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Technical advice by the European Banking Authority on classes of arrangements to be protected in a partial property transfer

Introduction and legal basis

1. Under Article 76(4) of Directive 2014/59/EU (Bank Recovery and Resolution Directive, 'BRRD')[1], the Commission is mandated to specify classes of arrangements that fall under Article 76(2). Article 76 provides as follows:

   Article 76

   Safeguard for counterparties in partial transfers

   1. Member States shall ensure that the protections specified in paragraph 2 apply in the following circumstances:

   (a) a resolution authority transfers some but not all of the assets, rights or liabilities of an institution under resolution to another entity or, in the exercise of a resolution tool, from a bridge institution or asset management vehicle to another person;

   (b) a resolution authority exercises the powers specified in point (f) of Article 64(1).

   2. Member States shall ensure appropriate protection of the following arrangements and of the counterparties to the following arrangements:

   (a) security arrangements, under which a person has by way of security an actual or contingent interest in the assets or rights that are subject to transfer, irrespective of whether that interest is secured by specific assets or rights or by way of a floating charge or similar arrangement;

[1] Where this advice refers to articles without referring to any legal instrument, it refers to the BRRD.

(b) title transfer financial collateral arrangements under which collateral to secure or cover the performance of specified obligations is provided by a transfer of full ownership of assets from the collateral provider to the collateral taker, on terms providing for the collateral taker to transfer assets if those specified obligations are performed;

(c) set-off arrangements under which two or more claims or obligations owed between the institution under resolution and a counterparty can be set off against each other;

(d) netting arrangements;

(e) covered bonds;

(f) structured finance arrangements, including securitisations and instruments used for hedging purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to the covered bonds, which involve the granting and holding of security by a party to the arrangement or a trustee, agent or nominee.

The form of protection that is appropriate, for the classes of arrangements specified in points (a) to (f) of this paragraph is further specified in Articles 77 to 80, and shall be subject to the restrictions specified in Articles 68 to 71.

3. The requirement under paragraph 2 applies irrespective of the number of parties involved in the arrangements and of whether the arrangements:

(a) are created by contract, trusts or other means, or arise automatically by operation of law;

(b) arise under or are governed in whole or in part by the law of another Member State or of a third country.

4. The Commission shall adopt delegated acts in accordance with Article 115 further specifying the classes of arrangement that fall within the scope of points (a) to (f) of paragraph 2 of this Article.

For the interpretation of this text, recital 95 of the BRRD has to be taken into account:

(95) In order to preserve legitimate capital market arrangements in the event of a transfer of some, but not all, of the assets, rights and liabilities of a failing institution, it is appropriate to include safeguards to prevent the splitting of linked liabilities, rights and contracts, as appropriate. Such a restriction on selected practices in relation to linked contracts should extend to contracts with the same counterparty covered by security arrangements, title transfer financial collateral arrangements, set-off arrangements, close out netting agreements, and structured finance arrangements. Where the safeguard applies, resolution authorities should be bound to transfer all linked contracts within a protected arrangement, or leave them all with the residual failing institution. Those safeguards should ensure that the regulatory capital treatment of exposures covered by a netting agreement for the purposes of Directive 2013/36/EU is not affected.

2. Article 76 does not mandate the Commission to specify what the appropriate form of protection is; as stated in Article 76(2), this is specified in Articles 77 to 80, even though these provisions do not make it fully clear whether the protection specified therein is an exhaustive specification of what represents appropriate protection within the meaning of Article 76(2), or whether Member States may decide to grant other forms of protection which they deem appropriate. Therefore the advice does not recommend any form of protection. Nevertheless, the advice makes assumptions about what form the protection could take.

3. There are two options for how the advice could be structured: one option would be for the advice to make a detailed specification of arrangements falling under Article 76, listing certain types of arrangements[2]. The alternative option would be a specification through rules and definitions that would be more specific than what is set out in Article 76.

4. The first option of a list of arrangements seems to achieve a higher degree of harmonisation; this, however, would require the list to be exhaustive. At the same time the risk would be that some types of arrangements relevant in certain Member States are missing, if the list had the character of a complete enumeration of arrangements to which Article 76 applies. Likewise, it would be difficult to capture all terms designating the arrangements concerned in all languages of all Member States. In addition, this list would have to be extremely voluminous to be comprehensive. In any event, the substance of an arrangement would have to prevail over its labelling. Finally, the specification would need to address future developments and innovations in financial arrangements. For these reasons, the advice is based on the second option and specifies the arrangements based on rules and definitions more specific than in the BRRD.

5. To assess the potential impact of any type of protection in a partial property transfer, the advice estimates and quantifies the importance in European credit institutions' balance sheets and business activities of some of the classes of arrangement, to the extent possible. That assessment and quantification is based on the most recent information the EBA has received in accordance with the ITS on Supervisory Reporting or on other statistical information available.

General comments / proposals

a. Differentiated approach in specifying the scope

6. The advice could either recommend that the delegated acts should aim at specifying exhaustively what arrangements fall under Article 76, and which liabilities and contractual relationships are covered by these arrangements. Alternatively it could recommend that the delegated acts specify certain core types of arrangements which should at any rate be protected under Article 76, and other types, for which protection makes sense under certain

[2] This is the approach taken in the US legislation for example. See SEC. 210. of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, in particular SEC. 210. (c) (8) and (9).

circumstances in a specific environment. Under this option, the delegated acts could also specify for which further types of arrangements the protection, in particular by a prohibition to separate them from each other under a partial property transfer, could potentially impair the effectiveness and feasibility of the resolution tools implying a partial property transfer. The delegated acts should contain criteria for the specification of the arrangements enabling Member States' authorities to ultimately exclude arrangements that do not or should not fall into the scope, or the protection of which depends on expert judgment, or liabilities and agreements that are not necessarily or should not be covered by the arrangement, from the protection.

7. Again, it does not seem possible, even taking a rule- and definition-based approach, to exhaustively capture all arrangements in all Member States which should fall into the scope and be protected regardless of the circumstances and environment, and to distinguish them from those which definitely do not fall into the scope. Given the absence of substantial harmonisation in insolvency law across Member States and the low degree of legal harmonisation in many relevant fields such as security interests or structured financing, a more differentiated approach seems to be required. This seems all the more necessary given the various economic purposes that arrangements potentially falling under Article 76 can serve.

8. The various categories in Article 76 are not equally clear cut, as some classes are fully defined while others are described in vaguer terms. In addition, some arrangements typically refer to one contractual relationship and one liability or a limited set of relationships and liabilities (for example full title transfer security), while others cover a larger number and an open range of mutual liabilities, transactions and relationships (for example set-off and netting arrangements and securities financing transactions). So in some cases the definition does not leave room for specification at all, whereas in other cases the potential scope seems broader and less clear. In these latter cases the BRRD leaves more flexibility for specification based on additional criteria through Member States' implementing acts and through expert judgment by the resolution authorities; the delegated acts should contain such criteria. These criteria may be immanent in the arrangements themselves or may depend on additional factors. Potential criteria relevant for the question whether arrangements fall into the scope, and to what extent and by which means they should be protected, are, for example, the type and scope of transactions covered by the arrangement, the economic purpose of the arrangement, its counterparties or the law by which they are governed.

9. All these criteria and principles require Member States and resolution authorities to make more differentiated considerations. For these reasons the advice opts for, and recommends for the delegated acts, the second approach, namely distinguishing between different categories of arrangements: a core category which should be protected in any event and others where the protection should depend on additional criteria and the specific circumstances. The advice also points out arrangements or circumstances where protection would impair the feasibility and credibility of a resolution strategy involving a partial property transfer, and which should preferably be excluded from the scope. Where the scope of

Article 76(2) is not completely clear, the specification in the delegated acts should make sure that Member States and resolution authorities have the power to interpret the scope and apply the safeguards restrictively in a way that excludes these types of arrangements from the protection, even though they might be subsumed under Article 76 in a very broad interpretation. This would enhance legal certainty for resolution authorities and the effectiveness of the resolution tools.

b. General principles

10. Although this advice does not elaborate on the appropriate form of protection, the BRRD seems to suggest, and this advice assumes, that protection does not necessarily mean that *all* agreements which may be subsumed under Article 76(2) need to be protected by excluding them from being split up and separated under a partial property transfer. This can be concluded from Articles 77 to 79, which seem to distinguish a variety of different forms of protection and different scopes of agreements covered by an arrangement. In certain cases, there is the risk that the efficiency and even feasibility of the partial transfer would be seriously impaired, if the protection were to prohibit the separation of any and all arrangements which may be subsumed under Article 76. Two particularly problematic examples should illustrate this concern – set-off arrangements and security arrangements:

    a) The counterparties of the institution may for example agree on a so-called catch-all or sweep-up set-off agreement including any and all rights and liabilities between the parties. It seems that according to Article 78 in consequence of this type of agreement any liabilities between the parties would be protected against being separated from each other[3]. This would make the partial transfer with regard to this counterparty unmanageable, and in general would jeopardise the feasibility of the tool altogether, as the resolution authorities might even not be able to discern which liabilities are or are not covered by these arrangements.

    b) Security arrangements may relate to any and all assets of the debtor (e.g. floating charges under English law before crystallisation). If these were fully protected against splitting the liability and the assets to which the security relates, this would make any partial transfer of the liabilities and the assets potentially falling under the security arrangement impossible.

11. These examples show that it would add much value to the delegated acts if the specification therein were to increase legal certainty for Member States' resolution authorities for either excluding these types of arrangements from the protection or at least making sure that the protection does not prohibit a separation in the case of a partial property transfer. In some

[3] With a view to this problem, which became evident in certain resolution cases in the United Kingdom, clause (f) of the definition of 'excluded rights' in Article 1(3) of the Banking Act 2009 (Restriction of Partial Property Transfers) Order has been amended to limit the protection of set-off agreements that covers transferable securities to those securities 'referred to or described in' the relevant set-off arrangement. ('(f) which relate to transferable securities (other than transferable securities referred to or described in a set-off arrangement, netting arrangement or title transfer financial collateral arrangement referred to in article 3(1))')

cases the optimal remedy for these concerns may be choosing appropriate form of protection, rather than excluding these arrangements from the protection altogether (for example by limiting the protection to those liabilities that are sufficiently clearly identified). This, however, is only possible where Articles 77 to 80 permit Member States and resolution authorities to do so. In any event, this impairs legal certainty with regard to the arrangements concerned.

12. For these reasons, the delegated acts should follow the principle to give the highest possible degree of legal certainty to the parties to a contract with regard to the integrity of the arrangement as a whole. At the same time, the delegated acts should avoid hampering the use of partial transfers within the application of a resolution tool. In particular,

    - the risk of legal challenges should be minimised;
    - the parties should not be able to structure contracts in a way that creates an impediment to a partial transfer without a legitimate interest, while the criteria should not hamper legitimate interests in developing new products and in structuring transactions;
    - it should be feasible to effectively prepare a separation in resolution planning under the operation of the safeguards;
    - the resolution authority should have sufficient flexibility in splitting the balance sheet to reach the resolution objectives.

    At the same time the protection should reflect the economic rationale for the specific legal treatment and statutory protection of those arrangements, i.e. their function in reducing systemic risk in financial markets by minimising contagion, and should take into account whether the arrangements are recognised for risk mitigation purposes under the applicable regulatory rules and whether the protection, in particular by non-separability, is a condition for this recognition. These considerations are supported by recital 95, which states that the safeguards should ensure that the regulatory capital treatment of certain arrangements is not affected.

13. It should also be borne in mind that it is a principal objective of the resolution framework to ensure that, first, shareholders and, after that, creditors bear the losses of the institution under resolution (which may imply a certain risk of contagion) and that creditors of the same class should be treated in an equitable manner[4]. This also applies to any partial transfer. The safeguards should not jeopardise loss participation by creditors, which is a main principle of the resolution framework. So resolution authorities have to apply the resolution tool, alone or in conjunction with the bail-in tool, and the safeguards in a way that ensures the loss

[4] Provided the no creditor worse off safeguard is complied with, there may be circumstances in a partial transfer where unsecured creditors are transferred without being subject to loss participation, e.g. for financial stability reasons or to ensure continuity of critical functions.

participation of creditors envisaged by the BRRD. The decision whether or not to apply the bail-in tool in conjunction with the transfer should take into account the effect of the safeguards, for example for secured liabilities.

c. Considerations applicable across the classes of arrangements under Article 72(b) – CCPs, payment systems and national insolvency laws

14. Article 76(2) also refers to Article 80 for the specification of appropriate protection. However, unlike Articles 77 to 79, Article 80 does not refer to specific classes of arrangements under Article 76 when stipulating that the application of a resolution tool must not affect the operation of trading, clearing and settlement systems. It can be concluded that arrangements potentially falling into the scope of Article 76(2) should be protected because they relate to certain counterparties rather than due to their specific (economic of legal) nature. This may be a reason to apply the protection to any such arrangement also where a Member State or resolution authority follows the differentiated approach considered in this advice.

15. This means in particular that, if the delegated acts allow and Member States apply a restrictive interpretation of the safeguards, or the delegated acts aim to narrow down the scope of Article 76(2), this should not necessarily relate to safeguards for these systems, and more generally, for any central counterparty (CCP)[5]. The delegated act should not prevent Member States and resolution authorities from protecting all types of arrangements mentioned in Article 76(2), which are linked to the counterparty's activity as a CCP (they may undertake transactions which do not relate to this activity though). This should in particular include, but does not need to be limited to the activity covered by a default fund under Article 42 of the EMIR Regulation (EU) No 648/2012.

16. The same applies to rights and liabilities relating to payment systems. Netting arrangements falling in the scope of the Settlement finality directive 98/26/EC are protected in insolvency and they should be protected under Article 76. However, it could make sense to extend this to all arrangements with payment systems falling under Article 76(2) and relating to their activity as payment systems, where applicable.

17. Several of the arrangements in Article 76 are also protected in national insolvency laws. This means that, while in the insolvency laws of many Member States the administrator has the right to cancel certain contracts while maintaining others, this right to cherry pick does not apply to these arrangements (in particular close-out netting). In a similar manner, in some Member States set-off rights can still be exercised when creditors can no longer seek repayment of their claims other than from the proceeds of the insolvency administration. Also security interests are usually recognised in insolvency; i.e. the right to require the disposal of assets to repay the secured liabilities from the proceeds remains unaffected by the insolvency proceedings and the security interest continues to be attached to the assets concerned. Article 34(1)(g) establishes the principle that no creditor shall incur greater losses than would

[5] For the systemic relevance of CCPs see, for example, ESRB: Central counterparties and systemic risk (2012)

have been incurred if the institution had been wound up under normal insolvency proceedings. For the use of the partial transfer tool this means that as a rule, resolution authorities should safeguard creditors' rights in a comparable manner. Pursuant to Article 75, creditors are entitled to compensation if they receive greater losses than in normal insolvency proceedings. As this safeguard is not limited to the bail-in tool, it also applies to losses resulting from a partial property transfer, and creditors could be entitled to compensation in this case. It is therefore reasonable for resolution authorities to avoid these losses by following the treatment in insolvency.

18. At the same time, the level of harmonisation of insolvency laws is very low[6]. Therefore the advice recommends that the delegated acts – although there is a need for a restrictive application of the safeguards in certain cases under Article 76(2) or for narrowing down their scope where possible, as mentioned above – should in general not prevent Member States or resolution authorities from protecting any classes of arrangements which (a) can be subsumed under one of the categories in Article 76(2) and (b) are protected in insolvency proceedings against a separation of rights and liabilities falling under these agreements according to their national insolvency law; this is the case, if a creditor would still benefit from the arrangement once insolvency proceedings had been initiated, and the administrator could not suspend or cancel individual rights without cancelling the whole arrangement. This applies in particular to security arrangements and netting arrangements that are protected according to national insolvency law.

Specific comments / proposals

In this section, the advice specifically considers each of the classes of arrangements listed in Article 76.

a. Security arrangements

19. Article 76(2)(a) implies but does not always make explicit some elements of a definition of security arrangements ('a person has by way of security an actual or contingent interest in the assets or rights that are subject to the transfer, irrespective of whether that interest is secured by specific assets or rights or by way of a floating charge or similar arrangements'). Security rights can be generally defined as any contractual arrangement that permits one party to seize or appropriate, sell or have sold assets of the other party upon the occurrence of a certain event (enforcement event), typically a default or non-payment of an obligation of that party, to use the proceeds to pay a specified liability. However, security rights can also result by virtue of law from another legal relationship without an explicit security

[6] The Winding up directive 2001/24/EU determines the governing law and covers certain procedural aspects, but does not harmonise substantial insolvency law. The BRRD harmonises only the insolvency ranking of certain deposits.

arrangement, for example a property lease may imply a right of lien over assets of the lessee in the property.

20. One of the underlying economic reasons for the BRRD and laws on banking to generally recognise and protect security interests is the role of secured financing as a refinancing source[7]. For this purpose, the delegated acts should make it explicit that securities lending, which is an important source of liquidity for banks, falls into the scope of Article 76(2), and more specifically under point (a) when it does not involve a full title transfer[8]. In general security interests also achieve mitigation of credit risk.

21. The concept used in Article 76(2)(a) is very broad. It explicitly includes for example floating charges, which may extend to all the assets of a company. The broad concept means that appropriate protection cannot always be identical to prohibiting the separation of the security interest and the assets, to which the security (potentially) may relate, from each other. Otherwise it would never be possible to implement a partial transfer as soon as there is only one floating charge or similar security interest over all the institution's assets. This conclusion is corroborated by the wording of Article 78(1): appropriate protection for security arrangements is specified in Article 78 (1)(a) preventing a separation of assets and secured liability in the case of a 'transfer of assets *against which* the liability is secured'. Given this broad concept in the BRRD, this 'against which' can hardly mean that the full safeguard in Article 78 can apply as long as the security interest is not attached to specific assets (e.g. before a floating charge has crystallised). This interpretation is supported by a comparison of the language in Article 78(1) with that used in Article 77(1). With this interpretation the solution for the problem resulting from floating charges, or other security arrangements not attached to specific assets, can be found at the level of the appropriate protection set out in Article 78.

22. Although the concept of secured liabilities is very broad, this seems to be the intention of the legislator, and the BRRD does not leave much room to make any further specification which would narrow it down further than the definition set out above. The problems in applying a partial transfer have to be addressed on the level of 'appropriate protection' rather than by constraining the definition. A specification in the delegated acts beyond a definition is possible, but the delegated acts should be careful to avoid any provision which would restrain Member States or resolution authorities' power to choose appropriate protection other than mandatory non-separation for security interests that imply that the interest is not attached to specific assets and should support an interpretation of Articles 76 and 78 that does not impair the feasibility and effectiveness of a resolution strategy involving a partial property transfer. This means that relevant security assets should be clearly identified, and that, when determining appropriate protection, it should be possible to ensure a reasonable limitation of assets against which the obligations are secured; this may take into account the relation to

[7] For a description of financial stability risks of secured financing markets please refer to ESRB: Towards a Monitoring Framework for Securities Financing Transactions (2013).

[8] Most securities lending transactions observed in the markets typically involve a full title transfer.

the value of the secured obligations, which may, however, provide for a certain degree of over-collateralisation.

23. Member States and resolution authorities should have the flexibility to include or exclude security arrangements existing by virtue of law (as opposed to those explicitly created by a contract), to the extent possible with a view to Article 76(3)(a).

b. Title transfer financial collateral arrangements

24. Article 76(2)(b) contains elements of a definition of title transfer financial collateral arrangements: these are arrangements 'under which collateral to secure or cover the performance of specified obligations is provided by a transfer of full ownership of assets from the collateral provider to the collateral taker, on terms providing for the collateral taker to transfer assets if those specified obligations are performed'.

25. Article 2(97) contains a comprehensive definition referring to point (b) of Article 2(1) of 2002/47/EC (the Financial Collateral Directive, 'FCD'): *'title transfer financial collateral arrangement' means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of, or full entitlement to, financial collateral to a collateral taker for the purpose of otherwise covering the performance of relevant financial obligations*.

    These definitions seem to be sufficiently exhaustive, also with a view to the economic rationale, the role of secured financing as a refinancing source and for minimising credit and contagion risks, in particular with regard to inter-financial institution financing, as widely used instruments such as sale and repurchase agreements (repos) are covered – the sale of securities combined with an agreement for the seller to buy back the securities at a later date fulfils the function of a loan with the securities as collateral. The same applies to securities lending transactions involving a full title transfer. The definitions allow authorities to identify the assets, rights and liabilities covered clearly.

26. According to data reported to the EBA under the ITS on Supervisory Reporting – in particular under its Asset Encumbrance templates – at the end of Q1 2015, European credit institutions' liabilities in form of repurchase agreements stand at close to 3 000 billion EUR (carrying amount). Approximately 140 credit institutions reported this information. Of that amount, around 5% (170 billion EUR, carrying amount) was secured (repo-based) funding from central banks. Half of the sample (70 banks) reported having received repo-based central bank funding.

27. The magnitude of repurchase agreements in the funding of European credit institutions is broadly confirmed by a recent ESRB ad hoc data collection[9]. Moreover, that analysis – which is based on a sample covering approximately 60% of the EU banking sector's total assets – quantifies the securities lending and borrowing activities of EU banks at more than 700 billion EUR (collateral value). Repurchase agreements and securities lending/borrowing transactions appear to be similarly important for EU banks as means of receiving as well as proving secured financing. At aggregate level, those types of arrangements (repurchase agreements, securities lending / borrowing) constitute more than 10% of European banks' balance sheets. These figures underline the economic importance of repos and other full title collateral arrangements and the need for appropriate protection.

28. Article 77 specifies how title transfer financial collateral arrangements are protected: the provision prevents a separation of the total of rights and liabilities. Under Article 1(4)(a) of the FCD, financial collateral consists of cash, financial instruments or credit claims. While this covers most forms of collateral existing in practice, a limitation to these forms of financial collateral does not seem to be required for the BRRD, as the reference in Article 2(97) to Article 2(1)(b) of the FCD does not extend to Article 1(4)(a) of the FCD.

29. Leaving aside this limitation, and although the BRRD in general derogates[10] from the FCD, these definitions are suitable and sufficient to identify any arrangements concerned and the assets, rights and liabilities covered. There does not seem to be room for a further specification of this class of arrangements in the delegated acts.

c. Set-off arrangements

30. Point (99) of Article 2(1) of the BRRD defines a set-off arrangement as 'an agreement under which two or more claims or obligations owed between the institution under resolution and a counterparty can be set off against each other'. This definition can be completed by an explanation of (contractual) set-off: pursuant to the contractual terms the mutual amounts outstanding between the institution and the counterparty are extinguished following a certain event (e.g. a declaration by one of the parties or automatically following an enforcement event). Usually this extinction has an effect identical to payment.

[9] ESRB: Securities financing transactions and the (re)use of collateral in Europe – An analysis of the first data collection from a sample of European banks and agent lenders (2014).

[10] Article 9a was added to the FCD providing that the FCD shall be without prejudice to the BRRD. In addition, the BRRD amended the FCD as follows: In Article 1 of the FCD, paragraph 6 was added providing that 'Articles 4 to 7 of this Directive shall not apply to any restriction on the enforcement of financial collateral arrangements or any restriction on the effect of a security financial collateral arrangement, any close out netting or set-off provision that is imposed by virtue of Title IV, Chapter V or VI of Directive 2014/59/EU of the European Parliament and of the Council, or to any such restriction that is imposed by virtue of similar powers in the law of a Member State to facilitate the orderly resolution of any entity referred to in points (c)(iv) and (d) of paragraph 2 which is subject to safeguards at least equivalent to those set out in Title IV, Chapter VII of Directive 2014/59/EU'.

31. The economic rationale for protecting set-off arrangements is risk mitigation for the institution and the counterparty, thereby reducing the contagion risk, and the objective of facilitating transactions as a source of refinancing and of creating liquidity in the markets, each in particular in the mutual relations between financial sector counterparties.

32. Article 77(1) stipulates that appropriate protection means preventing the transfer of some, but not all, of the rights and liabilities that are protected under a set-off arrangement. This may be interpreted in a way that Member States or resolution authorities are prevented from separating all rights and liabilities explicitly designated under any arrangement falling under Article 76(2)(c) from each other, if the arrangement entitles the parties to set-off or net those rights and liabilities (see the second subparagraph of Article 77(1)). It is questionable whether a contractual arrangement protecting for example any and all obligations owed from one party to another should be granted this level of protection. This would give the parties to the arrangements the power to determine the scope of protected liabilities and to extend them without limit. This could severely hamper the feasibility of a partial property transfer, as the authority would not be in the position to anticipate the existence of any such arrangement and what rights and liabilities would fall under it[11]. As in practice some arrangements contain general, 'sweep-up' clauses extending to all kinds of rights and liabilities including bonds, this would render a partial transfer completely incalculable. This possibility would also privilege counterparties with higher bargaining power or those who typically conclude certain types of transactions with the institution, regardless whether there was a link between all their claims against the institution and these types of transactions or of the rationale of the protection of this type of arrangements.

33. For these reasons, rules preventing a separation of rights and liabilities should be applied in a restrictive manner. In any event, the protection should be limited to liabilities clearly identified in the set-off arrangement (at least by category). In addition, the delegated acts should specify precise criteria when such arrangements and liabilities qualify for this protection. Ideally the scope of the safeguard should be limited to certain qualifying arrangements and certain liabilities.

34. Qualifying arrangements could for example include only financial contracts as defined in point (100) of Article 2(1), and the protection apply only to them (this term would need to include options, futures, swaps, forward rate agreements and any other derivative contracts). At least the protected mutual liabilities should be a homogenous class and there should be a link between the arrangement and the included contracts in terms of a common economic purpose such as their relation to financial contracts, transactions in financial instruments or

[11] There may be a case for addressing this issue in resolution planning by requiring comprehensive information on set-off rights from institutions. If set-off rights are protected without any limitations to scope or form, they may also constitute an impediment to resolvability which can be addressed by measures under Article 17, i.e. it would be advisable for the resolution authority to ban the use of arrangements with 'sweep up' clauses.

However, it is doubtful that the resolution authority would be able to obtain comprehensive information on all existing arrangements of this type; and it is also doubtful that it would be sufficient to require institutions to refrain from making such arrangements or to change or cancel existing ones.

short term intra-financial system lending only. In addition, set-off arrangements could be protected if their purpose is risk mitigation, and they are recognised for risk mitigation purposes under applicable prudential rules. Although the CRR does not mention set-off rights explicitly, they may have this effect under prudential rules.

35. The EBA recommends that the delegated acts should limit, or give Member States or resolution authorities the option to limit, the protection of set-off arrangements under Article 76 to those relating to financial contracts as defined in point (100)[12]. At the same time, it should be possible for Member States or resolution authorities to establish rules giving appropriate protection to any further set-off agreements which are recognised for risk mitigation purposes under prudential rules.

36. In line with the general reasoning above, Member States or resolution authorities should not be prevented from including further set-off arrangements that are protected in national insolvency law.

37. In certain Member States, set-off rights can arise by virtue of law. Again, Member States and resolution authorities should have the flexibility to include or exclude set-off arrangements existing by virtue of law (as opposed to those explicitly created by a contract), to the extent possible with a view to Article 76(3)(a).

d. Netting arrangements

38. Netting arrangements are important, well-established and widely used means of risk mitigation, for mitigating contagion risks and enhancing transactions as a source of refinancing and of creating liquidity in the markets.

39. Point (98) of Article 2(1) of the BRRD states: *'netting arrangement' means an arrangement under which a number of claims or obligations can be converted into a single net claim, including close-out netting arrangements under which, on the occurrence of an enforcement event (however or wherever defined) the obligations of the parties are accelerated so as to become immediately due or are terminated, and in either case are converted into or replaced by a single net claim, including 'close-out netting provisions' as defined in point (n)(i) of Article 2(1) of Directive 2002/47/EC and 'netting' as defined in point (k) of Article 2 of Directive 98/26/EC;*

    This refers to the definition of 'close-out netting' in the FCD: *'close-out netting provision' means a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any*

[12] In this regard it should be considered that, according to Article 71(7), institutions or entities within the scope of the BRRD may be required to maintain detailed records of financial contracts.

statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise:

(i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or

(ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party;

The definition in 98/26/EC (the Settlement Finality Directive) does not add any elements to these definitions: *(k) 'netting' shall mean the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders which a participant or participants either issue to, or receive from, one or more other participants with the result that only a net claim can be demanded or a net obligation be owed;*

These definitions seem to be comprehensive and accurate.

40. Article 295 of Regulation No 575/2013 (CRR) contains a definition of bilateral netting agreements: *bilateral contracts for novation between an institution and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that the novation fixes one single net amount each time it applies so as to create a single new contract that replaces all former contracts and all obligations between parties pursuant to those contracts and is binding on the parties.*

    The additional element of the amalgamation and novation of the obligations is not explicitly contained in the definitions above, but makes sense when characterising the specific nature of netting (as opposed to set-off).

41. Pursuant to Article 77, netting arrangements are protected in the same way as set-off arrangements. As the legal and economic consequences of both types of arrangements are nearly identical, similar principles to those for set-off arrangements should apply to netting arrangements. Again, rules preventing a separation of rights and liabilities should be applied in a restrictive manner, and the delegated acts should therefore specify precise criteria for when such arrangements and liabilities qualify for this protection. In any event, the protection should be limited to liabilities clearly identified in the netting arrangement (at least by category). Ideally the safeguard should be limited to certain qualifying arrangements and certain liabilities.

42. As for set-off arrangements the delegated acts should limit, or make it possible for Member States or resolution authorities to limit, the scope of protected netting arrangements to those relating to financial contracts and allow them the option, where appropriate, of extending the protection to those netting sets the purpose of which is risk mitigation and where the protection is a condition for recognising risk mitigation effects under prudential rules

applicable to the institution or the counterparty. For example Title II Chapter 4 Section 2 (Articles 195 ff.) and Chapter 6 Section 7 (Articles 295 ff.) of the CRR contains rules for the recognition of netting agreements for the purposes of capital requirements. These rules limit the recognition to certain classes and require certain conditions such as legal enforceability. Pursuant to Article 296(2)(a) of the CRR, recognition for capital requirements purposes is limited to 'a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of default by the counterparty it would be entitled to receive or obliged to pay only the net sum of the positive and negative mark-to-market values of included individual transactions'; the validity of the contractual arrangements has to be verified by a written opinion.

43. The delegated acts should limit, or make it possible for Member States for resolution authorities to limit, the protection to agreements meeting these requirements. This may exclude for example arrangements containing a walk away clause (that means a provision that permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of a defaulter, even if the defaulter is a net creditor), which are not be eligible for netting for the purpose of calculating capital requirements (see Article 296(2)(d) of the CRR). Likewise, it should be possible to exclude multilateral netting arrangements.

44. The protection, however, should not be limited to risk mitigation for own fund requirements or to another specific existing or future field of prudential regulation, as the rules for recognition may diverge. For example for the calculation of the risk exposure in the context of the leverage ratio, cross product netting[13] is not recognised (Article 429(1) of the CRR), while, for example, cross-product netting arrangements approved by the competent authorities, would be recognised in accordance with Article 295(c) of the CRR. Member States and resolution authorities should not be prevented from including arrangements relevant for any of these purposes.

45. In line with the general reasoning above, Member States and resolution authorities should not be prevented from including further netting arrangements that are protected in national insolvency law.

e. Covered bonds

46. The BRRD contains in Article 2(1) point (96) a definition of covered bonds referring to Article 52(4) of Directive 2009/65/EC, which reads as follows:

bonds … issued by a credit institution which has its registered office in a Member State and is subject by law to special public supervision designed to protect bond-holders. In particular,

[13] Defined in point 11 of Article 272(1) of the CRR: 'cross-product netting' means the inclusion of transactions of different product categories within the same netting set pursuant to the Cross-Product Netting rules set out in this Chapter;

sums deriving from the issue of those bonds shall be invested in accordance with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

47. According to data reported to the EBA under the ITS on Supervisory Reporting – in particular under the asset encumbrance templates – at the end of Q1 2015, European credit institutions held covered bonds of 650 billion EUR (carrying amount) in their portfolios. Almost half of European credit institutions' covered bond assets were encumbered (300 billion EUR). According to the data reported under the Asset Encumbrance Templates, European credit institutions had outstanding covered bond liabilities of nearly 2 000 billion EUR (carrying amount) at the end of Q1 2015. Approximately 100 credit institutions reported those types of information. Covered bonds play a very important role in many European credit institutions' medium- to long-term funding models and are a popular asset class amongst their institutional investors.

48. The protection for covered bonds is specified in Article 79, which prevents the assets, rights and liabilities from being separated under a partial transfer, or being terminated or modified through the use of ancillary powers.

49. This does not leave any room for further specification in the delegated acts. The protection of covered bonds is governed by the specific law applicable to those bonds[14]. This regularly implies that, where the coverage pool consists of specific assets, these assets must not be separated from the liabilities under the covered bonds.

f. Structured financing arrangements, including securitisations and instruments used for hedging purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to covered bonds, which involve the granting and holding of security by a party to the arrangement or a trustee, agent or nominee

50. The term 'structured financing arrangement' covers a broad range of different agreements with various parties which are required to maintain the functioning of the structured financing arrangement. Some of them relate immediately to and constitute the legal and economic prerequisite for financing and securing the payments under the structured securities issued under the arrangement; others ensure the operational and practical functioning of the arrangement. The latter, although necessary for the practical functioning of the arrangements, are more easily substitutable.

[14] For details on the treatment of covered bonds in insolvency refer for example to the EBA Report on EU covered bonds frameworks and capital treatment, Section 2.3 Segregation of cover assets and bankruptcy remoteness of covered bonds, pp. 23 ff.

51. Article 4(61) of the CRR contains a definition of the term ‘securitisation’:

    'securitisation' means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having both of the following characteristics:

    (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures;

    (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

    This definition seems accurate and should be referred to in the delegated acts.

52. According to its underlying economic rationale structured financing is a means of refinancing allowing risk diversification for financial market participants. It makes it possible to transfer credit risk to other market participants. Securitisations differ in the mechanism by which the exposures are tranched and transferred; this can be achieved by a full title transfer of the underlying exposures to a separate entity (true sale) or by means of contractual instruments, while the underlying assets remain on the balance sheet of the originator (synthetic securitisation). Under a true sale securitisation, the risk seller/originator does not hold the underlying exposures. So the need for protection is limited, unless the risk buyer itself is subject to resolution. The originator may nevertheless have a role in the structure, for example in servicing, as a provider of certain swaps or other form of risk protection, or as a liquidity provider. Therefore also in a true sale securitisation there may be an interest in maintaining this role, and the delegated acts should not prevent Member States and resolution authorities from protecting the mutual contractual relationships required for this on a case-by-case basis based on the general principles and recommendations set out in this advice.

53. The wording of Article 76 already contains some additional elements of a definition. It is not completely clear, whether all of these elements apply cumulatively, in particular the characteristic that they are secured according to national law in a way similar to covered bonds – this does not seem, however, a necessary condition as Article 76 states that these structures should be ‘included’. In case of full title transfer securitisations the assets/exposures are transferred to a separate entity; so the question how payment obligations are secured does not seem to arise, as apparently the rights and liabilities concerned have to be in the property of the institution under resolution. However, it should also be borne in mind that an SPV is not necessarily excluded from the scope of the BRRD. In particular, when the SPV is covered by the supervision of the parent undertaking on a consolidated basis in accordance with Articles 6 to 17 of Regulation No 575/2013, protection might be needed. Under a synthetic transaction, the risk seller/originator holds the underlying exposures and sells the risk to/ buys a protection from a third party. Various payment claims may be secured against the underlying. It is unclear under which criteria this structure can be considered similar to a covered bond. Given the economic rationale of ensuring legitimate confidence in securitisation structures, the delegated acts should not prevent resolution

authorities from protecting security over the underlying exposure in any form, regardless of whether it is comparable to a covered bond.

54. At the end of Q1 2015, financial vehicle corporations (FVCs) resident in the euro area had issued debt securities of 1 500 billion EUR (outstanding amount). Of that amount, around 85% had been originated as true sale securitisation and only a minor fraction as synthetic securitisation. At the same time, those FVCs held secured loans amounting to 1 200 billion EUR. Three quarters of that amount had been issued by euro area monetary financial institutions. Outside the euro area, the UK is the most important location for issuance of securitisation-based products.

55. The protection for structured finance arrangements is specified in Article 79, pursuant to which Member States shall prevent that some, but not all, of the assets, rights and liabilities which constitute or form part of a structured finance arrangement, to which the institution under resolution is a party, are transferred. This rigid requirement for protection may again raise an issue where under a synthetic securitisation the security interest is not attached to specific assets (as for the floating charges mentioned above). Therefore the delegated acts should not contain anything requiring Member States to grant this form of protection, unless the structured finance arrangement and security interests granted thereunder are attached to specific assets. Otherwise this would make the use of resolution tools involving a partial property transfer impossible or at least considerably less practicable. In general, however, structured financing arrangements observed in the markets typically are clear as to what assets are included within the arrangement.

56. As mentioned above, the classes of agreements constituting a securitisation structure can be many and manifold. They can cover the mutual relationships of originators, issuers, trustees, servicers, cash managers and swap counterparties, and, in particular in the case of a synthetic securitisation, credit protection counterparties. An overview over typical contractual relationships within a secured financing arrangement can be found in the Annex. The delegated acts should not contain anything preventing Member States or resolution authorities from limiting the protection of Article 79 and from providing it to only those assets, rights and liabilities that constitute the functional core of the secured financing arrangement, which means those contractual relationships that are directly linked to the underlying assets and the payments to be made from the proceeds generated by these assets to the holders of the structured instrument. This includes the underlying assets, liabilities under the instruments issued, security arrangements and derivative transactions required for maintaining the flow of payments under these liabilities.

57. However, agreements not directly relating to these functions such as servicing should not necessarily be protected. The delegated acts should not prevent Member States and resolution authorities from including these non-core relationships in the protection, but should not make it mandatory. Resolution authorities should be able to decide on this based on their assessment of the structure on a case-by-case basis based on the general principles and recommendations set out in this advice.

Annex

Overview of typical contractual relationships within a secured financing arrangement[15]

Form of secured financing arrangement	Contractual relationship	Parties to the agreement under typical structure	Remarks
Title transfer/true sale to entity that is not subject to resolution[16]			
	Underlying asset/receivable	SPV, third party obligors	Institution is no party
	Sale of assets (completed)	SPV, originator	Transaction completed
	Structured instrument/credit linked note	SPV, risk buyer	Institution is no party
	Trust agreement	Trustee, SPV, [risk buyer]	Institution is no party
	Security arrangement	Trustee, SPV, [risk buyer]	Institution is no party
	Servicing agreement	Servicer, SPV	Non-core, should be optionally protected

[15] This overview includes a security trustee. The concept of a trust is not recognised in all Member States. Where it is not, it has to be replaced by arrangements ensuring that the holders of the structured instruments/investors benefit from the security interest over the underlying assets.

[16] With reference to relationships which involve a SPV, which is subject to resolution, the Resolution Authorities should refer to the second part relating to synthetic securitisations.

Form of secured financing arrangement	Contractual relationship	Parties to the agreement under typical structure	Remarks
	Custody agreement	Custodian, SPV	Non-core, should be optionally protected
	Liquidity facility/guarantee	Bank, SPV	Non-core, should be optionally protected
	Credit enhancement	Bank, SPV	Non-core, should be optionally protected
	Hedging/additional swaps	Bank, SPV	Non-core, should be optionally protected
Synthetic			
	Underlying asset/receivable	Originator, third party obligors	Should be protected
	CDS (basket default swap)	SPV, originator	Should be protected
	Structured instrument/ credit linked note	SPV, risk buyers	Institution is no party
	Trust agreement	Trustee, SPV, [Orginator], [risk buyers]	Should be protected
	Security arrangement	Trustee, Originator, [SPV], [risk buyers]	Should be protected
	Liquidity facility/guarantee	Bank, SPV	Non-core, should be optionally protected
	Credit enhancement	Bank, SPV	Non-core, should be optionally protected
	Hedging/additional swaps	Bank, SPV	Non-core, should be optionally protected

Further relationships such as to rating agencies or underwriting agencies, should not be relevant in the context of the advice.