



Suspension of Contractual Rights of Counterparties to UK Banks

On 26 May 2015, the Prudential Regulation Authority (“PRA”) of the UK issued a consultation paper entitled “Contractual stays in financial contracts governed by third-country law”¹, proposing a new restriction that would apply to the business of UK banks, building societies and investment firms supervised by the PRA, as well as their UK parent companies.

Background

The Financial Stability Board (“FSB”), in its 2011 publication, “Key Attributes of Effective Resolution Regimes for Financial Institutions”, established common principles for the development of recovery and resolution regimes for failing banks. These Key Attributes have been endorsed by the G20 group of nations and have been largely adopted by several of those jurisdictions into their national laws, for instance via the Bank Recovery and Resolution Directive² in the EU (“BRRD”). One of the most important features of an effective bank resolution regime is the ability of the national resolution authority to stabilise a failing bank long enough to give a breathing space within which decisions can be made as to how to resolve that bank while minimising disruption to its critical functions and the consequent adverse effect that would have on financial stability.

Such stability would be impossible to achieve if a counterparty to a contract with the failing bank were able to rely on a resolution action as a reason to exercise early termination rights in relation to the contract or other rights such as powers of acceleration, set-off or netting, etc. Therefore, the Key Attributes provide that the entry of a bank into resolution and the exercise of any resolution powers should not trigger any set-off rights or constitute an event entitling a counterparty of the bank to exercise any contractual acceleration or early termination rights, provided always that the substantive obligations under the contract (such as payment, delivery and collateral obligations) continue to be performed. Such a restriction is sometimes referred to as a “permanent stay”. In addition, the resolution authority should have the power to temporarily suspend or stay such contractual rights where they have arisen only by virtue of the entry into resolution or in connection with the exercise of any resolution powers.

These restrictions and powers, prescribed by the Key Attributes, have been broadly implemented into the laws of the U.S., by virtue of Title II of the Dodd-Frank Act and into the laws of most EU member states, pursuant to national implementation of the BRRD.

¹ Prudential Regulation Authority Consultation Paper CP19/15 May 2015 - <http://www.bankofengland.co.uk/pru/Pages/publications/cp/2015/cp1915.aspx>.

² Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 - <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0059&from=EN>.

As a result, the Federal Deposit Insurance Corporation in the U.S. (as the Orderly Liquidation Authority under Title II of the Dodd-Frank Act) and national resolution authorities in EU member states have, or will have, powers provided by statute to impose a temporary stay on early termination rights for a short period, not exceeding two business days), in addition to any permanent stay provided by their domestic legislation. However, there is significant doubt as to the enforceability of such a stay against a contract counterparty, where the relevant contract affected by the stay is not being enforced in the jurisdiction of the resolution authority. In the EU, by virtue of the national implementation of the BRRD, a temporary stay imposed by the resolution authority of one EU member state will be enforceable in respect of contracts governed by the law of any EU member state. However, there would be a question of enforceability of any such temporary stay in relation to a contractual right governed by the laws of a non-EU jurisdiction, such as New York.

The FSB has acknowledged that a lack of cross-border recognition of resolution actions poses a major obstacle to the success of a resolution of a global systemically important bank, and in September 2014, it issued a consultative document proposing that FSB member jurisdictions should enact statutory cross-border recognition frameworks as a long-term solution to the problem. However, the FSB also acknowledged that it was likely to take several years for such statutory frameworks to be implemented, and that, as an interim solution, member jurisdictions should implement a contractual approach to achieve cross-border recognition of stays on early termination rights.

The International Swaps and Derivatives Association (“ISDA”) recently drafted a resolution stay protocol, by which parties to over-the-counter derivatives documented under one of the ISDA master agreements could agree, by signing the protocol, to incorporate the resolution stay recognition provisions into their master agreements. Initially, 18 of the largest global derivatives dealers adhered to the protocol in January 2015, and it is expected that later in 2015 a similar approach will be developed for securities financing and repo transactions.

Countries such as the UK, the U.S., Germany, France, Japan and Switzerland have committed to supporting initiatives such as these to entrench contractual recognition of resolution stays, and this consultation by the PRA sets out its proposals to achieve this in the UK.

The PRA’s Proposed Rule

The PRA is proposing a new rule that would prevent “in-scope” firms from creating new obligations, or making material amendments to an existing obligation, under a financial arrangement without a prescribed written agreement from its counterparty. The written agreement required from the counterparty is that it may only enforce any early termination right, right of acceleration, close out, set-off or netting, or any provision that prevents an obligation arising on its part, or that suspends, modifies or extinguishes an obligation (each, a “termination right”, for these purposes) to the extent that it would be entitled to do so under the UK’s Special Resolution Regime (contained in the Banking Act 2009) if (i) the relevant financial arrangement were governed by the laws of any part of the UK and (ii) the relevant firm were an institution subject to the Capital Requirements Regulation (“CRR”) in the EU³.

The requirement applicable to the creation or amendment of obligations will apply to UK banks and building societies and UK investment firms supervised by the PRA, as well as their respective parent undertakings that are either financial holding companies or mixed financial holding companies (each as defined in the CRR) incorporated or with a place of business in the UK. However, it will not apply to a mixed activity holding company (being a holding company whose subsidiaries are not exclusively or mainly credit institutions, investment firms or financial institutions).

³ Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 – <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32013R0575&from=EN>.

“Financial arrangements” are, unhelpfully, defined only on a non-exclusive basis. The definition includes financial contracts, such as (i) securities and commodities sales, purchases or loans, (ii) options on securities and commodities and (iii) repos or reverse repos on securities and commodities. It also includes futures and forwards contracts, swap agreements and other “derivatives” as defined in the EMIR regulation⁴. It includes inter-bank borrowing agreements with a maturity of three months or less, as well as master agreements for any of the above contracts or agreements or for the sale, purchase or delivery of currencies.

The Effect of the Proposed Rule

The effect of this proposed rule for an in-scope firm is that, when the provisions of the new PRA regulation become applicable to it, it will be unable to enter into any new financial arrangement governed by a non-EU law, unless it has the written agreement of its counterparty to be bound by the provisions of the UK’s Special Resolution Regime.

This will mean that, where the Bank of England, *inter alia*, takes resolution action in relation to a member of the in-scope firm’s group, and uses its powers to impose a temporary stay, the firm’s counterparties’ termination rights will be suspended for a period lasting up to midnight on the London business day following the date on which the stay order is published.

In addition, the counterparties will not be able to rely on the occurrence of events such as the exercise of a stabilisation power by the Bank of England or the UK Treasury, the recognition by the Bank of England of a third-country resolution, or any events directly linked to such events, to trigger an early termination right.

Certain counterparties, such as central banks, central counterparties and payments and securities settlement systems, are excluded from having to sign such a written agreement.

Proposed Timing

The PRA has proposed a staggered implementation of the new rule, based upon the type of counterparty that the in-scope firm is facing. It proposes that the restriction should apply as from 1 January 2016 for counterparties that are credit institutions and investment firms and from 1 July 2016 for counterparties that are asset managers (or their managed funds), insurers and other counterparties that act on a counterparty basis. The proposed six-month delay in application for these types of counterparties is due to the expectation that it may take some time for these types of entities to be able to achieve the changes that would be necessary to their investment mandates as a result of this provision.

For financial arrangements with all other counterparties, the proposed restrictions are intended to apply as from 1 January 2017.

The PRA consultation is open for comments until 26 August 2015.

Comment

Other major banking jurisdictions are expected to follow suit in due course in imposing similar restrictions on their financial institutions and related companies. However, to the extent that they lag behind in their implementation, this places UK banks and financial institutions at a disadvantage to those in other countries. Ultimately, a counterparty cannot be forced into agreeing to such provisions, except by the threat that its

⁴ Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 – <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32012R0648&from=EN>.

contractual relationships would have to cease with that particular institution. However, that may not be much of a threat so long as enough banks in other jurisdictions are able to provide them with similar financial arrangements, without the need for such a written agreement in their contract. Of course, another possible outcome is for all financial arrangements between the UK entity and its counterparties to be governed by English law, or the law of another EU member state that has implemented BRRD, in which case any resolution stay would be enforceable against its counterparties, with or without a contractual agreement to that effect.

One thing in particular that the PRA should consider is to define precisely which arrangements are “financial arrangements” for the purpose of this proposed rule. Defining this term only by stating which agreements are included within the definition means that market participants have no certainty as to whether other contracts, not specified, could also be within its scope.

Authors

Jeremy C. Jennings-Mares
London
+44 (20) 7920 4072
jjenningsmares@mofocom

Peter J. Green
London
+44 (20) 7920 4013
pgreen@mofocom

Oliver I. Ireland
Washington, D.C.
(202) 778-1614
oireland@mofocom

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We’ve been included on *The American Lawyer’s* A-List for 11 straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofocom. © 2015 Morrison & Foerster LLP. All rights reserved.

For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkt.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.