

Successfully addressing stay regulations

Our four-step framework for
an efficient implementation

RRP Viewpoint

March 2017



Glossary

ACPR	Autorité de Contrôle Prudentiel et de Résolution (French Prudential Supervision and Resolution Authority)
BRRD	Banking Recovery and Resolution Directive (2014/59/EU)
CCP	Central Counterparty
EEA	European Economic Area
EMIR	European Market Infrastructure Regulation
ETD	Exchange-Traded Derivative
FDIC	Federal Deposit Insurance Corporation
FED	Federal Reserve System
FINMA	Eidgenössische Finanzmarktaufsicht (Swiss Financial Market Supervisory Authority)
FSB	Financial Stability Board
FX	Foreign Exchange
G-SIFI	Global Systemically Important Financial Institution
ISDA	International Swaps and Derivatives Association
JMP	ISDA Resolution Stay Jurisdictional Modular Protocol
LEI	Legal Entity Identifier
OCC	Office of the Controller of the Currency
OLA	Orderly Liquidation Authority
OTC	Over-The-Counter
PRA	Prudential Regulation Authority
RRP	Recovery and Resolution Planning
SAG	Sanierungs- und Abwicklungsgesetz (German Recovery and Resolution Act)
SFT	Securities Financing Transaction
UP	ISDA Universal Resolution Stay Protocol

Notation

The present RRP Viewpoint uses the industry’s simplified terminology.

The temporary suspension of termination of financial contracts applied by an empowered resolution authority is generally referred to as a **‘temporary stay’** or, simply, a **‘stay’**.

Various local regulations across the world that require counterparties’ contractual acknowledgment of such a possible suspension to ensure cross-border effectiveness is generally referred to as a **‘stay regulation’**.

The term **‘early termination’** is used as a collective term; it might include the use of remedies in financial contracts such as acceleration, close-out, set-off, netting and similar provisions.

The RRP Viewpoint generally refers to institutions that are in the scope of a specific stay regulation, i.e. in most jurisdictions banks and similar financial institutions such as security dealers, as **‘firms’**.

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Executive summary

Stays are a key resolution tool for regulators and must be enforceable

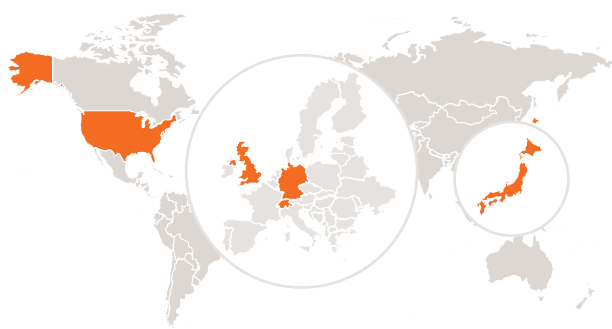
The financial crisis revealed that banks and other financial firms suffer from a major vulnerability when counterparties can close out on trades before their original maturity date ('early termination'). This can result in adverse effects such as an unbalanced risk exposure or significant operational efforts, which can further destabilise firms and disrupt resolution measures. To increase the chances of a successful recovery and resolution, lawmakers around the globe granted resolution authorities certain powers to suspend early termination rights for a limited period, thus ensuring a 'temporary stay'.

The key purpose of stays is to grant a short period of time to re-establish performance and/or solvency through restructuring in a way that grounds for early termination no longer apply after the stay period and therefore remain revoked.

The enforceability of such local resolution powers is questionable if a trading agreement is governed by foreign law. Hence, stay regulations are worked out in such a way that firms themselves are responsible for the enforceability. Consequently, stay provisions need to be included in the applicable trading agreements.

Stay regulations are a global topic

Stay regulations are applied in various jurisdictions around the globe. By 2018, firms will be subject to explicit rules in UK, Germany, Switzerland, US and Japan. Further jurisdictions, like France, likely follow suit.



While the regulatory requirements share certain aspects in terms of scope, they vary widely in the timing of their implementation, thus giving the industry time to develop contractual implementation tools for each of the regulations and to gain experience from their implementation in stages. Firms operating globally must not only ensure that they develop a holistic understanding of which legal entities might be affected by stay regulations but should

also identify potential overlaps between the various rules and assess their impact on the interactions with counterparties.

We propose a four-step framework to implement stay regulations efficiently

We believe the multi-jurisdictional scope and the potentially high number of contracts affected both require a firm to adopt a centrally coordinated approach in order to ensure compliance in the most effective and cost-efficient manner. To efficiently implement stay regulations, we propose a four-step framework:

1 Setup of implementation governance

By jurisdictional regulation

2 Run scoping process

3 Conduct counterparty outreach

Jurisdiction A
Jurisdiction B
...

4 Setup of reporting and risk management to ensure ongoing compliance

The framework (1) sets up an appropriate implementation governance, (2) identifies by jurisdiction the scope of affected contracts for a given regulation, (3) conducts the corresponding counterparty outreach and (4) ensures continuous compliance with the rules.

Once implemented, firms can achieve regulatory compliance and reconcile all their trades to either (a) contracts that do not require a stay provision, (b) contracts that require a provision and have it included or (c) legacy trades that will be run down over time because the counterparty has not implemented a stay provision, thus preventing the firm from entering into new contracts with the said counterparty.

The scope of this RRP Viewpoint

This RRP Viewpoint has two main objectives. Firstly, it raises awareness of globally emerging stay regulations and gives a general overview of the regulatory approaches taken in various jurisdictions. Secondly, it proposes a best-practice framework to implement stay regulations effectively and cost efficiently. By leveraging our experience in this area, this RRP Viewpoint takes a practitioner's view to implementing stay regulations rather than examining in detail the legal aspects.

Stay regulations at a glance

Understanding stay regulations can be challenging, as their elaboration needs to take into account many different aspects and considerations. These range from the role of trading products for a financial institution to the legal and economic mechanics that the underlying financial agreements are subject to in a resolution case.

The following steps (A) to (F) outline our view of why stays are considered a key principle of resolution planning and why cross-border effectiveness is crucial for transforming this principle into a credible resolution instrument.

A) Term trades are key to managing a financial firm's risk

The maturity of trading products is a key factor in a firm's business and risk management. Term structures in trading vary significantly across products. Securities financing transactions (SFTs) mainly have short- and medium-term maturities, while a firm's derivative exposure can have a complex maturity profile. Contractual maturities enable firms to balance efficiently the term structure of its assets and liabilities. Thus, they are a crucial aspect to consider in a recovery or resolution case when a firm's survival is at a tipping point.

B) Contractual maturity profiles can break up in recovery and resolution

Under certain circumstances, counterparties can close out on trades before their original contractual maturity date. Such early termination rights are based on events that are typically – but not necessarily – linked to the precarious economic situation of a firm, such as its non-performance on trading liabilities or bankruptcy. External rating downgrades might also serve as a trigger event although not as commonly used. As the downgrades can also occur in a firm's going-concern phase, they are accounted for by the bank's risk management to a much greater extent, not least because they can also trigger additional collateral support requirements.

C) Early terminations can cause severe adverse effects for a bank

The early termination of financial contracts can severely destabilise a financial firm and even – if a firm is systemically relevant – the entire financial system. Close-out actions when a firm enters recovery or resolution could lead to the firm's books becoming unbalanced and undermine the objectives of resolution actions that seek to maintain the critical functions. Two adverse effects on the firm's risk exposure are of particular concern: (1) the break-up of term matching and (2) the break-up

of back-to-back hedges. In particular, due to their business purposes and their complex term structures, the early termination of derivatives can cause both effects at a time when a firm is denied access to the market. The severity of unplanned inflows and outflows of proceeds has decreased, from a funding perspective, since the industry moved to almost fully collateralised trading after the financial crisis in 2008 to 2009. However, the expected sharp increase in market risk and the huge operational efforts resulting from terminated trades would jeopardise stabilisation efforts during a recovery or resolution phase.

D) Stays are an important resolution measure

The financial crisis demonstrated that the before-hand mentioned issues must be addressed if recovery and resolution concepts are to be credible and executable. As suggested by the FSB, stays have been included in the repertoire of options that resolution authorities can apply in jurisdictions that have resolution regimes (e.g. as introduced by the BRRD in the EU and transposed into national law). By ordering a stay, the resolution authority suspends early termination rights of financial contracts for a limited period (typically 24 or 48 hours) during which time the counterparties of the failed firm cannot close out (or make use of similar rights). The key purpose of this suspension is to apply resolution measures during a 'resolution weekend'. Most importantly, the termination rights remain revoked once the circumstances that would have led to them being executed are resolved (e.g. after the firm has been successfully recapitalised or when the bank or a bridge bank is wound down in a solvent manner). Without such a revocation, the mitigating actions might be in vain as large parts of the derivatives and SFT portfolio might be closed out after the stay period, thus destabilising the firm simply a short time later.

Although dependent on the specific rules in force in a jurisdiction, stays are generally not subject to the full discretion of the authority. Instead, specific conditions must be satisfied before the authority is allowed to make such a serious intervention.

E) Cross-border effectiveness of stays is paramount

To serve as an efficient and credible resolution measure, stays need to be legally enforceable by the corresponding local resolution authority. If a financial contract is governed by a foreign law, however, it remains a possibility that a foreign court could declare the stay inadmissible. Regulators view such uncertainty as a major impediment. Consequently, stay regulations have been developed that the

individual firms have to implement. To ensure cross-border effectiveness, stay regulations make explicit contractual recognitions between counterparties ('stay provisions'). Such provisions are a prerequisite for trading where legal uncertainty would exist without them.

F) The industry approach to comply with stay regulations

Industry representatives from ISDA have developed the Jurisdictional Modular Protocol (JMP) in order to provide an efficient and effective contractual instrument for the implementation of local stay regulations. Under this standardised 'umbrella' structure, regulated entities can achieve compliance with local stay regulation by requiring counterparties of business relationships within the scope of application to adhere to this standardised approach.

The JMP was launched in May 2016. Separate jurisdictional modules have been published tailored to local stay regulations after the latter have been finalised. Such 'tailoring' includes references to the products that are in scope of the local stay regulations (typically, derivatives, SFTs and other banking products including prime brokerage). Through the adherence of a firm's counterparties to the JMP and a specific jurisdictional module, regulated firms obtain the counterparty's consent to be subject to a stay under the firm's special resolution regime in a particular jurisdiction. Counterparties can adhere with respect to all regulated legal entities or specify the legal entity that will obtain the contractual stay recognition. The latter possibility is particularly important for buy-side parties who have a fiduciary duty towards their own clients that needs to be taken into account when deliberately relinquishing certain contractual rights.

It is worth mentioning that cross-border effectiveness was already established in 2014 and 2015 between large parts of the sell-side with regard to ISDA master agreements and important SFT master agreements before the above-mentioned stay regulations emerged. This 'self-regulatory' approach was driven by the FSB and enabled by ISDA through the Universal Resolution Stay Protocol (UP), which was signed mostly by large banks and other sell-side parties. Buy-side parties are particularly reluctant to adhere to the UP because this would imply the mutual recognition of stay provisions between all of the adhering parties – in contrary to the JMP, it is not possible to narrow the scope of stay consent to selected parties.

The UP co-exists with the JMP and remains available to establish cross-border effectiveness between firms in certain resolution regimes. Adherence to both the UP and the JMP results in an overlap rather than a conflict. Some local regulators might find it sufficient if systemically important banks in their jurisdiction become part of the group of mostly sell-side parties that adhere to the UP and provide mutual stay provisions to each other.

The implementation of local stay regulations for which the present RRP Viewpoint provides a framework therefore refers mainly to the JMP and its modules tailored to the local rules.

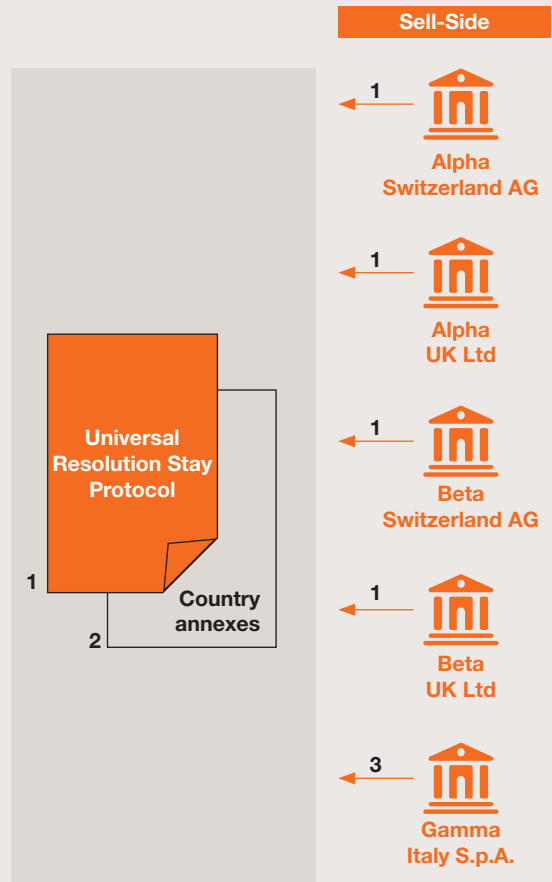
ISDA protocols

UP (ISDA Universal Resolution Stay Protocol, 2015)

- All legal entities that adhere to the UP provide mutual consent to each other to opt in into the adhering counterparties' special resolution regimes and acknowledge the counterparties' resolution authorities' right to impose a temporary stay on covered contracts.
- Originally, six special resolution regimes were covered (UK, Germany, France, Switzerland, US, Japan); legal entities subject to another special resolution regime could not use the protocol to obtain a stay consent from the other legal entities; country annexes for other jurisdictions are published subsequently to cover further jurisdictions (requires a new adherence to the annexes).
- The UP represents a self-regulatory approach, mostly for G-SIBs, encouraged by various local regulators; not used generally by buy-side parties (it might conflict with their fiduciary duties).

Illustrative example (right):

- 1 Alpha and Beta are G-SIBs and adhere to the UP through legal entities (in UK and Switzerland) that engage in third-party derivative and SFT trading; stay provisions are provided between all these legal entities across the different (protocol-eligible) jurisdictions.
- 2 Through a country annex, the Italian special resolution regime becomes eligible for protocol.
- 3 Gamma, an Italian G-SIB, is encouraged by its regulator to adhere to the UP and the Italian country annex. Although already adhering to the UP, Alpha and Beta are encouraged by their regulators to adhere to the Italian country annex as well to ensure mutual recognition of stays (Gamma "joins" the group of adhering parties).

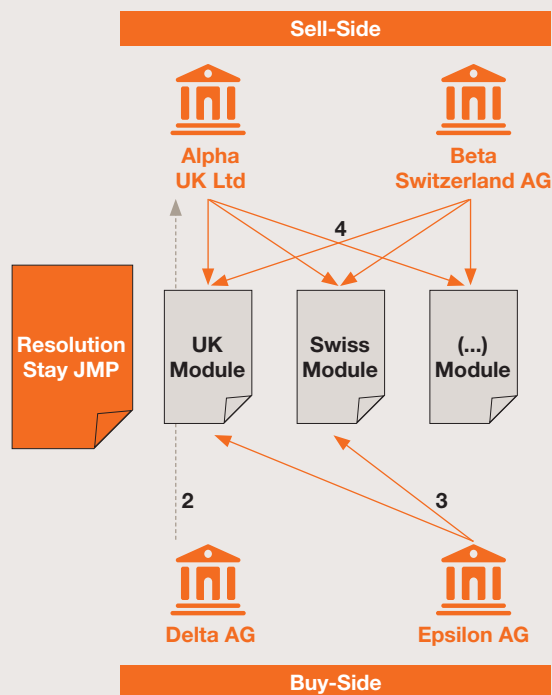


JMP (ISDA Resolution Stay Jurisdictional Modular Protocol, 2016+)

- Generally, the same mechanics as the above UP, but with a modular approach; each module is tailored to the specific requirements of a local stay regulation (i.e. JMP addresses statutory approaches in different jurisdictions, not a globally encouraged self-regulatory approach like the UP).
- Market participants (particularly on the buy-side) can chose the counterparties for which they want to adhere.

Illustrative example (right):

- 1 Delta AG, a small fund based in Switzerland, is a client of Alpha UK Ltd; the firm is asked by Alpha UK Ltd to adhere to the UK module because Alpha UK Ltd would otherwise not be eligible to continue trading with Delta AG.
- 2 Delta AG adheres to the UK module in a limited capacity, i.e. only with respect to Alpha UK Ltd – a stay provision is not provided to any other firm.
- 3 Epsilon AG is a global asset manager incorporated in Germany and trades with Alpha UK Ltd and Beta Switzerland AG; it adheres to the UK and Swiss module with respect to all regulated entities (full capacity).
- 4 Alpha UK Ltd and Beta Switzerland AG (as G-SIBs) adhere to all available modules because they are regulated legal entities subject to the local stay regulation or because they are asked to adhere by counterparties to ensure trading in future.



Global overview of stay regulations

In its 2016 peer review report on resolution regimes, the FSB identified eleven resolution regimes in which stays have been established as a resolution power. The RRP Viewpoint focusses on the five jurisdictions (Switzerland, UK, Germany, Japan, US) where the resolution regimes are or will be complemented by stay regulations (as per early 2017), i.e. by explicit rules to secure the cross-border effectiveness of stays.

Although regulators and lawmakers implement these rules differently (even within the EU, where stay regulations are not part of the BRRD), we observe common characteristics in most of these jurisdictions with respect to the scope of the affected firms and the type of financial agreements. This is an achievement not least of the industry's coordinated feedback to regulators, most notably orchestrated by ISDA.

A common characteristic in general is that once a stay regulation enters into force, the obligation for stay provisions applies to new contracts or 'material amendments' to existing contracts after the effective date (where entering into a new trading liability can be considered a material amendment). Where master agreements with counterparties exist, all new single contracts under such frameworks are required to include a stay provision, irrespective of whether the master agreement existed before the effective date or not. Generally, existing contracts without a stay provision can be run down to maturity.

However, the jurisdictional stay regulations differ significantly in their timing. Across the five jurisdictions that we look at here, the effective dates for the regulations range from 2016 to 2018. This gives the industry the opportunity to leverage the experience for the implementation and for the responses to consultation processes in other jurisdictions.

Overlaps between the jurisdictional approaches (financial arrangements subject to more than one set of stay regulations) exist but are limited. One example is foreign branches, which might need to comply with the local stay regulations of the host jurisdiction as well as with those of their parent legal entity's home jurisdiction. Another example relates to cross-default relationships by legal entities.

It is important for firms to understand where these overlaps occur and whether they require additional instruction to help counterparties avoid misunderstandings. Under such circumstances, a counterparty might receive only one adherence request from a local firm and two requests from a foreign firm represented by a branch. Some regulators, like FINMA in Switzerland, explicitly address the avoidance of competitive disadvantages between domestic and foreign firms in their explanatory material to the stay regulation. However, we do not expect conflicts between stay regulations in terms of content, as stays imposed by different regulators are complementary rather than contrary resolution actions.

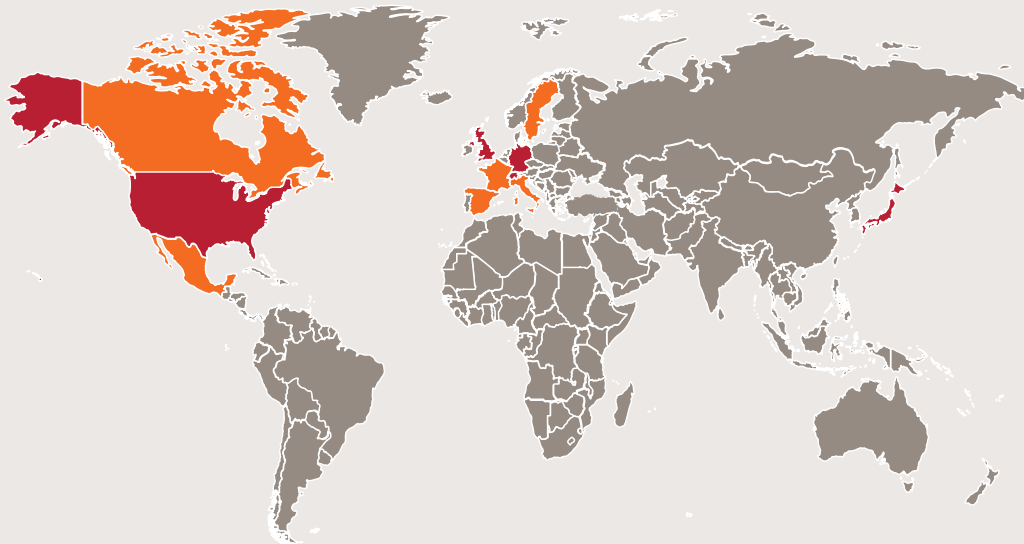
Switzerland

The Swiss Financial Market Supervisory Authority FINMA is empowered by the Swiss Banking Act (BA) to impose stays during resolution. Regulated firms, i.e. Swiss banks and security dealers, are obligated by the Swiss Banking Ordinance (BO) to ensure that this power is also enforceable through stay provisions. Concrete implementation guide-lines, including the scope of financial agreements and the timeline for the implementation, were published by FINMA in March 2017. The resulting amendment to the Banking Insolvency Ordinance FINMA (BIO-FINMA) comes into effect on 1 April 2017.

The Swiss stay regulations affect banks and security dealers regulated by FINMA at a group level and apply to a set of financial agreements that is very much aligned to the BRRD definition used by EU peers. Notably, the scope of the regulation is limited to financial agreements to the extent that the counterparty can justify an early termination based on FINMA's resolution action of imposing a stay under Swiss law. This is likely to exclude subsidiaries domiciled in foreign jurisdictions from the obligation to implement stay provisions. However, some financial contracts include terms and provisions that allow the counterparties of foreign subsidiaries to make use of a termination right after FINMA imposes a stay upon a Swiss legal entity. Art. 56(1)h BIO-FINMA explicitly encompasses subsidiaries domiciled in a foreign jurisdiction if they are guaranteed or otherwise secured by a bank or securities dealer domiciled in Switzerland. In such cases, the banks and security dealers affected in Switzerland should be aware that regulatory overlaps with the foreign jurisdiction might exist. As elaborated in the following section, we believe that firms should consider such regulatory overlaps in order to coordinate any communication with counterparties.

Overview of local stay regulations

Switzerland	Germany	United Kingdom
<p>Regulation Art. 12 (2^{bis}) BO Art. 56 and 61a (BIO-FINMA)</p> <p>Effective (implementation period) 1 April 2018 (financial counterparties) 1 October 2018 (all other counterparties)</p> <p>Scope (contract types) 'Financial agreements' as defined in art. 56(1)a-h BIO-FINMA (similar to BRRD definition)</p> <p>Scope (governing law) Non-Swiss law</p> <p>Scope (branches) Swiss branches of foreign financial institutions are generally not in scope</p>	<p>Regulation Sanierungs- und Abwicklungsgesetz (SAG) §60a</p> <p>Effective (implementation period) 1 January 2016 (with deferred enforcement)</p> <p>Scope (contract types) 'Financial agreements' as defined by the BRRD, including derivatives as defined in EMIR</p> <p>Scope (governing law) Non-EEA law</p> <p>Scope (branches) German branches of foreign financial institutions are generally not in scope</p>	<p>Regulation PRA Policy Statement 25/15 PRA Supervisory Statement 42/15</p> <p>Effective (implementation period) 1 June 2016 (financial counterparties) 1 January 2017 (all other counterparties)</p> <p>Scope (contract types) 'Financial agreements' as defined by the BRRD (with some amendments), including derivatives as defined in EMIR</p> <p>Scope (governing law) Non-EEA law</p> <p>Scope (branches) UK branches of foreign financial institutions are generally not in scope</p>



United States (draft)	Japan	Further jurisdictions with stays
<p>Regulation Separate regulations from the FED, the OCC and the FDIC</p> <p>Effective (implementation period) Expected for 2018</p> <p>Scope The exact scope of these rules and possible overlaps are yet to be finalised (expected during 2017)</p>	<p>Regulation Several regulations</p> <p>Effective (implementation period) 1 April 2017</p> <p>Scope (contract types) Contracts that match JFSA's definition of a 'covered agreement' which is generally comparable to the scope of the BRRD definition</p> <p>Scope (governing law) Non-Japanese law</p> <p>Scope (branches) Japanese branches of foreign legal entities are in scope, including when their financial arrangements are already covered by another stay regulation</p>	<ul style="list-style-type: none"> ▪ The resolution regimes of France, Italy, Spain, the Netherlands, Sweden, Canada and Mexico include stays as a resolution power but have not (yet) been complemented with explicit, additional regulations to address cross-border effectiveness; ▪ Leveraging the existing, sell-side focused UP (incl. country annexes), regulators in France, Italy, Spain and the Netherlands have the possibility to encourage their systemically important banks to adhere; and ▪ While the industry expects France, Italy, Spain, the Netherlands and Sweden to publish stay regulations in 2017, this is generally not the case for Canada and Mexico.

The Swiss stay regulations exclude inter alia financial agreements with market infrastructures, central banks and natural counterparties (e.g. private clients). Financial agreements of non-financial group subsidiaries and agreements used in primary market issuances are excluded as well. The deadlines to implement the regulation in Switzerland are staggered: 1 April 2018 for financial counterparties (banks and security dealers) and 1 October 2018 for all other counterparties.

United Kingdom

In the UK, final stay regulations have been published by the PRA (Policy Statement 25/15). These require that financial institutions within the scope of application ensure stay provisions are provided for applicable non-EEA law contracts. While the rules came into effect on 1 June 2016 for counterparties that are credit institutions and investment firms, an extra six months were granted for all other counterparties to implement the rules, which entered into force on 1 January 2017. The rules apply to UK-incorporated subsidiaries of foreign firms but, generally, not to the UK branches of foreign firms.

The financial arrangements covered by the regulations largely follow the BRRD definition of a ‘financial contract’ and thus include contracts for OTC derivatives and ETDs, FX, repurchase agreements, securities lending agreements, the sale and purchase of transferable securities and other transactions. These contracts may be established as single contracts or under master agreements. Unlike the BRRD definition, short-term interbank borrowing agreements are excluded by the PRA. Counterparties that are operators of financial market infrastructure, such as CCPs and central banks, are not in the scope of the regulations if they match the PRA’s definition of ‘excluded persons’.

Firms covered by the rules can apply the UK’s jurisdictional module to the JMP in order to implement the contractual recognition of counterparties – a possibility that has been widely used in the industry since its publication in May 2016.

Germany

Although not a part of the BRRD, the obligation for stay provisions is added in Germany as an additional paragraph to the transposition of the BRRD into German law (SAG §60a). The rules came into effect on 1 January 2016, a time when no industry-wide solution for implementing contractual recognition with buy-side parties was available. Although no (explicit) implementation period was granted, the regulator’s enforcement took into account that industry ‘tools’ for contractual recognition were published in mid-2016 in the form of a German jurisdictional module for the JMP and a supplementary agreement (‘SAG Zusatzvereinbarung’) provided by the Association of German Banks. The somewhat tentative adherence to the JMP module might indicate frequent use of the supplementary agreement, which also deals with the recognition of bail-in power as required under German law.

The scope of the German stay regulations is very similar to the UK approach, i.e. requiring a recognition of financial agreements under non-EEA law as defined by the BRRD. Again, financial market infrastructures are generally excluded.

Japan

Japanese stay provisions will enter into force on 1 April 2017 and apply to a set of agreement types that is very similar to the BRRD definition. Thus, they apply primarily to derivatives and SFTs (provided a cancellation/termination clause is included). The rules apply to financial institutions that are subject to the Deposit Insurance Act and cover financial agreements governed by non-Japanese law.

A notable difference to peer jurisdictions with stay regulations is that, in general, the rules include contracts governing trades entered into by the Japanese branches of foreign firms. This is the case even when they might already be covered by foreign stay regulations, i.e. where the home resolution authority of the foreign firm could (also) impose a stay in a resolution case. Since a branch is typically not a signing party to a trading master agreement (but can be specified as a trade-eligible branch), global firms with Japanese branches need to consider in their scoping approach that agreements entered into by one of their (non-Japanese) legal entities might fall within the scope of the Japanese stay regulations.

As with most other stay regulations (whether finalised or drafted), no stay provision has to be implemented when the counterparty is a CCP. However, unlike most other stay regulations, central banks and central governments are not excluded.

United States (draft status)

In the US, the FDIC, as the authorised resolution authority, is eligible to impose a stay under both the resolution regime of the OLA for SIFIs and under the resolution regime of the FDIA for insured depository institutions.

To ensure cross-border effectiveness on qualified financial contracts covered by the resolution power, the FED, the OCC and the FDIC have developed stay regulations. The three institutions gathered comments and recommendations on the proposed rules in the second half of 2016; their finalisation is expected in 2017, entering into force in 2018. The exact scope of each of the rules in terms of the entities covered, possible overlaps between the rules and the implementation timeline are yet to be clarified. The same is true for whether a single jurisdictional module of the JMP would be suitable to address all of the rules.

France, Italy, Spain, the Netherlands, Sweden, Canada and Mexico

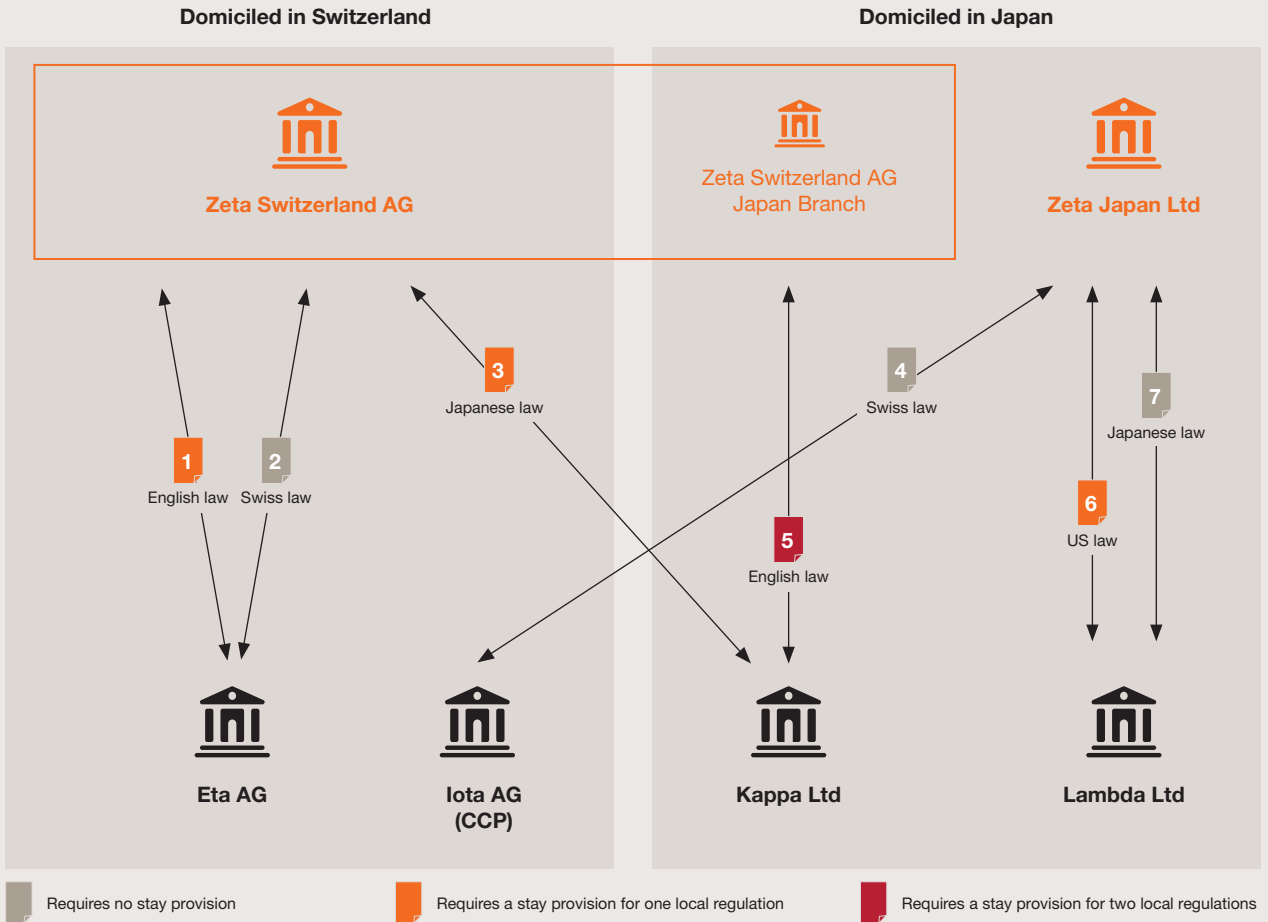
In the resolution regimes of France, Italy, Spain, the Netherlands, Sweden, Canada and Mexico, stays have been implemented as a resolution power. However, no explicit additional regulations or implementation guidelines have been issued or drafted to address the cross-border effectiveness of the measures.

As one of Europe's key financial markets, France domiciles four G-SIFIs and it was one of the countries spearheading the discussions on the cross-border effectiveness of resolution actions with the ISDA, starting in 2013. France, as well as Italy, Spain, the Netherlands and Sweden (which all domicile at least one G-SIFI), is expected to work out stay regulations in 2017. In January 2017, stays became part of the solvency assessment criteria for systemically important banks implemented by the French regulator ACPR. Irrespective of explicit rules, G-SIFIs in these jurisdictions might be encouraged by their regulators to adhere to the UP and its (upcoming) country annexes in the meantime.

The industry does currently not expect Canada and Mexico to issue stay regulations in the near future.

Evaluation of the applicability of stay regulations (simplified example)

- These hypothetical cases illustrate in simplified terms how different local stay regulations, legal entity domiciles, governing laws and counterparty types determine whether explicit stay provisions are required from trading counterparties.
- The example takes the perspective of Zeta, a Swiss banking group with a legal entity in Switzerland, a related branch in Japan and a legal entity in Japan.
- It is assumed that the stay regulations in Switzerland and Japan are in force and that all of the contracts shown are new contracts established after the effective date of the regulations and that they govern trading products that are in scope.
- **The example demonstrates, that the governing law of the contract and the domicile of the booking entity are important factors to determine the applicability of stay regulations while the domicile of the counterparty is generally not relevant.**



- 1 Since the contract is under non-Swiss law, Zeta Switzerland AG requires a stay provision from Eta AG. To this end, Eta AG can adhere to the Swiss module of the JMP (if Zeta Switzerland AG adhered as a regulated entity).
- 2 This contract between Zeta Switzerland AG and Eta AG is governed by Swiss law, i.e. there is no legal uncertainty that the Swiss resolution authority of Zeta Switzerland AG can impose a temporary stay of termination – no actions required from Zeta.
- 3 Since the contract is under non-Swiss law, Zeta Switzerland AG requires a stay provision from Kappa Ltd. To this end, Kappa Ltd can adhere to the Swiss module of the JMP. This case is analogous to (1) and shows that the governing law is predominant for the evaluation rather than the counterparty’s domicile.
- 4 CCPs are excluded counterparties under the Japanese stay regulations, therefore no explicit stay provision is required (although the contract is governed under non-Japanese law).
- 5 Due to the fact that Zeta Switzerland AG is the contracting party for Kappa and the contract is under non-Swiss law, a stay provision is required for the Swiss stay regulation. As foreign branches are also in scope of the Japanese rules and the contract is governed by non-Japanese law, a stay provision is required for the Japanese stay regulations as well. Kappa Ltd can provide these by adhering to both the Swiss and the Japanese JMP module.
- 6 The contract is under non-Japanese law, therefore a stay provision for the Japanese stay regulation is required from Lambda.
- 7 No actions required from Zeta Japan Ltd. since the contract is under Japanese law.



Implementing stay regulations

Stay regulations require an efficient implementation framework

Firms around the globe may be affected very differently by stay regulations. Generally, firms face fewer efforts to comply with stay regulations the more often trades entered into by their respective legal entities (or branches in limited cases) are governed by the domestic law of the entity's domicile. However, certain non-US and non-UK domiciled entities may have a significant number of financial agreements (such as ISDA master agreements) that are subject to foreign law because of the predominant role of US and UK law in many master agreements for derivatives and SFTs. The operational effort required to ensure master agreements remain eligible contractual frameworks for new trades entered into after the regulation have come into effect increases with the number of agreements in scope. This is even more the case if trades are entered into on a contract-by-contract basis without the use of a framework agreement because it has to be ensured that a stay is enforceable for each contract.

To efficiently implement stay regulations considering these global challenges, we propose a four-step implementation framework consisting of (1) the setup of an implementation governance, (2) the identification of in-scope agreements, (3) the coordinated outreach to counterparties and (4) the setup of reporting and risk management processes to ensure continuous compliance.

1 Setup of implementation governance

Stay regulations are a global topic and apply common principles developed by regulators using a globally coordinated approach. Though specifications vary depending on the jurisdiction and the implementation status, a globally operating firm can realise significant efficiency gains by implementing a highly centralised governance set-up to deal with stay regulations. This needs to take into account that agreements for various trading products are in scope. It can potentially leverage existing governance set-ups established to address similar requirements, such as the implementation of bail-in provisions.

For each relevant jurisdictional regulation, it can be decided whether and how to shift responsibilities 'downstream' to local teams (e.g. detailed legal analysis of the regulations) or to the business divisions (e.g. the implementation of different products). In any case, we strongly believe that a central team at group level adds significant value by, for example:

- Monitoring legal developments globally and participating in industry consultations (e.g. ISDA working groups);
- Defining responsibilities for steps (2) - (4) in our implementation framework;
- Leveraging lessons learned across local stay implementations;
- Identifying where processes (such as a counterparty outreach) can be leveraged from the implementation of other regulations (e.g. bail-in provisions or bilateral margining); and
- Monitoring implementation progress and reporting to management on compliance with each new set of regulations that comes into force.

Overview of PwC's proposed implementation framework



2 Run legal scoping process

To establish compliance with any given local stay regulation, firms should start with a general breakdown of the full population of financial agreements into (a) agreements that do not require a contractual recognition of stays and (b) those that do. A detailed analysis and scoping is required as each set of jurisdictional stay regulations needs to be translated into a set of scoping parameters that can be applied to all agreements. The derivation of scoping parameters from the regulatory text should be performed or signed off by the (local) legal department to avoid any incorrect legal interpretations. The scoping process itself can involve other internal functions (e.g. operations) as well as the business side.

Screening process

The optimal order and process to apply multiple scoping parameters consecutively depends on how a firm's systems (e.g. repositories for agreements and financial reporting systems) are set up. A reasonable starting point for scoping is to consider only those legal entities that are in the scope of a given stay regulation (II in our example of a scoping approach provided on the next page). Often, this corresponds to legal entities that are incorporated in the jurisdiction in which the stay regulation applies. However, it might include legal entities in other jurisdictions if the regulation applies to the whole group (and its

foreign subsidiaries). Legal entities, as the contractual parties entering into trading agreements, are the principal level to consider. Nevertheless, some local stay regulations (such as the Japanese rules) break up this view and consider single branches to be in the scope of application (although the 'parent' legal entity might not be in scope as such). We believe therefore that scoping requires a clear understanding of the eligibility of branches to trade under an agreement signed by the branch's legal entity and the actual trading volume booked in the branches.


Two other key scoping parameters are the regulators' definitions of a ('qualified') financial agreement (III) and the governing law (IV). Furthermore, exceptions might apply depending on the regulations (V). CCPs are commonly exempted as counterparties because most regulators anticipate that CCPs are not expected to sign stay provisions. Central banks might also be excluded. The continued access of G-SIFIs to financial market infrastructures during resolution is addressed by separate, globally coordinated, initiatives.


Finally, a list of the existing documentation is available with those counterparties that need to agree to a stay provision before the documentation can govern any new trades after the stay regulations come into effect (VI).

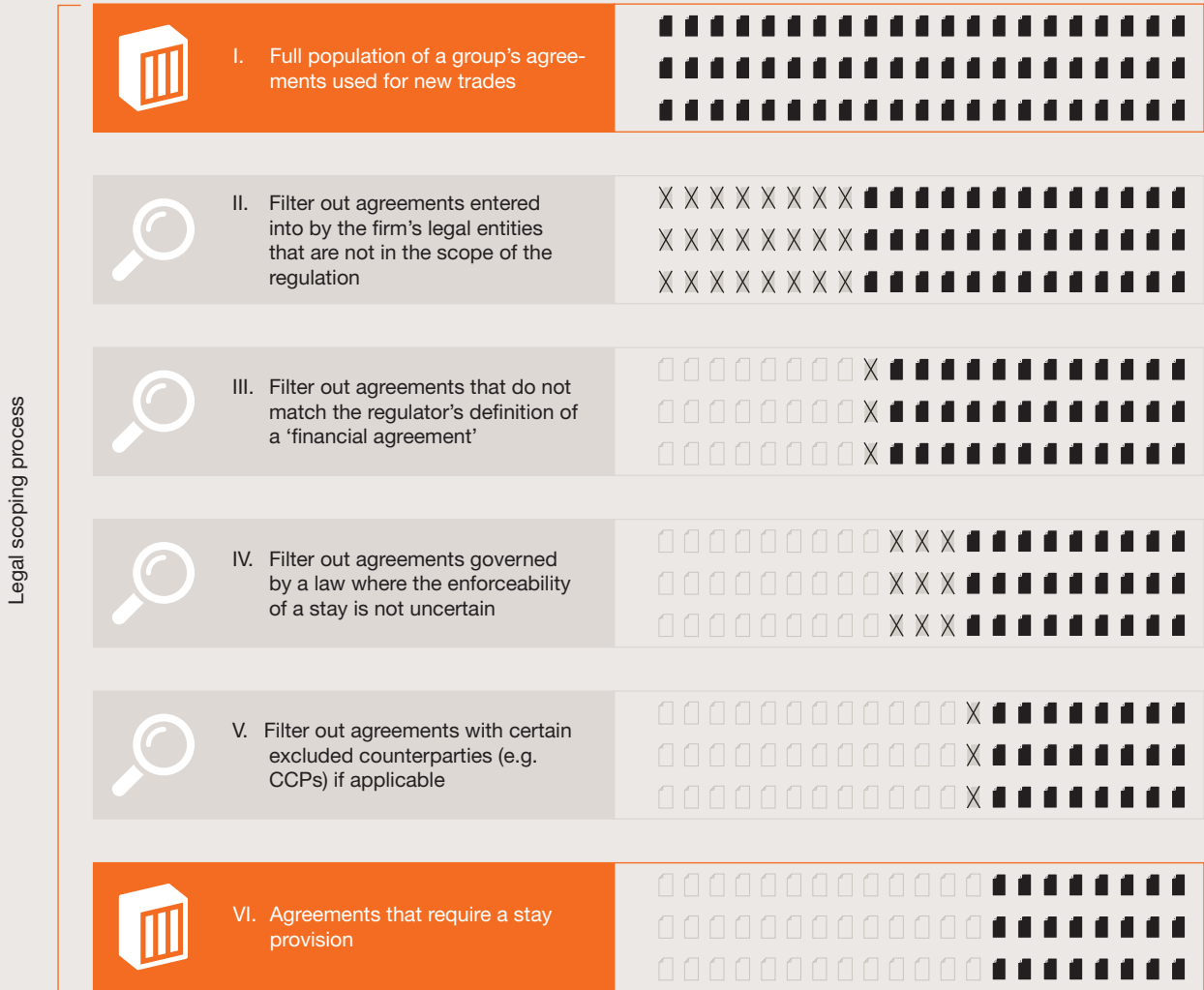


Scoping approach for an individual stay regulation (simplified example)

Illustration for step 2 of our implementation framework

 Documentation excluded from the scope of an individual stay regulation


 Legal documentation (e.g. master agreement) remaining in scope during an individual scoping process step




Business decision for counterparty outreach



VII. Confirm which framework agreements are still used for business purposes (counterparties to be included in outreach process) and which can be considered legacy because the counterparty is no longer trading with the firm (block new trades with the counterparty for the corresponding products)

 Legacy (save efforts of outreach and deactivate trading account)

 Reach out to counterparties of these agreements

Additionally, two considerations might be applied before reaching out to counterparties. Doing so could exclude further contracts from the list and therefore reduce the implementation costs (VII).

Firstly, some existing framework agreements might be considered 'legacy' if no trades have been entered into with the counterparty for a certain time. Master agreements typically do not have an 'end date' and would appear on the scoping list even if no trading had taken place in the preceding years. To minimise implementation costs, the business side should define which financial agreements are eligible to govern future trades and which can be considered legacy. In our experience, it is important to identify these legacy agreements to ensure they are classed as ineligible for governing new trades and avoid potential non-compliance cases (step '4 risk management' deals with the necessary actions related to such legacy agreements).

Secondly, sell-side counterparties might be excluded if they have already provided contractual recognition via the UP. However, while the modules of the JMP are tailored to specific regulations and to the agreements covered by such regulations, the UP (without any amendments) covers only a specific list of eight master agreements for derivatives and SFTs. We recommend therefore these counterparties to be included in any JMP-based outreach – even if they already adhered to the UP – to ensure all financial agreements in the scope of the regulations are covered.

3 *Conduct counterparty outreach*

For efficiency reasons, we recommend aligning any outreach relating to local stay regulations with that relating to other regulations, if feasible. A coordinated and well-prepared approach is indispensable to save counterparties unnecessary efforts. The nature of the protocol-based approach can lead to a 'late-mover advantage' in cases where the local stay regulations apply to several firms that have mutual counterparties: If firm A asks the mutual counterparty to adhere to the JMP and the counterparty does so in a capacity that also includes firm B (which is generally possible), no further action has to be taken by firm B.

As already outlined in the global overview of various stay regulations above, firms should also think about the overlaps of two or even more regulations. They must be prepared to explain to counterparties the need to sign two protocols. As with any other outreach, client-facing staff needs to be well trained in counterparty communications.

The progress and level of completion can be tracked efficiently by using the adherence data that is made available (e.g. by ISDA and its partner financial information company IHS Markit) in cases where the JMP is used for the implementation. The tracking process can be eased significantly if a firm stores Legal Entity Identifiers (LEIs) used industry-wide in its counterparty repository systems.

Outreach efficiency

If a firm has a substantial number of agreements that require revision, the key to doing this efficiently is to set up a programme with clearly defined rules and responsibilities for every step of the implementation



framework. This implies a cascade of responsibilities: The outreach team must be able to rely fully on the list of counterparties provided as a result of step 2 'run legal scoping process'. It should not need to spend effort on understanding why a counterparty is in scope or not. Similarly, the scoping team that generates the list must be able to rely fully on the parameters derived from the regulations without having to interpret the legal situation on its own. If this cascade of responsibilities works well, significant efficiency gains are feasible.

Reconciliation after the outreach

To ensure the completeness of the implementation of the stay regulations, the firm should be able to reconcile all of its trading volume (or other metrics) for a specific product group to the original population of contracts and to one of the following categories:

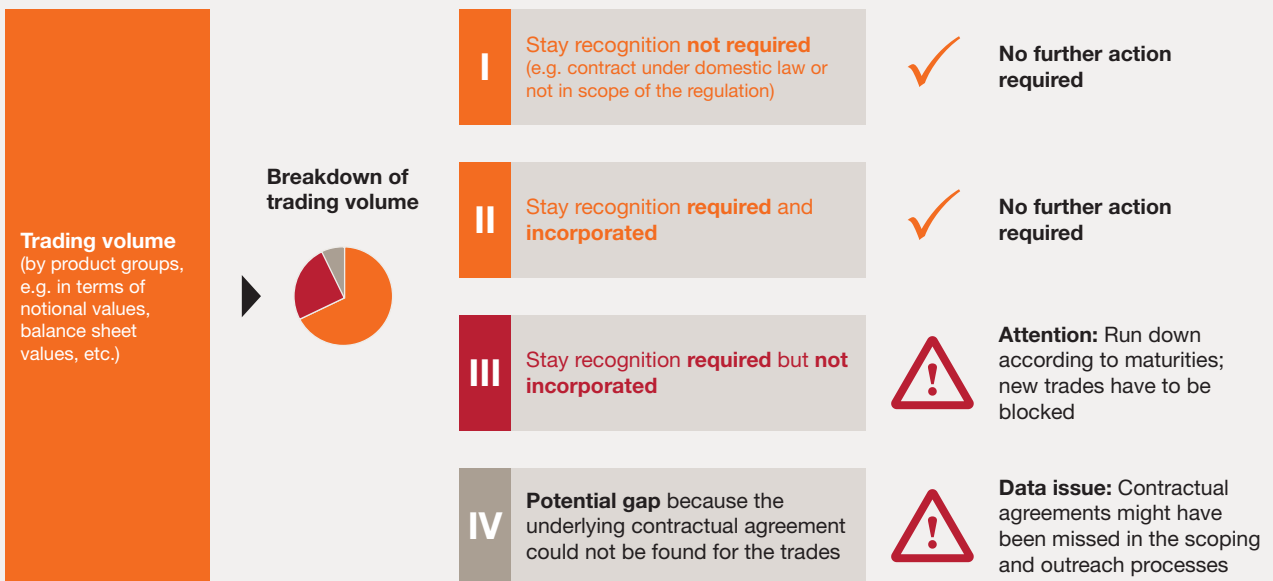
- I. No (explicit) stay provision is required (e.g. the contract is already subject to domestic law or is not in scope of the stay regulations)
- II. A stay provision is required and incorporated in the trading documentation (i.e. particularly, in master agreements)
- III. A stay recognition is required but not (yet) incorporated in the documentation

Category III should trigger a red flag because it means a counterparty for currently booked trades has not accepted a stay provision. Depending on the rules of the applicable local stay regulations, it is likely the firm is not allowed to enter into new trading liabilities with this counterparty after the stay regulations have come into force (existing trades are largely unaffected). Questions should be raised as to whether the counterparty has been properly informed regarding the consequences of its actions and whether adequate risk management is in place to ensure that no new trades are entered into (taking into account that some stay regulations allow for exceptions, e.g. when maturing trades are automatically rolled over to new trades without active intervention). Firms should be able to provide management and regulators a run-down profile of the trading volumes classified under category III.

As long as there are no data issues between a firm's trade systems and contract repositories, it should be possible to map all trading volumes to one of the three categories. If not, red flags should be raised since the contractual basis for unclassified trades is unknown (category IV). In such cases, it may be that agreements have been overlooked by the scoping process (e.g. when less standardised or formalised contracts are unknowingly stored outside the firm's main repository tools).

Reconciliation of trading volume to stay recognitions after outreach

Illustration for step 3 of our implementation framework



4 Set up risk management to ensure continuous compliance

Firms must ensure ongoing compliance with all stay regulations once they have come into effect. As with many other regulations, an ‘eligibility flag’ system can be used to indicate compliance to the stay regulations and either allow or block trading with the corresponding counterparty of a specific legal entity for a given product after a specific date.

Risk management design

The eligibility flag for a new trade can be based, in essence, on the response to two questions:

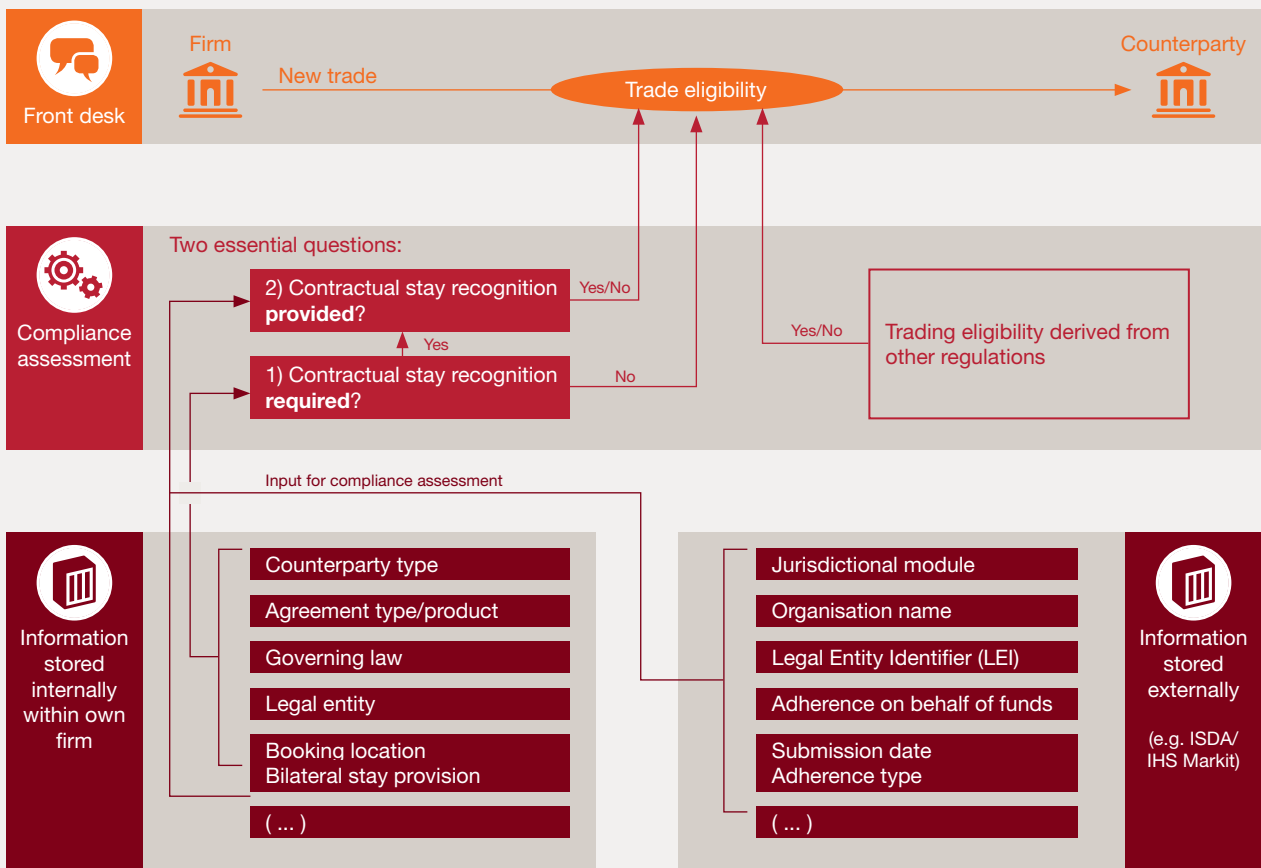
1. Is an explicit stay provision required for one or more local stay regulations?
2. If yes, is such a stay provision provided by the counterparty?

A framework to ensure continuous compliance with stay provisions can be designed alongside these two questions. The first question is analogous to applying the parameters in the scoping process for local stay regulations. ISDA and IHS Markit provide data to answer the second question, at least where the ISDA JMP has been used as a contractual tool for stay provisions. Firms must make sure they can efficiently

map the identifying data of adhering counterparties (i.e. legal entity name and LEI number) to their own repository systems with counterparty information. Where a stay provision for new trades is provided bilaterally by the counterparty and without the use of an industry-wide solution like the JMP, this information should be stored in the firm’s counterparty information or trading documentation repository. Tracking bilateral stay provisions is of particular importance for new agreements negotiated with a counterparty after it has adhered to the JMP. This is because the JMP does not override the terms and conditions agreed after the date of entry into force (i.e. the JMP does not work prospectively). Therefore, risk management relating to stay regulations also has to cover amendments to the documentation and the negotiation processes (e.g. due to policy changes) to ensure that a stay provision is included in all framework agreements and single contracts negotiated after a counterparty has adhered to the JMP.

Schematic risk management setup

Illustration for step 4 of our implementation framework



Risk management efficiency

To a large extent, a firm's ability to enter into new trades will not be determined by the counterparty but by the law governing the financial contract or the overarching master agreement. Theoretically, a firm might be allowed to enter into repurchase agreements but not into derivatives trades with a given counterparty. This could be the case if the underlying master agreement for the repurchase agreements is subject to domestic law while the master agreement for derivatives is governed by foreign law.

Due to the general nature of trading documentation relating to sell-side and buy-side trading relationships, we believe a firm should evaluate whether cases like the example described above apply generally to its counterparty relationships. Significant efficiency gains might be realised (depending on the set-up of the firm's trading and risk management systems) if trading eligibility is confirmed at the counterparty level when all agreements with the counterparty concerned are compliant and denied if at least one contract is not compliant. This might be a suitable approach if the governing laws applicable

to all of a firm's contracts with one counterparty are very similar. The alternative is to define trade eligibility for a given counterparty on a product-by-product basis. In our experience, this can add significant complexity to the risk management system, unless this level of granularity has already been taken into account with regard to other regulations.

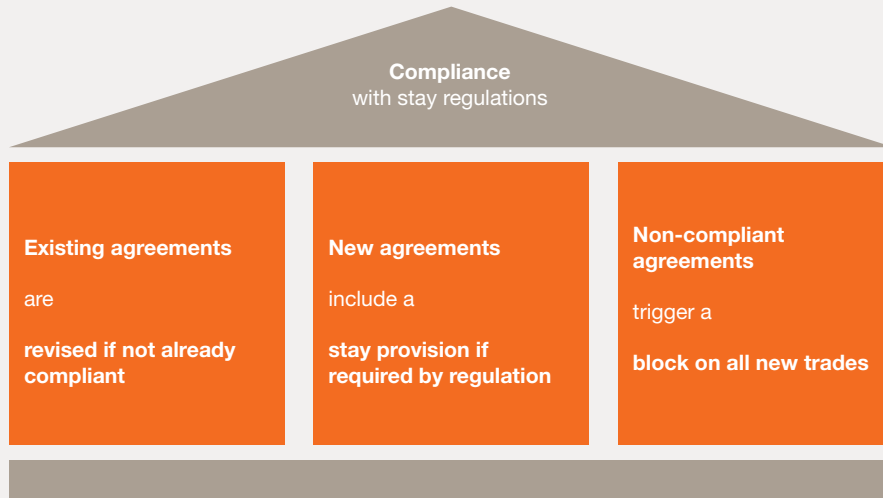
Summary

Ensuring continuous compliance with stay regulations is based on three main pillars:

- All existing agreements that are eligible for trading have been assessed and revised as necessary through an outreach process;
- All new agreements within the scope of application of a local stay regulation include a stay provision; and
- No new trades can be entered into if they breach the trading eligibility assessment.



Three pillars of compliance with stay regulations



About PwC's RRP Centre of Excellence in Zurich, Switzerland

PwC's RRP Centre of Excellence

The RRP Centre of Excellence is PwC's response to one of the most complex, comprehensive and costly challenges that large institutions have faced since the financial crisis.

PwC's RRP Centre of Excellence is a specialised team based in Zurich, Switzerland. Since 2011, it has provided an interdisciplinary service offering in all areas of recovery and resolution planning, including bank restructuring. The team takes a holistic view to encompass the financial, legal, operational and IT aspects of RRP.

The team operates out of a country that has spearheaded the regulatory developments relating to TBTF since the 2007/2008 financial crisis. Positioned in the centre of Europe and home to banks whose assets are four times the country's gross domestic product, RRP is uniquely relevant for Switzerland.

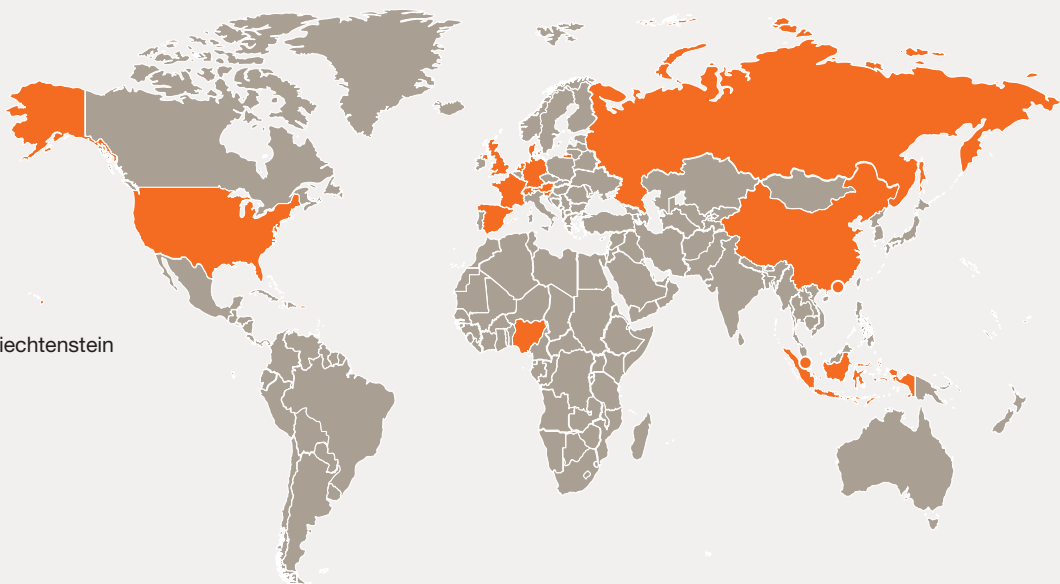
Supporting you in successfully addressing stay regulations

Because our services encompass the full suite of RRP with respect to stay regulations and related cross-border enforceability of recovery and resolution measures, we can leverage our client experience to support you in:

- Setting up your governance to manage stay regulations;
- Assessing which stay regulations apply globally to which of your legal entities, branches and related products;
- Scoping the counterparties that are required to provide you with a stay provision;
- Designing and conducting counterparty outreach to implement stay regulations;
- Setting up corresponding reporting and risk management measures to ensure continuous compliance with stay regulations; and
- Evaluating counterparty requests (from sell-side parties) asking you to provide a stay provision.

Global footprint of the Zurich RRP Centre of Excellence

- Switzerland
- Austria
- China
- Denmark
- France
- Germany
- Hong Kong
- Indonesia
- Principality of Liechtenstein
- Netherlands
- Nigeria
- Russia
- Singapore
- Slovenia
- Spain
- United Kingdom
- United States



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