

9 February 2015

**THE LEGAL COMMITTEE OF THE ICC BANKING COMMISSION**

**To: the ICC Banking Commission Executive Committee**

**Re: A PROPOSAL FOR A POSITION PAPER BY THE LEGAL COMMITTEE OF THE ICC  
BANKING COMMISSION – CRR ARTICLE 194**

Dear members of the Executive Committee,

ICC Banking Commission rules are regularly used in guarantees, letters of credit and bank-to-bank reimbursements across the world as credit mitigation arrangements. The consistency of their use, their broad acceptance and the relative uniformity in their interpretation by national courts and arbitral tribunals with the guidance of Commission opinions make the ICC rules a key factor of legal certainty *ex ante*.

In its transposition of the Basel 3 accord through the CRD IV regulations, the European Union issued the Capital Requirements Regulation which entered into effect on January 1, 2014 (CRR). CRR article 194 requires financial institutions that use credit mitigation arrangements to ensure that they are legally effective and enforceable in all relevant jurisdictions. Moreover, those institutions are required to provide, upon request of their regulators, the most recent version of the independent, written and reasoned legal opinion or opinions that it used to establish whether its credit protection arrangement

Banks subject to CRR article 194 (which includes any bank that undertakes banking activity in the EU) expressed legitimate concerns as to the additional costs that will likely ensue from their duty to obtain an independent legal opinion for each guarantee or letter of credit that they use as credit protection.

ICC Banking Commission can considerably alleviate this burden by commissioning a law firm to issue a generic legal opinion stating the effectiveness of guarantees, letters of credit and bank to bank reimbursements issued subject to ICC rules. To the extent that national regulators were additionally to require a specific local legal opinion, local firms can opine from a local law standpoint on the generic legal opinion, thus limiting substantially the likely costs and delays.

In commissioning such an opinion, ICC Banking Commission would align itself with other international organisations that consistently commission similar opinions in relation to their rules or master agreements, including ISDA and BAFT.

Firms bidding for such a task are expected to charge a nominal fee that should be easily met out of the Commission budget or a special budget to be set from monetary ear-marked contributions by interested Commission members.

The Legal Committee proposes that the Executive Committee:

- endorses and acts upon the recommendations set out in the attached report, and
- in the meantime, posts the attached on the Commission website as a Position Paper.

Sincerely,

Dr Georges Affaki

Chair

19 January 2015

To: Members of the ICC Banking Commission Executive Committee

Rapporteur: Angelia Chia

**Proposal to obtain a legal opinion on the instruments governed by URDG 758, UCP600 and URR 725 to meet the requirements of Article 194 of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (“the CRR Regulation”)**

### **Executive Summary**

In order to ensure legal certainty and a level playing field within the European Union, a single set of regulations for all market participants was considered to be a key element for the functioning of the internal market. Regulation (EU) No. 575/2013 and Directive 2013/36/EU form the legal framework governing the access to the activity, the supervisory framework and the prudential rules for credit institutions and investment firms. Against this backdrop, a new requirement is set out under Article 194 of the Regulation (EU) No. 575/2013 (“the CRR Regulation”).

**Article 194** provides as follows:

1. *The technique used to provide the credit protection together with the actions and steps taken and procedures and policies implemented by the lending institution shall be such as to result in credit protection arrangements which are **legally effective** and **enforceable in all relevant jurisdictions**.*

***The lending institution shall provide, upon request of the competent authority, the most recent version of the independent, written and reasoned legal opinion or opinions that it used to establish whether its credit protection arrangement or arrangements meet the condition laid down in the first sub-paragraph.***

*(emphasis added)*

Whilst this requirement of a legal opinion does not usually pose a challenge in relation to a security document which is registrable in an official registry in a local jurisdiction (eg. Nonpossessory security) it is more of a challenge where there are cross-jurisdictional issues and where local law may not have kept pace with the efforts of the ICC to foster certainty in banking.

URDG 758, UCP 600 and URR 725 are used regularly in credit risk mitigation arrangements covering billions of dollars. This happens notwithstanding many jurisdictions not having court decisions or statutes explicitly endorsing the rules of ICC in publications URDG758, UCP600 and URR725. The legal certainty and the comfort in the use of ICC rules stem from the effectiveness that is seen in practice and effective modes of dispute resolution outside of the court process such as through ICC Docdex.

The Legal Committee proposes that ICC should lend its support to the effectiveness of credit risk mitigation arrangements governed by URDG758, UCP600 and URR725 as outlined below.

### **How do the CRR Regulations apply to URDG758, UCP600 and URR725?**

Besides Article 194 set out above requiring a legal opinion, the CRR Regulations also prescribe the requirements for funded and unfunded credit protection arrangements.

In relation to unfunded credit protection arrangements, the ICC has rules which apply to certain Trade products that would qualify as unfunded credit protection arrangements. These are:

- A. Guarantees governed by the ICC Uniform Rules for Demand Guarantees 2010 Revision ICC Publication No. 758
- B. Standby Letters of Credit governed by the Uniform Customs and Practice for Documentary Credits 2007 Revision ICC Publication No. 600

C. Reimbursement Undertaking governed by the Uniform Rules for Bank to Bank Reimbursements under Documentary Credits ICC Publication No. 725

In reviewing whether an unfunded credit protection arrangement is legally effective and enforceable in all relevant jurisdictions, several Articles in the CRR Regulation have to be considered.

Who can be a provider of an unfunded credit protection?

Article 194(5) provides that the entities that shall qualify as an eligible protection provider if they are included in a list set out in Article 201 or 202.

Bearing in mind the objectives of the ICC, the Legal Committee proposes that ICC only focuses on financial institutions and assume that the scope of the legal opinion only covers institutions and financial institutions which fulfil the criteria of Article 201(1)(f) and Article 119(5). This should cover any regulated and supervised financial institution (See Article 119(5)).

What type of agreements shall qualify as an eligible protection agreement?

Article 194(6) provides that

- (a) the agreement must be included in a list of eligible protection agreements set out in Article 203 and 204(1);
- (b) the agreement must be legally effective and enforceable in the relevant jurisdictions, to provide appropriate certainty as to the credit protection achieved having regard to the approach used to calculate risk-weighted exposure amounts and to the degree of recognition allowed;
- (c) the protection provider meets the criteria set out in Article 194(5).

Under Article 203, guarantees are specifically listed an eligible unfunded credit protection.

Although Standby Letters of Credits and Irrevocable Reimbursement Undertakings are not specifically mentioned in the CRR Regulation, the ICC Legal Committee proposes the view that they can, in this respect, be treated similarly to guarantees and the same criteria can be applied to all of them.

Working on the aforementioned view, Articles 213 and 215 set out the requirements that are applicable to guarantees.

**Article 213** provides as follows:

*Subject to Article 214(1), credit protection deriving from a guarantee ... shall qualify as eligible unfunded credit protection where all the following conditions are met:*

- (a) the credit protection is **direct**;
- (b) the extent of the **credit protection is clearly defined and incontrovertible**;
- (c) the **credit protection contract does not contain any clause, the fulfilment of which is outside the control of the lender, that**
  - (i) **would allow the protection provider to cancel the protection unilaterally**;
  - (ii) **would increase the effective cost of protection as a result of a deterioration in the credit quality of the protected exposure**;
  - (iii) **could prevent the protection provider from being obliged to pay out in a timely manner** in the event that the original obligor fails to make any payments due, or when the leasing contract ....
  - (iv) **could allow the maturity of the credit protection to be reduced by the protection provider**;
- (d) **the credit protection contract is legally effective and enforceable in all jurisdictions which are relevant at the time of the conclusion of the credit agreement**.

**Article 215** provides as follows:

*Guarantees shall qualify as eligible unfunded credit protection where all the conditions in Article 213 and all the following conditions are met:*

*(a) on the qualifying default of or non-payment by the counter-party, **the lending institution has the right to pursue, in a timely manner, the guarantor for any monies due under the claim in respect of which the protection is provided and the payment by the guarantor shall not be subject to the lending institution first having to pursue the obligor;** ...*

*(b) the **guarantee is an explicitly documented obligation assumed by the guarantor;***

*(c) either of the following conditions is met:*

*(i) the **guarantee covers all types of payments the obligor is expected to make in respect of the claim;***

*(ii) **where certain types of payments are excluded from the guarantee, the lending institution has adjusted the value of the guarantee to reflect the limited coverage.***

*(emphasis added)*

## **Proposal**

In light of the nature of the instruments, the parties and the requirements of the CRR Regulation, the Legal Committee proposes that ICC instructs an external law firm to issue a generic legal opinion that would address the regulator's requirements under Article 194 of the CRR Regulations when read with the other applicable regulations, on the relevant instruments. This opinion would then be the lynchpin for local opinions that may be issued in relevant jurisdictions.

It is proposed that funding be shared by ICC members/ICC members based in the European Union.

Pending the Executive Committee's decision on instructing a firm, the Legal Committee requests that this paper be posted on the ICC website as a source of information on this important topic.

This proposal is supported by the Legal Committee.