "appropriate protection" for title transfer financial collateral arrangements and set-off and netting arrangements (herein each a "protected arrangement") in order (a) to prevent the transfer of some but not all of the rights and liabilities that are the subject of a protected arrangement and (b) to shield protected arrangements from modification of the governing contract.

The issue in relation to a transfer of some but not all of the rights and liabilities under a protected arrangement is that such a partial transfer would disrupt the composition of the netting set, and mutuality of obligation, between the original parties to the protected arrangement, thereby undermining the enforceability of netting on insolvency. This would alter the parties' credit risk on each other and regulatory capital position. The approach of the BRRD safeguard is that either the whole protected arrangement must be transferred, in order that the same netting set is preserved under the new arrangement with the transferee, or the whole protected arrangement should remain intact between the original parties.

The BRRD does not offer guidance on the meaning of "appropriate protection" for this purpose and no technical standards are planned on this topic. Consequently member states must implement the safeguard without specific legislative guidance. Key concerns in the implementation of Article 77(1) will be the need (a) to maintain each set of rights and liabilities that are the subject of a protected arrangement as one mutual set of reciprocal obligations, whether they are transferred or remain with the institution in resolution, (b) to ensure that the ancillary power to modify contracts (explained above) is not used to disrupt in any way the protection given by a protected arrangement and (c) to provide effective remedies for breaches of this safeguard.

Given the potential for implementation to differ across member states, participants in the derivatives market will need to assess the precise scope of the protections for close-out netting and collateral provisions in derivatives contracts for each relevant national implementing regime. Changes may be made to related legal opinions on netting and collateral in order to take account of the potential impact of resolution measures.

In the UK, the component of Article 77(1) relating to partial transfers is implemented by adjusting the existing safeguard under the Safeguards Order.

- **Protection for security arrangements.** Again, there is to be "appropriate protection", in this case by a prohibition on (a) transferring separately assets against which the liability is secured, the secured liability or the benefit of the security and (b) use of the ancillary power to modify contracts such that the relevant liability is no longer secured.

  Under the UK regime, there already exists a safeguard against partial transfers of security arrangements under the Safeguards Order.

- **Protection for clearing, trading and settlement systems.** The operation of such systems is not to be affected by any partial transfer of assets, rights or liabilities of an institution in resolution or by any exercise of the power to modify contracts.
- **No provision for breach of safeguard**. The BRRD assumes that member states and resolution authorities will not breach the safeguards and does not specify the consequences of breach. In the UK, under the Safeguards Order a partial property transfer in breach of the safeguard for netting and set-off is expressed not to affect the exercise of the relevant netting or set-off right.

Bail-in

The concept of bail-in is relatively new, having arisen from the financial crisis. The aim of bail-in is that shareholders and creditors of the failing institution bear an appropriate part of losses arising from the failure of the institution, in order to restore the institution to a sound financial condition and long-term viability.

In contrast to a bail-out, which involves the injection of capital into the relevant institution from an external source, bail-in achieves internal recapitalisation by the write-down of liabilities and/or conversion of liabilities into equity. The BRRD makes provision for the treatment of shareholders in a bail-in and specifies the sequence for write-down and conversion of relevant instruments.

Status

Under the BRRD, the bail-in tool is due to apply from 1 January 2016. The UK has implemented the bail-in provisions of the BRRD early, from January 2015, except the minimum requirement for eligible liabilities (which is essentially an anti-avoidance measure to prevent institutions from seeking to create liabilities in forms that are outside the scope of bail-in). Also, the requirement to include a contractual recognition of bail-in in the terms of liabilities governed by the law of a non-EU state will be set out in changes to the PRA and FCA rules, which have not yet been published at the date of publication of this briefing. The effective date of the requirement for contractual recognition of bail-in is not publicly available at the date of publication of this briefing. The PRA plans to publish final rules in mid-January and the FCA has said that it will publish final rules as soon as practically possible.

Scope

The liabilities that may be subject to bail-in are defined by reference to those that are excluded. Derivatives are not expressly excluded, however liabilities that are secured or collateralised are excluded to the extent of the value of the relevant security / collateral. Therefore, if the liabilities under an OTC agreement are fully collateralised, then they should effectively be excluded from bail-in.
In addition, resolution authorities are given the discretion to exclude certain liabilities from bail-in, although this is expressed to apply in "exceptional circumstances" only.

Bail-in of derivatives

Bail-in can be applied to derivative transactions only after they have been closed out in order that they are reduced to one net liability. The UK implementation applies the same protection to repo and stock loan transactions. The UK implementation also includes a remedy for contravention of the restrictions on bail-in set out in the relevant statutory instrument. Where any person considers that bail-in has breached relevant restrictions (such as the requirement for derivative transactions under a master agreement to be closed out), and so notifies the Bank of England, and the Bank of England agrees, the relevant institution can be required to provide compensation by issuing or transferring securities of the relevant institution or a bridge bank, as applicable, or paying such sum as the Bank of England considers necessary to put that person in the position that it would have been in had the breach not occurred. This remedy appears reasonable, particularly since it would not be feasible to implement any alternative that requires unwinding the bail-in, although the remedy is by nature uncertain and/or may involve a delay since it depends on the response from the Bank of England.

Resolution authorities are empowered to close out derivative transactions in order to apply bail in. Therefore, in the event of a bail-in, market participants may find their derivative transactions terminated on a mandatory basis outside their control.

Valuations for bail-in

Although bail-in of a derivative should occur on a net basis, the BRRD contains significant ambiguity about the method of valuation of derivatives for bail-in purposes.

On the one hand, Article 49(3) provides:

"Where derivative transactions are subject to a netting agreement, the resolution authority or an independent valuer shall determine as part of the valuation under Article 36 the liability arising from those transactions on a net basis in accordance with the terms of the agreement."

On the other, Article 49(4) provides:

"Resolution authorities shall determine the value of liabilities arising from derivatives in accordance with the following:

(a) appropriate methodologies for determining the value of classes of derivatives, including transactions that are subject to netting agreements;

(b) principles for establishing the relevant point in time at which the value of a derivative position should be established; and

(c) appropriate methodologies for comparing the destruction in value that would arise from the close-out and bail-in of derivatives with the amount of losses that would be borne by derivatives in a bail-in."

Article 49(3) suggests that the terms of the relevant agreement will govern any close-out valuation for purposes of determining what, if any, resolution action is appropriate, whereas Article 49(4) suggests that the resolution authority may use extraneous methodologies in valuing derivatives for bail-in purposes. Therefore the basis of valuation may not be entirely clear. In addition, even where the valuation is carried out in accordance with the terms of the agreement, that the valuation is carried out by a third party (i.e. the resolution authority or an independent valuer) may mean it produces a materially different result from the one that would have been produced by a non-defaulting party operating the same valuation methodology.

It is to be hoped that this ambiguity will be resolved by the regulatory technical standards on valuation that the EBA is to produce in relation to Article 49(4), although under Article 49(5) the EBA is required to take into account but not necessarily adopt the close-out methodology set out in any applicable netting agreement, therefore it is not certain that the EBA will uphold the contractual methodology. The draft technical standards are due by 1 January 2016.

The UK implementation of Article 49 states more clearly 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.

Contractual recognition

Where a relevant liability is governed by the law of a non-EU state, BRRD requires an "opt-in" in respect of bail-in. This specifies that agreements creating certain liabilities must include a contractual term under which the creditor recognises that the liability may be subject to bail-in and therefore written down. Relevant liabilities are those that are:

(a) governed by the law of a non-EU state;

(b) issued or entered into after the date on which the relevant member state has transposed Article 55;

(c) not excluded under Article 44(2); and

(d) not a preferred deposit under Article 108.

In addition, resolution authorities may require relevant institutions to provide a legal opinion on the enforceability of any such term.

Cross-border issues relating to bank resolution

Having considered the regime that BRRD applies to the competent authorities and resolution authorities within EU member states, we now consider briefly how resolution actions in such member states should interact with, firstly, other member states and, secondly, non-EU states.

The BRRD amends the Credit Institutions Winding Up Directive to include resolution action within the definition of "reorganisation measures", thereby giving the authorities of an institution's home state the jurisdiction to carry out such resolution and providing for mandatory recognition by the other member states. Furthermore, the BRRD contains a framework for cooperation between member states for resolution of cross-border groups, in particular through resolution colleges.

The BRRD also contemplates that the European Commission may produce proposals for non-binding framework agreements with non-EU states regarding cooperation between resolution authorities. Pending such agreements, Article 94 provides generally for recognition of third-country resolution measures. Although this provision may seem rather generous, it is subject to detailed public interest / public policy exclusions under Article 95, which may perhaps detract from its practical significance.

The FSB recently carried out a consultation on proposals to achieve recognition in one state of resolution measures taken by a resolution authority in another state. Pending legislative developments, the issue of cross-border recognition of resolution regimes has initially been addressed at a contractual level, principally through the Stay Protocol.

The Stay Protocol

Aim

Just as the BRRD contains powers for resolution authorities to suspend or override the termination rights of counterparties facing a financial institution in resolution (discussed above), so other SRRs contain similar powers. However, it is not certain that such suspensions and overrides would be enforceable against a counterparty where the law of the relevant SRR is different from that of the governing law of the relevant contract between a financial institution in resolution and such counterparty. Hence the Stay Protocol aims to achieve cross border recognition of such suspensions and overrides by incorporating such recognition into the relevant contract.

Key components

The Stay Protocol amends ISDA Master Agreements and related credit support documents in two distinct ways under two separate sections. The amendments apply to both existing trades and future trades.

Opt-in to SRRs

Section 1 of the attachment to the Stay Protocol sets out an "opt-in" mechanism, under which each adhering party agrees to be bound by the SRR applicable to its counterparty to each covered agreement and each "related entity" of its counterparty (including Credit Support Providers, Specified Entities and certain parents). In doing so, the adhering party is agreeing that it will be able to exercise termination rights under the covered agreement only to the extent that such SRR permits. Accordingly in this regard the parties are effectively in the same position as if their agreement were governed by the laws of the jurisdiction of the applicable SRR rather than the express governing law.

Section 1 also provides that any transfer of a covered ISDA Master Agreement or credit support document to a successor of an institution in resolution will be effective only to the extent that such transfer would be effective if the agreement or document were governed by the laws of the jurisdiction of the applicable SRR.

The SRRs currently covered by the Protocol are those of the UK, France, Germany, Japan, Switzerland and the US. For each of the UK, France and Germany, the relevant SRR is the local implementation of the BRRD.

The Stay Protocol also contemplates that new regimes in the other jurisdictions represented in the FSB could be added, provided that they satisfy certain conditions. The conditions are primarily safeguards for the protection of creditors, including among others:

(a) that there is no discrimination between creditors on the basis of nationality or location of creditors, or the jurisdiction in which claims are payable;

(b) if a temporary stay is imposed on the exercise of termination rights, such stay must not last longer than two business days; and

(c) protection of all netting and set-off rights under the applicable agreements.

It remains to be seen when the other FSB jurisdictions will adopt regimes that are eligible to be added to the Stay Protocol.

US insolvency proceedings

Section 2 of the attachment to the Stay Protocol provides that each adhering party agrees not to exercise certain cross-default rights under ISDA Master Agreements if an affiliate of its counterparty becomes subject to ordinary (i.e. non-SRR) insolvency regimes such as the US Bankruptcy Code and the Federal Deposit Insurance Act. Since these regimes do not include stays on termination for cross-default, Section 2 seeks to fill that gap rather than to operate by way of opt-in. There is significant complexity in Section 2, the detail of which is beyond the scope of this briefing.

This is a pre-emptive response to regulations expected to be introduced in 2015, therefore it will become effective on the date for compliance with those regulations.

Limitations

Plainly the Stay Protocol is currently limited in that certain SIFIs but very few other entities have adhered to it. Although those SIFIs together constitute a predominant proportion of the non-cleared derivatives market, there is an asymmetry in the market: if one of the adhering SIFIs were to become subject to resolution action presently, the others would not be able to terminate derivative transactions as a result; other counterparties to the SIFI in resolution may not, however, be prevented from using the resolution action as a trigger to terminate transactions.

In order for the Stay Protocol to be a useful solution, therefore, other banks and non-bank market participants need to adhere in the near term. The original intention had been for banks and buy-side firms to adhere at the same time but buy-side adherence has been separated because of concerns that asset management firms could not voluntarily give up termination rights since to do so would not be consistent with their fiduciary duty to act in the best interests of their clients. Accordingly such firms will need to be incentivised or compelled to opt in by new regulation.

The FSB's recent consultation on cross-border recognition of resolution action (mentioned above) sets out measures that national regulators can use to support adoption of contractual stay provisions, effectively to convert the present voluntary approach into a regime that is mandatory for a range of market participants. Since many asset management firms are not subject to prudential regulation, they are likely to be compelled to opt in through indirect means, by the introduction of new rules preventing banks from trading with counterparties that have not contractually agreed to stay provisions.

Future developments

The FSB has stated that its member jurisdictions are committed to supporting the opt-in process and are aiming to take the necessary regulatory or supervisory action such that banks and, where appropriate, other firms with significant derivatives exposures adopt contractual stay provisions on a cross-border basis by the end of 2015. It is possible that the Stay Protocol may be updated in future to reflect any such action.

However, the Stay Protocol should be a temporary measure, since in the longer term regulators are expected to seek to implement more comprehensive statutory frameworks for the cross-border recognition of resolution action. Accordingly the FSB consultative document outlines a set of elements that jurisdictions should consider including in their legislation.

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