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 – Articles 44 and 55 BRRD

Dear members of the Executive Committee,

Applicable as from 1 January 2015 in the EU, the Bank Recovery and Resolution Directive (BRRD) establishes a framework for the recovery and resolution of EU credit institutions. In particular, Article 4 BRRD directs EU Member States to ensure that the powers of a resolution authority in relation to writing down or converting liabilities (the "bail-in tool") may be applied to all liabilities of a bank, with the exception of fully secured liabilities and certain liabilities with remaining maturity of less than seven days. There is no general exemption for liabilities resulting from trade finance transactions.

Article 55(1) requires banks to include a "Bail-in Recognition Clause" in all of their agreements (under which liabilities can arise) by which the counterparties recognise the effects of a bail-in, unless the relevant liabilities are governed by the laws of an EU country or a third country that recognises the exercise of bail-in powers under the BRRD. It is difficult to conceive how the required bail-in recognition clause can be systematically stipulated in standardized guarantees and letter of credits or why counterparties from third countries would accept it. This is likely to cause substantial disruption to trade finance instruments and increased costs due to the need to carve out relevant situations from standard processing.

Call for Action: the Legal Committee urges the Executive Committee of the ICC Banking Commission to identify the best means to contact EBA with a view to explaining the nature of trade finance transactions and the reasons for their exemption from the stipulation requirement. All the arguments are outlined in the attached paper and demonstrate that the rationale for bail-in should not apply to trade finance.

EBA is currently conducting a consultation on certain aspects of BRRD. While responses are required by 5 February 2015, the Legal Committee seeks the approval of the Executive Committee to participate in the consultation and file a belated response in line with its attached recommendations.

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

9 February 2015

Proposal in relation to bail-in powers and obligation of institutions to ensure contractual recognition of bail-in powers by their counterparties (Articles 44 and 55 BRRD)

Rapporteur: Ron van Staten

1. Background

(1)- BRRD

The Bank Recovery and Resolution Directive (*2014/59/EU*) (**BRRD**) establishes a framework for the recovery and resolution of EU credit institutions and significant investment firms. [1]

The aim of BRRD is to ensure that authorities have tools and powers to tackle crises at banks and certain investment firms. It directs each EU Member State to transpose the BRRD rules into national law. It entered into force on 2 July 2014. The deadline for Member States to have their legislation in place was 31 December 2014. Application of the new legislation should have started on 1 January 2015 provided that Member States are permitted to apply the provisions on the bail-in tool from 1 January 2016.

(2). Bail-in tool

BRRD defines bail-in tool as "*the mechanism for effecting the exercise by a resolution authority of the write-down and conversion powers in relation to liabilities of an institution under resolution in accordance with Article 43*".

Article 4 BRRD directs EU Member States to ensure that the "bail-in tool" may be applied to all liabilities of a bank and certain investment firms and financial entities (as specified in Article 1 BRRD (covered institutions), with the exception of certain types of liabilities specified in Article 44 (2) BRRD (exempted liabilities).

Exempted liabilities include secured liabilities (Article 44 (2) (b) BRRD) and certain liabilities with remaining maturity of less than seven days (Article 44 (2) (f) BRRD).

There is no general exemption for liabilities resulting from trade finance transactions or similar transactions.

(3). Bail-in Recognition Clause

The Member States must require covered entities, under Article 55(1) BRRD, to include a contractual clause in all of their agreements (under which liabilities can arise) by which the counterparties recognise the effects of a bail-in, i.e. a reduction of the principal or outstanding amount due, a conversion of the liability into equity or cancellation of the liability (the "**Bail-in Recognition Clause**").

A Bail-in Recognition Clause will not be required for liabilities governed by the laws of: (i) an EU country, (ii) a third country jurisdiction in relation to which the competent national regulatory authority has determined that the resolution regime of that third country already recognises the

[1] The current full text can be found through the following link: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN.

exercise of bail-in powers under the BRRD or (iii) countries with which inter-governmental agreements have been entered into to this effect. It is expected that such exemptions will apply to jurisdictions which have introduced or are about to introduce similar resolution regimes based on the "Key Attributes of Effective Resolution Regimes for Financial Institutions" of the Financial Stability Board of 15 October 2014 (FSB Key Attributes). However, no exemptions have been identified so far and it is likely that only very few jurisdictions will have resolution regimes that recognise the exercise of the bail-in powers under the BRRD.

(4) Task of the EBA

The European Banking Authority (**EBA**) is tasked with: (i) developing regulatory technical standards (**RTS**) to further determine the list of liabilities to which the exclusions from the scope of a bail-in applies and (ii) determining the content of the Bail-in Recognition Clause, under Article 55 (3) BRRD.

EBA is to submit draft RTS standards before 3 July 2015 (Article 55(3)) to the European Commission for adoption. The European Parliament is involved in the adoption process.

EBA has recently published a consultation paper setting out proposed draft technical standards (*Consultation Paper - Draft Regulatory Technical Standards on the contractual recognition of write-down and conversion powers under Article 55(3) of the Bank Recovery and Resolution Directive (BRRD)* – EBA/CP/2014/33). Responses to this consultation can be submitted until 5 February 2015.

The draft RTS are to further determine under which circumstances a collateralised liability may qualify as secured liability. Secured liabilities are exempted from the scope of a bail-in. Under the draft proposal, liabilities which are not fully collateralised at all times during the term of the transaction will not qualify as an exempted secured liability. Further exemptions are not considered in the draft RTS.

(6). Affected financial institutions

Naturally, banks and certain investment firms in the EU will be directly affected by Member States legislation that transposes the BRRD. Non-EU banks and firms will be indirectly affected. They will have to consider: (i) the risk of their claims against an EU bank or firm being written off or converted outside insolvency proceedings; and (ii) whether or not to agree the contractual 'bail-in' terms in their contracts with EU banks and firms.

2. Impact on trade finance

A large portion of trade finance transactions will be affected by the requirement for a Bail-in Recognition Clause:

- Most liabilities arising under trade finance transactions or connected thereto will not be excluded from the scope of the bail-in described in Article 44 (2) BRRD. However, depending on the interpretation of secured liabilities (see Article 44 (2) (b) BRRD) (as further determined by the future RTS) and liabilities with remaining maturity of less than seven days (see Article 44 (2) (f) BRRD), it may be possible to wholly or partially exempt some trade finance related liabilities from a bail-in.
- Liabilities governed by the laws of an EU member's state would not be required to have a Bail-in Recognition Clause but would, of course, fall within the scope of a bail-in unless exempted. However, many trade finance transactions are subject to the laws of a third country. In addition, for many trade finance instruments it is not common to have an express choice of governing law.

In any event, the mere fact that liabilities may be subject to a bail-in is highly likely to discourage counterparties from a third country from recognising the bail-in tool and accepting a Bail-in Recognition Clause. This would discourage them from entering into trade finance transactions with institutions which are subject to the BRRD. It should also be noted that most trade finance is done through standardized documents used globally between trade finance banks. Industry experts predict that it will be extremely difficult to get counterparties in all corners of the world to accept the EU Bail-in Recognition Clause.

This will create a direct and serious competitive disadvantage for all European institutions and directly affect access of European manufacturers and service providers to trade finance instruments which will weaken their competitiveness in international markets. In view of the importance of trade finance instruments for international trade, in particular, for small and medium sized companies, a general exemption for trade finance liabilities from the bail-in tool should be seriously considered.

3. Options

Currently, the following options exist to address the issue of the negative impact of the BRRD's requirement for a Bail-in Recognition Clause on trade finance transactions. These options could be pursued in conjunction or alternatively:

<u>1) Approaching the national and EU legislators for General Exemption</u>

The BRRD is already in force so it will not be possible to introduce a general exemption for trade finance transactions in the BRRD in the short term. However, that should not prevent institutions and organisations involved in trade finance from contacting the EU and national legislators. They can point out the concerns and expected negative consequences for trade finance and call for a revision of the BRRD and introduction of an exemption for trade finance transactions from the requirement to have a Bail-in Recognition Clause. To be successful such actions should start sooner rather than later.

In addition, affected institutions could use their resolution planning discussions with national and EU regulators to clarify if and to which extent regulators deem it necessary to include a bail-in clause in trade finance liabilities.

There is limited time and opportunity to convince the EBA and the national and EU legislators that liabilities arising under trade finance instruments should be added to the list of excluded liabilities in Article 44. Nonetheless, the EU legislator, the EBA and the national regulators which transpose the BRRD into national law, should acknowledge the special nature of trade finance compared to other types of finance.

<u>2) Response to the EBA Consultation</u>

The above request for a general exemption could be combined with calling on the EBA to ensure that at the very least the RTS currently under discussion (and yet to be adopted by the European Commission) are used to alleviate some of the negative consequences for trade finance transactions, in particular by ensuring that:

> (i) the existing exemptions for secured liabilities and liabilities with a remaining maturity of less than seven days (Article 44 (2) (b) and (f) BRRD) are refined or clarified in such a way that they capture some types of trade finance transactions, and

(ii) all other possibilities are explored to introduce further exemptions in respect of certain types of trade finance transactions within the constraints set by the BRRD.

4. Reasons for Exemptions

The following arguments could be raised in support of a general exemption or at least of measures to limit the negative effects:

(1) Not excluding trade finance products would not contribute to the loss absorption of the type sought through the BRRD. Trade finance liabilities arise not out of a desire to fund a bank but out of the desire to fund a real trade transaction funded or supported by a bank. Trade finance instruments facilitate an underlying trade. The decision to accept a trade finance exposure on a bank is mainly driven by what is required to support the underlying transaction. Reason why the remuneration to which the creditor is entitled for that exposure is often not paid by the debtor bank but by another party.
Adding trade finance to the article 44 exclusions would not make parties less diligent in accepting a liability on a bank. As said, that decision is mainly driven by other factors (e.g. the requirements of that trade). Furthermore, the fact that a liability cannot be subjected to the bail-in tool does not remove the risk for the creditors. They will still be at risk for making a loss (although see (5) below).

(2) The BRRD requires that financial institutions in scope of the bail-in tool meet the Minimum Requirement for Own Funds and Eligible Liabilities ("**MREL**"). The MLER is the minimum buffer of own funds and liabilities that can potentially be bailed in. Presumably the Bail-in Recognition Clause aims to achieve that as many liabilities as possible can be bailed in (and count towards the MLER). However, liabilities with a remaining maturity of less than one year will not be included in the calculation of the MLER (Article 45(4)(d) BRRD).[2] Importantly, trade finance liabilities generally have a remaining tenor of less than one year. Why require banks to insert Bail-in Recognition Clauses for trade finance liabilities when these liabilities will not be included in the MLER?

(3) Trade finance liabilities are to a large extent contingent liabilities representing off-balance sheet obligations. A bank's financial position will not benefit from the bail-in of contingent liabilities. Therefore, serious thought should be given to the need to classify contingent liabilities as liabilities eligible for bail-in. A bail-in of contingent trade finance liabilities is likely to merely disrupt the underlying trade transaction between two (innocent) trade parties rather than have a positive effect on the bank's financial position.

(4) Trade finance is the lifeblood of international commerce and often crucial for a country's economy. For this reason, short term trade finance is often exempted from the restrictions introduced under a country's moratorium. The trade finance business of banks supports real underlying trade transactions. Without trade finance services offered by banks international trade would be nigh impossible. The exposure on banks that arises in trade finance is not the purpose of trade finance, it's rather an inevitable corollary of these services provided to sellers, buyer, traders, exporters and importers. Making the liabilities on banks subject to an EU bail-in tool would make trade finance in the EU more expensive and less available. It

[2] This fact should take away the concerns of those banks that believe that they need trade finance liabilities in order to meet the required MLER.

would in general negatively impact trade by companies in the EU and therefore the EU real economy.

(5) In many cases (e.g. letters of credit, bank guarantees) trade finance related liabilities are backed by a counter-indemnity or reimbursement claim of the covered entity. The covered entity will usually not face a loss if it meets its obligation under the trade finance related liability. It will have a claim for the amount it paid out against another party, usually the party that instructed it to issue the relevant trade finance instrument. Data collected by the ICC demonstrate that the default risk for trade finance instruments is exceptionally low. As the risk to incur an actual loss in connection with a trade finance liabilities is low, why would there be a need to make the trade finance liability subject to a bail-in?

(6) Article 44 (3) (c) BRRD provides for the exclusion of certain liabilities where necessary and proportionate to avoid widespread contagion (…) '*which would severely disrupt (...) the financial markets (...) in a manner that could cause a serious disturbance to the economy of a Member State*'. The legislators and regulators should consider the effects a write-down of a bank's trade finance liabilities will have on the bank's clients, such as exporters and international traders, and on other trade finance banks in the same country. A bail-in in trade finance related liabilities will primarily affect manufacturers and service providers and the export sector as a whole. Application of the bail-in tool against a bank is likely to have a contagious effect on other banks (and their clients) in the same country. These clients will find it hard to agree payments terms and may either not sell or be forced to agree less safe payments terms. The effect on the country's import and export and therefore its economy would be severe. Excluding trade finance liabilities from the bail-in tool would however have an insulating effect on a country's export and international trade. Which would be much needed in these circumstances.

(7) Article 44 (3), paragraph (b) BRRD provides for the exclusion of certain liabilities where necessary and proportionate to '*achieve critical functions and core business lines*'. The argument is that trade finance **is** such a critical function and core business line. In much the same way that looking after customers' cash deposits is. Continuity of those critical functions and core business lines would not be achieved by subjecting trade finance exposure to the bail-in tool. On the contrary, it would have the exact opposite effect. If one of the BRRD's main aims is to ensure the continuity of a failing financial institution's critical financial and economic functions then trade finance liabilities should clearly be in the list of excluded liabilities in Article 44 BBRD.

If the ICC were to seek an exemption for trade finance liabilities it could consider adding general statistical and other information on the importance of trade finance for international trade and the EU economy (perhaps through a separate Annex). In addition, ICC may want to offer to EBA its willingness to further discuss the impact article 44 and 55 BRRD will have on international trade finance.

16 January 2015

Ron van Staten (ING Bank N.V.) on behalf of the
Legal Committee to the ICC Banking Commission

with helpful comments and suggestions from:Michael Seeger (Deutsche Bank A.G.) and Lambert Köhling (Association of German Private Banks)